

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

GGG - Q1 2016 Graco Inc Earnings Call

EVENT DATE/TIME: APRIL 21, 2016 / 3:00PM GMT



CORPORATE PARTICIPANTS

Caroline Chambers *Graco Inc. - VP, Controller and Information Systems*

Pat McHale *Graco Inc. - President and CEO*

Christian Rothe *Graco Inc. - VP and Treasurer*

CONFERENCE CALL PARTICIPANTS

Matt Summerville *Alembic Global Advisors - Analyst*

Joe Ritchie *Goldman Sachs - Analyst*

Mike Halloran *Robert W. Baird - Analyst*

Kevin Maczka *BB&T Capital Markets - Analyst*

Charley Brady *SunTrust Robinson Humphrey - Analyst*

Walter Liptak *Seaport Global Securities - Analyst*

Matt McConnell *RBC Capital Markets - Analyst*

Liam Burke *Wunderlich - Analyst*

Jim Foung *Gabelli & Co. - Analyst*

Jeff Hammond *KeyBanc Capital Markets - Analyst*

Jim Giannakouros *Oppenheimer & Co. - Analyst*

PRESENTATION

Operator

Good morning. Welcome to the first-quarter 2016 conference call for Graco Inc. (Operator Instructions). If you wish to access the replay for this call you may do so by dialing 888-031-112 within the United States or Canada. The dial-in number for international callers is 719-457-0820. The conference ID number is 459-5390. The replay will be available through April 25, 2016.

Graco has additional information available in a PowerPoint slide presentation which is available 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 Item 1A of the Company's 2015 annual report on Form 10-K and in Item 1-A 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.

I will now turn the conference over to Caroline Chambers, Vice President, Corporate Controller and Information Systems. Please go ahead.



Caroline Chambers - *Graco Inc. - VP, Controller and Information Systems*

Good morning, everyone. I'm here this morning with Pat McHale and Christian Rothe. Our conference call slides are on our website and provide additional information on our quarter.

Last evening Graco reported first-quarter sales of \$305 million, net earnings of \$40 million and diluted net earnings of \$0.70. The effect of foreign currency translation rates continue to be a slight headwind for us and impacted sales by 2%. Incremental sales from acquired operations contributed 2 percentage points of growth while organic sales and consistent translation rates declined by 1 percentage point.

A brief reminder for everyone, results for first quarter last year in 2015 included \$30 million or \$0.49 per diluted share of net investment income from the held separate liquids finishing businesses. These businesses were sold in April of 2015. A reconciliation of our operating earnings is included on page 8 of our slide deck.

Gross profit margins this quarter were consistent with rates in the prior year. Favorable effects of realized pricing and reduced acquisition and related purchase accounting were offset by timing of factory project spending and volume. Operating expenses increased by \$4 million as compared to the prior year of which expenses from acquired operations totaled \$3 million.

We continue to invest in new product development and commercial resources. Incremental spending for these initiatives was approximately \$1 million in the quarter and offset by slightly lower spending in other areas. Unallocated corporate expense increased by \$1 million primarily due to increases in stock compensation and pension.

For the full year, we expect unallocated corporate expense to be similar to the full-year in 2015.

The effective tax rate for the quarter was 31%, up from 22% last year. Post tax dividend income from the hold separate businesses reduced the effective tax rate in the first quarter of 2015. The effective tax rate of 2016 benefited from foreign earnings taxed at lower rates than the US rate and from the Federal R&D tax credit that had not been reinstated in the first quarter last year.

As you look forward to the next quarter, I would also like to call out a couple of items from the second quarter last year in 2015.

First, we completed the sale of the held separate liquids finishing businesses in April last. The conclusion of that transaction resulted in post tax dividend income and net gain on sale after-tax of \$110 million or \$1.85 per diluted share.

Also during the second quarter last year, we had two nonrecurring items that benefited the tax rate related to the completion of a tax planning project and the initial assertion that the Company will indefinitely reinvest earnings of foreign subsidiaries to support the expansion of our international business. Combined, we had a favorable tax expense impact of \$9 million or \$0.15 per diluted share in the second quarter last year.

