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GGG - Q1 2018 Graco Inc Earnings Call

EVENT DATE/TIME: APRIL 26, 2018 / 3:00PM GMT



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PRESENTATION

Operator

Good morning, and welcome to the First Quarter 2018 Conference Call for Graco Inc.

If you wish to access the replay for this call, you may do so by dialing 1 (888) 203-1112 within the United States or Canada. The dial-in number for international callers is (719) 457-0820. The conference ID number is 3053454. The replay will be available through April 30, 2018.

Graco has additional information available in a PowerPoint slide presentation, which is available as part of this -- as part of the webcast player. At the request of the company, we will open the conference up for questions and answers after the opening remarks from management.

During this call, various remarks may be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for the purposes of the safe harbor provisions of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as a result of various risk factors, including those identified in the Item 1A of the company's 2017 annual report on Form 10-K and in Item 1A of the company's most recent quarterly report on Form 10-Q. These reports are available on the company's website at www.graco.com and the SEC's website at www.sec.gov.

Forward-looking statements reflect management's current views and speak only as of the time they are made.

The company undertakes no obligation to update these statements in light of new information or future events.

Today's call is being recorded.

I would now like to turn the conference over to Caroline Chambers, Vice President, Corporate Controller and Information Systems.



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Caroline M. Chambers - Graco Inc. - VP of Information Systems, Corporate Controller & Principal Accounting Officer

Good morning, everyone. I'm here this morning with Pat McHale and Christian Rothe. Our conference call slides have been posted on our website and provide additional information that you may find helpful.

A few housekeeping items before I get into the results for the quarter. We adopted a new revenue recognition standard this quarter with no significant effect on operating results. We also adopted the new accounting standard related to pension, which requires service costs be included in operating expense and other pension costs to be included as nonoperating expense. For Graco, there was no change to the classification of service costs and the other pension-related financing costs that were previously included in unallocated corporate expense have been included in other income expense during this quarter. For consistency, \$1.6 million was reclassified from unallocated corporate expense to other expense for 2017.

A view of the key slides in our slide deck include Page 4, which is an overall summary of our results; Page 5, which shows components of our net sales change and our sales by currency; and Page 6 provides a reconciliation of the change in operating earnings from the prior year. The individual segment pages are later in the deck.

We saw strong sales in all segments and regions with an increase of 11% from the prior year at constant exchange rates and without acquisitions with especially strong revenue growth in Asia Pacific. The effective currency translation added 5 percentage points of growth and acquired operations added 3 percentage points or approximately \$11 million in the first quarter. [At current] currency exchange rates, sales from acquisitions are expected to be approximately \$40 million for the full year.

Reported net earnings totaled \$85.5 million for the quarter or \$0.49 per diluted share. After adjusting for the impact of excess tax benefits from stock option exercises, net earnings totaled \$84 million or \$0.48 per diluted share.

Gross margin rates remained strong, up slightly from the first quarter last year as the favorable effects from currency translation were nearly offset by the unfavorable effect of lower gross margins from acquired operations, including a charge of \$1 million related to purchase accounting inventory valuation. We expect a similar amount from purchase accounting during the second quarter.

During the first quarter, favorable manufacturing performance offset material and other cost increases. At current projected factory volumes, we expect that pricing and strong factory operating performance will continue to offset expected increases in commodities and costs for the remainder of the year.

Operating expenses increased by \$12 million compared to the first quarter last year, including \$3 million related to currency translation, \$2 million from acquired operation and \$3 million in sales and earnings-based incentive compensation and market-driven share-based compensation.

The effective tax rate was 20% for the quarter, which is 5 percentage points lower than the first quarter last year, and I'll take a moment to work through that change. First, the excess tax benefit related to stock option exercises reduced the effective tax rate by 1 percentage point in the first quarter of 2018 as compared to 4 percentage points in the first quarter last year. The effect of the 2017 U.S. tax reform legislation reduced the effective tax rate by 8 percentage points compared to last year. So we had the benefit from the lower corporate rates of 8 percentage points, partially offset by lower excess tax benefit related to stock option exercises for the overall lower rate of 5 percentage points.

As a point of comparison, if the lower tax rate had been in place for 2017, it would have added \$0.04 to diluted EPS.

Cash flows from operations totaled \$59 million compared to \$50 million in the first quarter last year.

Taking advantage of volatility in the share price during the quarter, we made share repurchases, net of shares issued, of \$67 million. We will continue to make share repurchases on an opportunistic basis going forward.