I will turn the call over to Pat now for further discussion.

Pat McHale - *Graco Inc. - President and CEO*

Thanks, Carol, and good morning everyone. Overall we are off to a bit of a slow start in Q1. Our revenue from EMEA and Asia-Pacific was solid while contractor Americas came in below expectations. Despite the slow start, we are holding to our outlook for the full year. Let me get right into the details by segment and region.

Let's start out with our industrial segment. On an organic constant currency basis, the industrial business posted low single-digit growth worldwide with double-digit growth in EMEA and Asia-Pacific and a decline of mid-single digits in the Americas. The Americas had a strong Q4 of 2015 growing high single digits and most of the change from quarter to quarter was related to project activity.

Generally we are seeing stability in our major industrial markets in the Americas and do expect the year to be okay.



You may recall that in the first quarter of last year operating margins in the industrial segment declined by 2 points, 1 point from foreign currency and another from expense leverage. At that time we discussed on the call that we had an unfavorable regional sales mix. Growth in the Americas had a decline in the international markets.

As you can see in Q1 of this year, we had the opposite happen and we regained the point that we lost a year ago on expense leverage due to regional mix. Incremental margins for this segment were solid in Q1.

Moving on to the process segment, sales were off worldwide on an organic constant currency basis of low double digits. We had declines of high single digits to low double digits in most product categories in this segment in Q1. Our oil and natural gas businesses were particularly hard hit, off by about one-third from the first quarter of 2015. The process segment is home to most of our direct oil and natural gas exposure. We did see growth and a couple of product categories related to environmental and high tech.

The decremental margins were high in this segment in Q1. While we had about \$1 million in inventory step up from Q1 for the LandTech Geotech acquisitions, the first quarter of 2015 had about \$3 million of inventory step up so that should have created a favorable operating earnings impact of a couple million dollars. That was partially offset by about \$0.5 million of incremental spend for investments in growth initiatives. If you net out those changes, organic constant currency decremental margins were slightly more than 50%. I would expect that number to be less under normal circumstances but with sales off by double digits, there are manufacturing volume pressures and pressures on operating leverage.

Moving onto the contractor segment, Contractor Americas was up against a very difficult comp versus Q1 of 2015 and we posted organic growth of 27%. Last year we launched most of our new products in Q1 whereas this year most new products will launch in Q2. We had anticipated Q1 would be flattish for Contractor Americas but due to some new product launch slippage and the timing of some promotional activity, we obviously missed that projection.

Out the door sales from our channel partners remained strong during the quarter in both the paint stores and home centers. We anticipate a good second quarter and we are holding to our full year outlook.

Our contractor EMEA region posted a very strong performance and we also had high single-digit growth in Asia-Pacific contractor. International growth offset much of the decline in the Americas. Operating margin in contractor suffered a couple of points in Q1 impacted by spending items included expenses related to implement new factory equipment. We believe we can get good growth out of this business in 2016 and continue to spend to support the annual outlook.

Moving on from contractor, I will make a couple of quick comments on our overall business in the regions. In EMEA, the developed economies posted double-digit growth while the emerging markets were flat. Russia did take another step down in Q1 but it was a low double-digit decline as opposed to last year where our sales were cut in half. Continued growth in the Central and Eastern European markets offset the headwinds in emerging EMEA. The end result was a low double-digit growth rate for the overall region.

In Asia-Pacific, we continue to experience lumpiness in order trends from month to month and quarter to quarter. This quarter was mid single-digit growth against an easy comp. Although this is our fourth consecutive quarter of growth in Asia-Pacific, with the choppiness we continue to see throughout the region I don't expect consistent growth trends quarter to quarter throughout the year.

Now I will give some color on order trends. On our Q4 conference call, we indicated that orders were tracking January consistent with our outlook. That changed when the calendar turned to February with booking declines in every region of the world and double-digit declines in the Americas. That remained the case throughout the month of February.

As we moved into March, we started to see orders normalize consistent with what we experienced in January. So two decent months and one lousy one. Book-to-bill was pretty close to 1 for the quarter so backlog is similar from the beginning of the year to the end of Q1.

Through the first three weeks of the second quarter, we are seeing decent bookings and our team is upbeat so we are holding our overall outlook for the year at low to mid single-digit constant currency organic growth.

Let's dive into the outlook a little bit more. Starting with contractor Americas, our team began the year with a view that they can grow in the Americas high single digits for both the first half and the full year 2016. Despite being down high single digits through Q1, the team is holding their view. That means we need to have solid double-digit growth in contractor Americas in Q2.

We recently launched several new products focused on the home center, line striping and professional painting markets. A good portion of the launch is on the home center side where we have significant loading costs. As such, I anticipate no margin expansion in contractor from Q2 of last year but the top line looks like it should be up nicely and drive earnings dollars.

For Graco as a whole, we continue to have a full-year 2016 outlook of mid single-digit growth in the Americas and low single-digit growth in EMEA and Asia-Pacific. Further, we are holding to our expectation that all reportable segments will post growth for the full year.

The biggest risk we see to our outlook of every segment growing in 2016 is the process segment. Between mining and oil and natural gas, about one-third of this segment's sales are exposed to end markets that are weak. We are already down double digits compared to the prior year and our highest process segment sales quarter in 2015 was Q2 so we will likely post a decline again in Q2.

We have taken a close look at our initiatives and anticipate that we still have an opportunity to dig out of that hole during the second half of the year. Based upon this outlook, we will press forward with the growth initiatives that are in place and reevaluate later in the year. Overall Company incremental margins will likely be under some pressure in Q2 reflecting the store load costs in contractor and another weak quarter in process.

Our MA pipeline improved in Q1 and increased our optimism that we will get other transactions closed in 2016 likely to be smaller bolt-on opportunities.

In the first quarter, we spent \$49 million on acquisitions and \$48 million on buybacks. We remain opportunistic buyers of our stock, a strategy that has been in place for nearly a year. We took advantage of share prices in the 60s early in the quarter to reduce our share count.

To underscore a point that Caroline made, we had two items that bolstered GAAP earnings in Q2 of last year that will not repeat this year. First, the gain on the sale of a liquid finishing business that occurred in April of last year. And second, a one-time tax benefit of about \$9 million that we called out in Q2 of last year. Neither of these will recur and the result is that our GAAP earnings will be down in Q2.

To summarize our outlook, we are holding our overall view of low to mid single-digit constant currency organic growth for 2016. We are starting slower than I expected but there is still a lot of year left to make up ground. Orders for the first few weeks of the quarter look okay. We remain focused on our growth initiatives and we continue to work on our acquisition pipeline.

With that, operator, we are ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Matt Summerville, Alembic Global Advisors.

Matt Summerville - Alembic Global Advisors - Analyst

Good morning. Two questions. First, what needs to happen -- and I understand the math behind it -- but what needs to happen in process for you to achieve the growth objective in terms of low single digits? In particular in oil and gas and mining? And then if we talk about it in that chunk, what has to happen in vehicle services and what are you seeing there now?



Pat McHale - Graco Inc. - President and CEO

We are not going to break out and talk about vehicle services independently but overall, our outlook for getting growth in process is not dependent upon some expectation of significant end market improvement in the second half. It is really a look at the internal initiatives that we have got going on. We have made a lot of investments in the process space really over the course of the last couple of years. We have launched some new products in 2015. We have added some sales headcount, we are pushing forward with initiatives and we believe while looking at what we are doing that we can still make up ground in the second half. So it is not betting on future markets that we can't control but really trying to look at things that we are doing.

Matt Summerville - Alembic Global Advisors - Analyst

Got it. And then just a follow-up on the contractor business, can you just provide a little more granularity in terms of what drove the lack of linear performance if you will between January, February, March? Were your customers taking down inventories? If so, was that kind of a normal thing? I guess how much slippage was there and the impact involved with timing of promotions?