Capital expenditures were \$9 million this quarter. Looking forward, we expect capital expenditures for machinery and equipment to be approximately \$40 million for the full year, and our current estimate for brick-and-mortar projects is approximately \$35 million for 2018.



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At current rates, the effective currency exchange will continue to be a tailwind for us, with full year effect estimated to be 2 percentage points on sales and 6% on earnings with more than 2/3 of that in the first half.

We expect unallocated corporate expense to be approximately \$28 million. Pension costs included in nonoperating expense are expected to be approximately \$7 million in 2018, which is up about \$1 million from last year.

Our 2018 full year tax rate is expected to be approximately 22%, excluding any effect from excess tax benefits related to stock option exercises.

I'll turn this call over to Pat now for further segment and regional discussion.

Patrick J. McHale - Graco Inc. - President, CEO & Director

Thank you, Caroline. Good morning, everyone. All of my comments this morning are on an organic constant currency basis.

This was the fifth consecutive quarter where we had growth in every segment and in every region of the world and our second consecutive quarter of achieving that growth against difficult comps from the prior year. For reference, Q1 of last year was also a double-digit growth.

Demand levels continued to be broad based. I'll focus my comments on a few of the areas that I think are notable.

We had double-digit growth in every segment in the first quarter, with high single-digit growth in the Americas and EMEA and strong double-digit growth in Asia Pacific. In Contractor Americas, we continued to see good demand from home center and paint store customers with both channels contributing nicely to the high single-digit growth. Out-the-door sales remained solid in both channels. The EMEA contractor team continued on their role with their seventh consecutive double-digit growth quarter.

In the Process segment, our lubrication and environmental product lines performed well.

Our direct oil and natural gas sales were down as growth in North America was more than offset by weakness in EMEA. More broadly, we are seeing some uptick in sales to oil and natural gas customers in the Americas and certain product lines in our Industrial segment.

A quick note on growth from acquisitions in the first quarter. In early January, we acquired a European engineering company that designs and builds vertical powder-coating systems for extruded aluminum applications. The business nicely complements our Powder Finishing business and operates mostly in Europe and Asia.

We also had 2 very small acquisitions in the Contractor and Process segments in the last 12 months.

In total, acquisitions added \$11 million in sales, which was 3 percentage points to our Q1 worldwide sales growth. You can see the sales impact by segment and region in our slide deck.

Moving on to profitability. For reference, our incrementals in Q1 of 2017 were extremely strong, so profitability in Q1 was also against a difficult comp. Excluding FX and acquisitions, incremental margins in 2018 were approximately 40% in the first quarter, in line with our expectations for the full year.

Contractor segment incremental margins in the first quarter were a little light, in the mid-20s. However, they were up against incrementals that were in the 40s a year ago and were only about \$0.5 million off from where we would have liked them to be. As Caroline mentioned, solid performance in volume growth helped our factories offset material cost increases. Favorable pricing was offset somewhat by an unfavorable mix with a higher level of finishing systems and project activity in our Industrial segment in Q1. All in all, I'm satisfied with our overall incrementals for the quarter.

Moving onto our outlook. Incoming order rates continue to hold through every month thus far in 2018 at a growth rate that's similar to our full year outlook. Demand levels appear to be steady.

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For our full year outlook, we've raised it from mid-single-digit organic constant currency growth to mid- to high single-digit growth. Strong across-the-board performance in the first quarter is the biggest driver of the increase. We are expecting growth from every reportable segment, and our outlook assumes mid- to high single-digit growth from each region.

Lastly, we nuanced a message in our press release last evening around our Industrial segment and I'll give a little more color. Industrial orders have shown a nice steady mid- to high single-digit growth through the second half of last year and into the beginning of this year, but shipments have been a bit lumpier during that time frame. The fourth quarter last year was low single digits, while the third quarter last year and the first quarter this year were up double digits. We expect sales in Industrial for the first half will likely be in the mid- to high single-digit range, meaning the second quarter is expected to be low single-digit growth. Simply put, customer delivery dates were weighted more heavily towards Q1. We're going to see that growth rate moderate in Q2, but that's not indicative of any weakness in the business, it's just timing.

I'd like to thank all Graco employees, our suppliers and our distributor partners for getting the year off to a fast start. As Graco legend, Dale Johnson says, "Start fast, finish first."

Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first one comes from Jim Giannakouros with Oppenheimer.