Pat McHale - Graco Inc. - President and CEO

Yes, the end markets in North America are fine. They are actually very strong and out the door sales in our channels were good. Our issues in the first quarter, we had some slippage in new product. We had a big new product Q1 last year and some of that has now slipped into Q2 this year. So we should have a big Q2 in terms of new product.

Then there was some promotional activity that we had thought was going to happen in Q1 that got pushed out. So it was a little bit of a surprise but I am not concerned that we lost market share or that we have necessarily lost any business. I am anticipating that we will have a strong Q2 and at the end of July, we will be having a different conversation.

Matt Summerville - Alembic Global Advisors - Analyst

Great. Thanks a lot, Pat.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - Goldman Sachs - Analyst

Thanks. Good morning, guys. I apologize, I think I may have missed that last question and so I apologize if I am asking the same one. But I wanted to dig to the monthly trends just a little bit just because the double-digit declines that you saw in February order rates seemed to be at odds with what we were hearing from distributors across the rest of the channel. And so is there any more color that you can give us on what happened in February and then the subsequent pickup in March?

Pat McHale - Graco Inc. - President and CEO

Other than the fact that I had a pale look on my face every Monday morning when I looked at weekly (technical difficulty) I really don't have a lot of input to give you on there. It was an odd situation because January looked reasonable and was running within expectations and we started getting bookings reports in February that were pretty ugly. But things turned around in March and I can't put my finger on it. It was across product lines, it was across regions and there was nothing really specific.



I was a little bit worried I will tell you that and it might have been the new cycle, it might have just been one of those things where everything comes together at the wrong time but I think that is behind us.

Joe Ritchie - *Goldman Sachs - Analyst*

Good to hear on that front. I guess maybe focusing on industrial for a second, you guys put up some good growth there in margin expansion. Any other color you can give us on the end markets specifically as it relates to auto, aero, general industrial, any commentary there?

Pat McHale - *Graco Inc. - President and CEO*

Yes, globally automotive and the Tier 1s, that continues to be good business for us. The construction markets worldwide continue to provide opportunities for us particularly in North America and Western Europe as related to our industrial business that serves portions of that market, window and door and cabinet and things like that. The ag market is pretty dead right now. Obviously mining and oil and natural gas and everything kind of connected to those upstream or downstream outside just the process and the fluids is tough. So it is a bit of a mixed bag but generally automotive and construction are the best.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. Maybe one last question. On free cash flow, fully recognize that typically this is a seasonally low quarter but 1Q was lighter than normal. How much of that was building inventory for the product introductions and how should we be thinking about your ability to shorten your cash conversion cycle as the year progresses?

Christian Rothe - *Graco Inc. - VP and Treasurer*

Joe, it is Christian. As far as the inventory build side of it, there really wasn't a ton of that going on other than our normal seasonal build that we do in Q1. Obviously on free cash flow conversion there is a CapEx aspect of that and Q1 was relatively high as far as CapEx goes. We've got a number of projects going on that Pat talked about in his comments. The contractor had a number of machine tools come online too so those all really happened in Q1 and there was some spending associated with that.

So as far as the full-year goes, we feel pretty good about our ability to get decent free cash flow conversion like we have had historically so no concerns at all.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, great. Thanks, guys.

Operator

Mike Halloran, Robert Baird.

Mike Halloran - *Robert W. Baird - Analyst*

Good morning, everyone. So just following on that, your own inventory you just talked about that. But the inventory in the channels sounds like you feel like the channel inventory normalized out through March and April with the normalizing order rates. Is that fair?



Pat McHale - Graco Inc. - President and CEO

Well, the channel inventory was really driven by the fact that we had the lack of a new product launch and I will say the load in for the promotional activity that we would have had last year in Q1 that is being delayed this year. So I think channel inventory is okay and I think that part of us having a strong second quarter will be that promotional activity and new product load that we didn't see in Q1.

Mike Halloran - Robert W. Baird - Analyst

And then the contractor EMEA strength, was there a new product launch that happened there? I know the comps were a little bit easier but what drove the 20%+ growth in that segment?

Pat McHale - Graco Inc. - President and CEO

Yes, they had some. In general the environment has been tough over there in recent years and it seem like construction markets particularly in the West are starting to heal although Central East Europe has been strong as well. So it wasn't any one big thing but the general environment seems to be pretty positive for us.

Mike Halloran - Robert W. Baird - Analyst

And then last one, it doesn't sound like there has been a change but want to ask anyway. The sellthrough rate you are seeing on the contractor America side for your top customers, has there been any tenor change from them about the market outlook, the positioning of the contractor type products within their portfolios and things? It doesn't sound like it but just want to hear what the channel partners are saying right now.

Pat McHale - Graco Inc. - President and CEO

I think everything looks good. I would say it is a positive environment and channel partners are doing well, equipment is selling and there is nothing that is really new from any prior years.

Mike Halloran - Robert W. Baird - Analyst

That is what I thought. Thanks a lot for the time.

Operator

Kevin Maczka, BB&T Capital Markets.

Kevin Maczka - BB&T Capital Markets - Analyst

Good morning. On slide eight, the mix price product cost item was negative this quarter. I'm just wondering if you can touch on that? Usually price and product costs you do a good job on. Are you seeing any pricing pressure anywhere in process or anywhere else?

Pat McHale - Graco Inc. - President and CEO

Pricing pressure is -- our pricing has been looking pretty normal this year so I don't anticipate any issues or changes on that front as we go through the year either. A little bit of pressure on some of the oil and gas businesses but that makes up a really small portion of our overall portfolio. Our



issue really on the price cost mix has been more on the manufacturing side and manufacturing volumes and spending associated with capital projects that are being implemented in various locations.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Got it. Pat, you touched on the industrial end markets, auto, construction still good but just to be clear, what was weak in Q1 in the Americas?

Pat McHale - *Graco Inc. - President and CEO*

For sure the big CapEx investments in ag and anything related to mining and oil and natural gas have all been soft. Around the world we have seen some softness in marine in certain locations so outside of automotive and construction, it hasn't been great. I mean even you saw some aerospace having -- under a little bit of pressure in Q1.

Kevin Maczka - *BB&T Capital Markets - Analyst*

So again embedded in your outlook for industrial for the year, do you think the year shapes up much like Q1 or was there a timing issue there as well like in contractor where maybe we start to see some better trends in Q2 in Americas and maybe the e double digits elsewhere is not really a sustainable number?

Pat McHale - *Graco Inc. - President and CEO*

Yes, that is the way I would look at it. It is going to jump around from quarter to quarter. Overall we think industrial is going to be okay for the year and I would anticipate that the Americas will have a better year than they did first quarter and that the regions will have not as much strength in the rest of the year as they do the first quarter. But we have had noise in that number before.

Christian Rothe - *Graco Inc. - VP and Treasurer*

Kevin, it is Christian. Just to remind you as Pat said in his script, that we had a 9% organic growth in industrial Americas in Q4 so that is evidence of that moving around from quarter from quarter.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Just finally from me, where are you on the timing of your contractor capacity decision?

Pat McHale - *Graco Inc. - President and CEO*

You mean in terms of step function increase to add more floor space?

Kevin Maczka - *BB&T Capital Markets - Analyst*

Yes.



Pat McHale - Graco Inc. - President and CEO

We have not made a decision as of yet. The team continues to work on alternatives. I still anticipate maybe sometime this year that they will come forward with a plan. I am not sure that we are going to get much spending done. Christian can weigh in on that.

Christian Rothe - Graco Inc. - VP and Treasurer

I think that is absolutely right, Pat.

Kevin Maczka - BB&T Capital Markets - Analyst

Okay, thank you.

Operator

Charley Brady, SunTrust Robinson Humphrey.