James Giannakouros - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Pat, you mentioned you still expect 40%-or-so incrementals. I had that number pegged to mid-single-digit organic. Any offsets to that EBIT line that's going, just given that your rate guidance for this year?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

No, I mean, generally speaking, when we have volume, we do well and I think the 40% number is still a good number for your model for the balance of the year.

James Giannakouros - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Okay. And you guys are doing very well in Contractor. It feels like you're taking share. I mean, is there any granular points you can make? Did you benefit from greater shelf space in big box? Or are there new products gaining greater traction than you modeled? Any color would help.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Well, the business was strong worldwide. We're seeing strength across the channels. We've got a good team. We've got a solid product offering. Everybody's working hard. I wouldn't put my finger on anything in particular. I think the construction environment is pretty good around the world, and we're well positioned and we're just going to continue to what we do.

Operator

And we'll go next to Deane Dray with RBC Capital Markets.

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Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

I was hoping you could go into some of the dynamics across the businesses on price cost. You mentioned it -- all the industrial players here are combating this to various degrees. It looks like you do still have pricing power here. But give us both sides of the equation. How are you on raw materials and on the timing on getting and passing through price increases? And what's that baked in for your guidance here?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, so our factories performed really well in the first quarter and typically, with volume, they do. And so our factories have done a nice job of driving to our internal 0 cost change metric, and factory performance has been able to offset material cost increases. And with volume the rest of the year, I think they've got a good shot to continue to do that. Pricing, we continue to put through pricing on an annual basis relatively consistently in terms of timing and size that we have in prior years. What you can bake typically a 1.5% sort of realized price into your model. And the biggest thing that swings that around is mix and whether one of the lower higher-margin businesses tends to grow faster or slower in any particular quarter. But generally, I feel like we're in good shape going into the rest of the year and we'll be fine.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

And then just a related question, is there anything on the horizon with regard to the tariffs? Anything showing up that would impact your business directly or indirectly? And it's probably the indirect one that is going to be more interesting.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, I don't have any kind of crystal ball like that. I'll leave that to you guys to try to figure out what might happen. There's lots of game to be played. Generally, I feel good about the overall economic environment. We're seeing strong performance across the regions and across product lines and I'm not losing any sleep over it.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Just want to make sure you understood the question. I'm not asking about your prediction of what happens in Washington. It's like are any of your products or suppliers showing up on any list? And might that be factored into the second half?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Again, I understand the question. The rules aren't written. There's lots of stuff that's going to change, and I'm not spending any of my time at Graco trying to figure out the details what might happen in the future. Again, I don't view it as a significant risk at this point in time and I think we're better off focusing on our current execution opportunities than trying to predict what might happen at a granular level at this point.

Operator

And we'll go next to Charles Brady with SunTrust Robin Humphrey (sic) [SunTrust Robinson Humphrey].

Charles Damien Brady - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Well, I'm struggling to find anything to pick out on you guys here. So I guess, I'll go with a broader picture question. When you look out at your M&A strategy, and you guys have done some small tuck-in stuff and some of the larger deals. But I'm wondering, at some point, you've expanded

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out to the addressable market, do you think about going a little bit farther afield to kind of where you are right now, branching out, something, another growth market? Or do you just kind of stick to what you've been doing?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

You can expect that most likely we're going to stick to pump, meter, mix, dispense, fluid handling-type applications. There's a lot of opportunities out there. And we've got a team that's aggressively pursuing things. Frankly, valuations are really high. And we feel pretty confident in our organic growth story and the investments that we make in terms of new product development and channel expansion, new geographies and we don't feel like we're under a lot of pressure at any given point in time to run out and get some deals done. And at these kind of valuations, you're probably going to continue to see us be pretty disciplined. We do like to find opportunities where there's a natural fit with our business, and we think that we can get some leverage. We've done that with some of the smaller acquisitions. Certainly, it would be nice to do one on a larger acquisition, but we're not going to pay a ridiculous price to get that done.

Charles Damien Brady - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Yes, fair enough. I'm wondering, are you hearing any from your customers in terms of, with the tax reform, more capital being released, people obviously get more cash because they're not paying taxes on it. Is that spurring any kind of additional growth yet? Or is it still maybe too early to see some of that growth come out?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, we just finished operating reviews with all of our business units and we talked about that for a little bit. And I would say generally here in the Americas, we think it's a little bit early.

Operator

And we'll go next to Mike Halloran with Robert W. Baird.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

So just on the guide quick. I know you said the -- you're expecting growth every region within that mid- to high single-digit range. Does that hold true for the segments as well, Pat?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Generally, we don't break down our forecast by segment. It just gets more complicated. So I think we'll leave our guidance the way it is.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Any -- okay, that's fair. And then any new product timing nuances this year that would be different from what you've seen in prior years?