Charley Brady - SunTrust Robinson Humphrey - Analyst

Good morning, guys. Just on contractor, I just want to go back to the comment about your expectation there. You were saying that internally you guys thought you could get high single digits both in the first half and second half. Did I hear that correctly?

Pat McHale - Graco Inc. - President and CEO

For the Americas, we expect to get high single digits for the first half and full-year, yes.

Charley Brady - SunTrust Robinson Humphrey - Analyst

So that was not at all-in contractor segment commentary?

Pat McHale - Graco Inc. - President and CEO

No, that was contractor Americas.

Charley Brady - SunTrust Robinson Humphrey - Analyst

Okay. Thanks for clarifying that. Just on the margin contractor, your expectation there of kind of flattish on a year-over-year basis, is it a function of-- because you have got the product rollout in Q2 which generally ought to have I would say some decremental margin hit to it as you are rolling out the cost of doing that. But is it the fact that the higher absorption, the better absorption from higher sales is offsetting that or is there something else, some better pricing you are putting in on top of that new products that go out?

Christian Rothe - Graco Inc. - VP and Treasurer

I think it is a number of factors. So I mean there is some loading costs along with that but there's also product mix aspect that goes with it because of the fact that there is home center, there is a good portion of home center that is happening with that portion of the business. So that is what is keeping it really again as we called out that we are not going to get much expansion in operating margins in Q2.



Pat McHale - Graco Inc. - President and CEO

And I think we are still going to have some of our manufacturing cost and contractors filling into Q2 for getting new capital investments up and running so we might see some of that spill in. And I'd expect that we will see some of the profitability both from the load in and that capital equipment to start to help us in the second half.

Charley Brady - SunTrust Robinson Humphrey - Analyst

Okay, great. Thank you.

Operator

Walter Liptak, Seaport Global.

Walter Liptak - Seaport Global Securities - Analyst

I've got a follow-on to the contractor discussion. I think you went into this a little bit last quarter too. But just with the timing of the promotions for this year and the new product rollout, are the products in the channel now and how was the sellthrough? It sounds like we are pretty confident that the contractor is going to get -- they are going to hit the market in time this year.

Pat McHale - Graco Inc. - President and CEO

Yes, so the products are moving into the channel. Certainly on the home center side, we've got a load schedule that will implement as we go through the quarter so there will always be some risk that the load schedule did not hold. But generally speaking, the products that are now available in the marketplace and we just need to roll that home center launch through the quarter. I think the products are going to be well received and we are feeling pretty good about where we are at.

Walter Liptak - Seaport Global Securities - Analyst

Okay, good. In a similar way, you talked about growth initiative costs in the process business. I wonder is this in the hundreds of thousands or millions of dollars of cost to get the products out? I thought you had a number of products like the ChemSafe and the Electric Double Diaphragm that have already been put out into the market. Are there other products than that that you are talking about hitting the market for a better 2016?

Pat McHale - Graco Inc. - President and CEO

The larger investments in that space have to do with getting feet on the street. When we launched the oil and gas organic product in the middle of last year we had to ramp up a sales force so we still haven't fully lapped all those costs. We've got some activities happening in various areas of the process segment with facility consolidations. We are implementing new capital equipment so there is a variety of things that we have got going on as kind of part of putting together a process segment.

I think I mentioned last time, long-term that business should have operating margins in the 20s. Over the short term, we are getting things together, investing in headcount and I don't see anything here coming through the next quarters that -- it is going to stick out like a giant spike. I think it is going to be more of the same.

Walter Liptak - *Seaport Global Securities - Analyst*

But when we look at process operating margins compared to last year, it sounds like we should expect that for the full-year they are going to be down a little.

Pat McHale - *Graco Inc. - President and CEO*

If we achieve our low growth rate in process this year, I think that is very likely.

Walter Liptak - *Seaport Global Securities - Analyst*

Okay, great. Thank you.

Operator

Matt McConnell, RBC Capital Markets.

Matt McConnell - *RBC Capital Markets - Analyst*

Thank you. Good morning. So on the process decline, had there been backlog in oil and gas or did you just see a pretty dramatic change in what is happening in the end market there because it had been fairly muted some of the declines through most of last year. So I am wondering what the big sequential change was in the first quarter?

Christian Rothe - *Graco Inc. - VP and Treasurer*

Hi, Matt. It is Christian. Yes, we did have a step down that happened in Q1 with the oil and gas business. In fact we actually did have backlog grow a little bit in Q1 so book to bill was a little bit better than what it comes across and what Pat talked about in his script. So we were probably down on orders call it mid-20s whereas in shipments we were down in the 30s.

Matt McConnell - *RBC Capital Markets - Analyst*

Okay. Was there backlog supporting the revenue last year in that segment because you were up organically in process and it didn't seem like the oil and gas piece was causing this kind of variability last year. I wonder if that was just because you had backlog or any other factors that made it worse this quarter than what we saw last year?

Christian Rothe - *Graco Inc. - VP and Treasurer*

Early on in the year that might have been the case but as the year went on last year, obviously any backlog that was there when we acquired the businesses had really come off. So most of that was gone and so there was a degradation that happened as we went through sequentially late last year and into the first quarter.

Matt McConnell - *RBC Capital Markets - Analyst*

Okay. Great. Thank you.



Operator

(Operator Instructions). Liam Burke, Wunderlich.

Liam Burke - *Wunderlich - Analyst*

Pat, you had a down year, down quarter in North America in contracting and it was explained but you saw good growth outside the US. What is driving the growth there?

Pat McHale - *Graco Inc. - President and CEO*

So particularly the Western European market and also Central and East Europe, it is coming off of a pretty long protracted bottom in the construction markets there. And although it is not a steep rebound like we saw in the US coming into the 2010 kind of timeframe, it does look like construction markets are starting to heal there. And if the contractors have got some jobs lined up they are much more willing to buy equipment. So the environment for us is definitely better there. We did have some new product in that number although that didn't drive that entire new number.

Still getting hurt pretty significantly in the East, particularly in Russia which was a strong contractor market for us. So looking forward to the time that that doesn't throw a negative on top of that but just generally the environment looks better in EMEA.

In Asia-Pacific, I am going to tell you it is spotty and we have had a good quarter and we have had a bad quarter and we do have some initiatives going on there. We had a change in management last year that we are hoping they're going to get some traction. But I think it is too early to ring the bell on that one yet. I think that still expect some noise in contractor, Asia-Pacific is probably prudent.

Liam Burke - *Wunderlich - Analyst*

And then on the new product introduction obviously contractor is going to have a big quarter but generally across the segments, you have got -- you are pretty much on pace to get all of them out during the course of 2016?

Pat McHale - *Graco Inc. - President and CEO*

Yes, we don't have a big rush on a particular season for new product in the other businesses like we do contractor. Obviously a large chunk of our business is not related to the outdoor market and so our implant stuff pretty much launches when it is ready. I like what we launched in the second half of 2015 and I think we've got some nice opportunities to continue to build on that and 2016 product launches look pretty good too. So I'm generally pretty happy across our business units what we have got in the pipeline for new products for this year.

Liam Burke - *Wunderlich - Analyst*

Thank you, Pat.

Operator

Jim Foug, Gabelli & Co.

Jim Foug - *Gabelli & Co. - Analyst*

I was just wondering, you kind of called out your discretionary spending in the press release, I was just wondering how much leeway do you have to move that spending around from quarter to quarter or year to year?

Pat McHale - Graco Inc. - President and CEO

Yes, called it out really saying look, we are watching our discretionary spending but really I was trying to emphasize the fact that we still think we can have a decent year. We like our growth initiatives and we are not cutting, we are moving forward and we are watching discretionary items where they make sense. Should things fall apart, there's lots of things we can do at Graco and we have done them in the past, we know how to do those things well. But I'm not anticipating things to fall apart. I am anticipating things to improve as we go through the year and so really right now we are spending on that basis.