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Patrick J. McHale - Graco Inc. - President, CEO & Director

No. I mean, we indicated back in December that for our Contractor business that it's not going to be a big new product year, although we did work hard to try to get that product that we do have coming out for '17 launched early. We got some nice stuff coming out. I think it's going to be business as usual.

Operator

And we'll go next to Saree Boroditsky with Deutsche Bank.

Saree Emily Boroditsky - Deutsche Bank AG, Research Division - Research Analyst

Given the strength in Industrial Lubrication and some of the more commodity-exposed reasons, could you talk about the demand from mining activity that you're seeing, if it should remain strong through the year because I believe it started to improve second quarter last year.

Patrick J. McHale - Graco Inc. - President, CEO & Director

Yes, and we suffered a lot throughout for a few years during that downturn. And although we don't have a mining business at Graco, we've got a lot of product lines that are significantly exposed to that end market and that's nice to see that doing well. And yes, I think our view on that is that's going to be continue to be a positive space for us here through balance of the year.

Saree Emily Boroditsky - Deutsche Bank AG, Research Division - Research Analyst

And then just from a modeling perspective, how much growth do you expect the acquisitions to contribute to the full year?

Patrick J. McHale - Graco Inc. - President, CEO & Director

We don't really make that sort of -- I mean, if we didn't do anything else, Caroline can give you a number, but...

Caroline M. Chambers - Graco Inc. - VP of Information Systems, Corporate Controller & Principal Accounting Officer

Yes, at the moment with current exchange rates, we think it'll be around \$40 million.

Christian E. Rothe - Graco Inc. - CFO & Treasurer

Without any further acquisitions.

Caroline M. Chambers - Graco Inc. - VP of Information Systems, Corporate Controller & Principal Accounting Officer

Yes.

Saree Emily Boroditsky - Deutsche Bank AG, Research Division - Research Analyst

Right. That answers the question. I appreciate it, it was helpful.

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Operator

We'll go next to Brett Kearney with Gabelli.

Brett Kearney - *G. Research, LLC - Research Analyst*

Just wanted to ask, I guess, the growth you guys are seeing out of South America and Africa and maybe some of the investments you guys are making to support opportunities you see there?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, those are smaller territories for us and they tend to be lumpy and business tends to bounce around, both incoming orders and sales bounce around from quarter-to-quarter. Africa's been getting a little better obviously with the improvement in oil prices and the improvement in some of the commodity prices that's a plus that the economy's driven obviously heavily by resources. South America was better last year, still a little bit soft. So I guess I'm kind of taking a wait-and-see attitude towards it.

Operator

And we'll go next to Walter Liptak with Seaport Global.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

I wanted to ask about your Industrial business, and the Asia growth was really strong. And you guys called out the adhesives business picking up. I wonder if you could provide some colors. Is this a new channel partner, new products or just a change in demand?

Christian E. Rothe - *Graco Inc. - CFO & Treasurer*

Yes, so we are having -- obviously, we've had several quarters in a row of good growth in the Asia Pac Industrial business and we've called out for a while now that the adhesive dispense area, things like electronics, have been positive, Tier 1 automotive continues to be good for us. There are a number of dynamics that have been positive in that market. We just -- we've seen those trends continue.

Operator

And we'll go next to Matt Summerville with D.A. Davidson.

Matt J. Summerville - *D.A. Davidson & Co., Research Division - Senior Analyst*

Can you talk a little bit more about what you're doing from a capital spend standpoint around bricks-and-mortar? Where specifically are you adding capacity in 2018? Do we need to start thinking about startup- and ramp-related costs in factoring those sorts of things into the models? And then, I guess, do you have a best guess of what the total value of this multi-year plan might look like?

Christian E. Rothe - *Graco Inc. - CFO & Treasurer*

So we did call, in fact, the bricks-and-mortar was going to be about \$35 million this year. That is not the entirety of our projects. We have an expansion project that's going on in our Rogers facility, that's going to be likely the largest of our expansion projects, but we also have a number of other smaller projects that are happening around the world. So \$35 million is the number for this year, but it's going to continue on especially,



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again, in the Contractor business into '19 and maybe some will follow on into early '20. Not a lot as far as startup costs go in this year. And frankly, as we look at what those costs could be, we're not really all that concerned as far as having much of a headwind for us in 2019.

Matt J. Summerville - *D.A. Davidson & Co., Research Division - Senior Analyst*

And then just a follow-up on Contractors, specifically maybe just focused on the Americas and Western Europe. To what extent do you feel like the installed base of equipment has been turned over or recapitalized at this point? And is there a distinct portion of your growth? This is sort of to a question earlier, is there a distinct portion of your growth that you can specifically point to and say it's being driven by added shelf space, it's being driven by recapitalization? Or is there a big influence from new products that you brought to market such that the everyday contractor customer instead of carrying 2 Graco things or sprayers in their truck, maybe they're carrying 3. Is there any color you can give around those various dynamics?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, so I think I'll have it and then if Christian and Carolyn want to weigh in, they can go ahead and do that. The big downturn in the housing market, both in Western Europe and the U.S., that was in that '06-'07-time frame. And really by 2010, that business was back and it was growing pretty rapidly again. So I don't really believe here in 2018 that there's any influence from people turning over their fleets, anything more than what would be normal in this environment. I do believe that as wages have gone up and as the construction market has bounced back and there have been challenge in some regions to get labor back into the market, the dynamic of using a sprayer is more positive than it was, there's no way for us to specifically measure that. But I do believe that trading equipment for labor is a good dynamic for us. That's a global dynamic that should be positive for that business probably for the next 20 or 30 years as we see wages go up in some of the emerging markets and it makes more sense to use equipment rather than to throw labor at the project. In terms of new customers and shelf space, I'd say the last couple of years has been pretty normal from that standpoint. I mean, we're always pursuing new channel partners and new customers in different regions around the world, but I wouldn't put my finger on any one thing that's really been driving the business. That team up there has got a very strong and very active product development process. They launch good products every year, they're definitely a part of the equation. Whether contractors are carrying more multiples of sprayers or not, I think that's a little bit hard to get a real measure on. But definitely, we have more products that contractors can choose to carry from Graco than we did 5 years ago.

Operator

(Operator Instructions) We'll go next to Jeff Hammond with KeyBanc.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is Brad, filling in for Jeff. Just a question on, clearly, not reflected in the incrementals in the first quarter, but if growth rates across all the businesses kind of sustains this high level, is there any risk in supply chain issues sprouting up until these capacity projects more fully materialize?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

No, I'm not too concerned about that. I mean, if you've ever been in manufacturing, there's a supply chain issue every day, but I don't see anything on the horizon for us to from that standpoint that's going to impede our growth. It's the normal challenge that we have every day and nothing special.

Bradley James Vanino - *KeyBanc Capital Markets Inc., Research Division - Associate*

Okay. And then I may have missed this, but did you make any kind of comments towards trends so far through April?



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Christian E. Rothe - Graco Inc. - CFO & Treasurer

Yes, Pat had that in his prepared comments around the order rates and the fact that basically from the beginning of this year through until now, they've held pretty nicely at that growth rate that's matching our outlook for the full year.

Operator

We'll go next to Liam Burke with B. Riley FBR.

Liam Dalton Burke - B. Riley FBR, Inc., Research Division - Analyst

Pat, you mentioned an acquisition in powder, that business is doing well. Are you seeing it growing faster than traditional liquid or applications shifting from liquid to powder?

Patrick J. McHale - Graco Inc. - President, CEO & Director

I don't see a ton of applications that are completely gone from liquid to powder, but what I do see when I'm out and again, this is anecdotal evidence and also from talking to our team when I get to a lot of factories, and I've seen more customers that are running both than I had 10 years ago. So I think that there are applications that would have been liquid before that are becoming powder. But I also think that in those same facilities there are still liquid applications. So I think that's a positive dynamic for us.

Liam Dalton Burke - B. Riley FBR, Inc., Research Division - Analyst

Okay. And then on automotive, the end markets there, I mean it looks like you've got strength across most end markets. Are you seeing continued momentum there?

Patrick J. McHale - Graco Inc. - President, CEO & Director

Yes, automotive's okay. I mean, obviously you can look up the data yourself on what unit volume is doing by region. But generally speaking, the automotive business is decent and we've been doing well, particularly in Asia Pacific.

Operator

Okay. This concludes our Q&A session. At this time, I'll turn it over to Pat McHale.

Patrick J. McHale - Graco Inc. - President, CEO & Director

All right. Well, as usual, I thank everybody for their time to attend our conference call this morning, and we're going to get back to work and see what we can do in Q2. Thank you.

Operator

And this concludes our conference for today. Thank you for your participation, and have a nice day. All parties may now disconnect.



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