Jim Foug - Gabelli & Co. - Analyst

Okay, very good. And then also in your annual report, you talked about the new warehouse in Shanghai and you did comment on Asia-Pacific. What else do you need to do in China and Asia-Pacific to get the growth that you would like to get in the future?

Pat McHale - Graco Inc. - President and CEO

There are lots of opportunities for us over there. If you take a look at the split of our business, that upside in that region is significant. We continue to build out channel particularly in certain geographies and within certain product lines. We continue to put feet on the street where it makes sense. We're trying to do a better job across the Company I would say over the last four or five years and design products that are tailored for the different needs that are in that market. The needs are not always the same as North America and Western Europe.

So we've got a number of initiatives and we continue to press forward with those on a regular basis.

Jim Foug - Gabelli & Co. - Analyst

Okay, great. Thanks so much.

Operator

Jeff Hammond, KeyBanc Capital Markets.

Jeff Hammond - KeyBanc Capital Markets - Analyst

Good morning, guys. Just a final one back on process. If you do see weakness kind of persist into the second half, is there anything you can do to kind of manage the decrements a little bit better?

Pat McHale - Graco Inc. - President and CEO

There is. The question will be whether I decide to do it or not. We've got some nice activities underway that are going to drive cost out over the long-term, machining improvements, facility consolidations, putting headcount in regions where we think that we've got holes. And if things get really bad then I will do what I have to do. But I hate to short change the long-term to make one or two quarters look a little bit better. So we have those discussions internally. We've got regular operating reviews here and we talk about our alternatives. But I will tell you, my focus is to try to grow.



Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Okay, good. Just to understand on Asia a little bit better, are you more concerned with the macro over there for calling kind of the end of the chopiness or is it more the stuff that you are doing internally to really get things going?

Pat McHale - *Graco Inc. - President and CEO*

We have always got our initiatives but a great economy is better than a great plan. And we are going to continue to push forward with our initiatives but the economy over there, it is just not getting out of its own way and particularly China, they really drive the region. And it is just hasn't been strong across the board. It has been I would say generally weak.

When I talk to our suppliers over there which is another view that we get, we can talk to distributors and end-users but I also like to talk to suppliers and generally our suppliers are slow which leads me to believe that manufacturing numbers in China if you knew exactly what they were they are probably not very good.

I think we need some help on that front from an economic standpoint but certainly there is lots of things that we can do and we continue to push where we can.

Jeff Hammond - *KeyBanc Capital Markets - Analyst*

Great. Thanks, Pat.

Operator

Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Good morning, guys. Thanks for taking my question. The contractors, just a follow-up to better understand the margin progression there. I get the mix headwinds in new product are weighted to the home center. When can we expect that mix to no longer be a headwind whether it be just from a year-over-year comparison, Christian, or just given what you see in your pipeline of new products elsewhere?

Pat McHale - *Graco Inc. - President and CEO*

There is a couple of things going on. You've got the mix between paint channel and home center and you've got the mix between the regions and the Americas and then you also have the mix between within our market segments whether contractors are buying our highest end products like our gas sprayers for doing tract homes versus whether the electricians are doing well. So there is a lot of mix issues within that. It is kind of hard to predict.

We have had good strong growth across product categories since 2010 and I would say that within the North American pro paint market for sure, we are selling more big units than we were selling in 2010, 2011 and 2012 so that mix is improving but our home center business has done really well. We have launched a lot of interesting products and so it is a little bit of a soup.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

That is all I had. Thank you.

Operator

There are no further questions at this time. I will now turn the conference over to Pat McHale.

Pat McHale - Graco Inc. - President and CEO

All right, not our brightest quarter but we are working hard and we anticipate better things and we will look forward to talking to you again at the end of July. Thanks.

Operator

This concludes our conference for today. Thank you all for participating and have a nice day. All parties may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2016, Thomson Reuters. All Rights Reserved.