REFINITIV STREETEVENTS

EDITED TRANSCRIPT

GGG.N - Q2 2021 Graco Inc Earnings Call

EVENT DATE/TIME: JULY 22, 2021 / 3:00PM GMT

OVERVIEW:

Co. reported 2Q21 sales of $507m and reported net earnings of $110m, or $0.63 per diluted share.

CORPORATE PARTICIPANTS

David M. Lowe *Graco Inc. - CFO & Treasurer*

Kathryn L. Schoenrock *Graco Inc. - Executive VP, Corporate Controller & Principal Accounting Officer*

Mark W. Sheahan *Graco Inc. - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Andrew Edouard Buscaglia *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Brett Kearney

Bryan Francis Blair *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Connor Joseph Lynagh *Morgan Stanley, Research Division - Equity Analyst*

Deane Michael Dray *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

Jeffrey David Hammond *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

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

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

Saree Emily Boroditsky *Jefferies LLC, Research Division - Equity Analyst*

Walter Scott Liptak *Seaport Research Partners - MD & Senior Industrials Analyst*

PRESENTATION

Operator

Good morning, and welcome to the Second Quarter Conference Call for Graco Inc. If you wish to access the replay for this call, you may do so by dialing (855) 859-2056 within the United States or Canada. The dial-in number for international callers is (404) 537-3406. The conference ID number is 9785074. The replay will be available through 2:00 p.m. Eastern Time, Thursday, July 29. 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 2020 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.

I will now turn the conference over to Kathy Schoenrock, Executive Vice President, Corporate Controller.

Kathryn L. Schoenrock - *Graco Inc. - Executive VP, Corporate Controller & Principal Accounting Officer*

Thank you, Shannon. Good morning, everyone. I'm here this morning with Mark Sheahan and David Lowe. I will provide a brief overview of our quarterly results before turning the call over to Mark for additional discussion. Our conference call slides and our second quarter Form 10-Q are on our website and provide additional information on our quarter.

Yesterday, Graco reported second quarter sales of $507 million, an increase of 38% from the second quarter of last year. The effect of currency translation added 4 percentage points of growth or approximately $12 million in the second quarter.

Reported net earnings were $110 million for the quarter or $0.63 per diluted share. After adjusting for the impact of excess tax benefits, from stock option exercises, net earnings were $108 million or $0.62 per diluted share.

Gross margin rates were up 220 basis points from the second quarter of last year as a favorable effect from realized pricing, increased factory volume, product and channel mix and currency translation offset the unfavorable impact of higher product costs.

Mix was favorable in the quarter due to the strong sales in the higher-margin Industrial segment. Supply chain constraints such as logistics capacity and component availability had an unfavorable impact in the quarter and will likely persist for the rest of the year.

On a sequential basis, gross margin rates were down 250 basis points as we saw cost pressures such as material, labor, freight and volume-based costs increase throughout the quarter. The majority of these cost increase impact the Contractor segment as that is our highest volume business.

We also saw unfavorable mix on a sequential basis due to projects in Asia Pacific in the Industrial segment. At current costs and volumes, we are estimating that realized price, strong factory performance and current production activity will offset higher product costs on a full year basis.

Our operating teams are working diligently to minimize the disruptions and have been effective at keeping pace with our incoming order rates. Operating expenses increased $27 million or 26% in the quarter. Sales and volume-based expenses increased $18 million against a very low comparable in the prior year. New product development and currency translation rates each increased operating expenses by $3 million. The adjusted tax rate for the quarter was 18%.

Cash flows from operations are at $220 million for the year compared to $143 million last year. This increase is due to the improvement in earnings in the quarter, partially offset by increases in accounts receivable and inventories that reflect the growth in business activity. Significant uses of cash are dividend payments of $63 million and capital expenditures of $55 million, including $21 million for facility expansion projects. A few comments as we look forward to the rest of the year. Based on current exchange rates, the full year favorable effect of currency translation is estimated to be 2% on sales and 5% on earnings, with the most significant impact having occurred in the first half of the year.

We expect unallocated corporate expenses to be approximately $30 million and can vary by quarter. Our full year adjusted tax rate is expected to be approximately 18% to 19%. Capital expenditures are estimated to be $150 million, including $90 million for facility expansion projects.

Finally, 2021 will be a 53-week year with the extra week occurring in the fourth quarter.

I'll turn the call over to Mark now for further segment and regional discussion.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Thank you, Kathy, and good morning, everyone. All of my comments this morning will be on an organic constant currency basis. Sales in the second quarter grew by double digits in every segment and every region. Broad-based growth for the quarter and for the year continued in all major product categories, resulting in record quarterly sales and operating earnings.

I would like to thank all of our employees, suppliers and distributor partners who continue to work long hours, keeping up with customer demand while navigating logistical and supply chain challenges.

Growth in Contractor continues. This is its fourth consecutive quarter with near 30% sales growth. The residential construction and home improvement markets have been strong in North America.

Demand in EMEA and Asia Pacific has accelerated, resulting in sales exceeding pre-pandemic levels. We are optimistic that incoming order rates will remain good in all regions during the second half of the year. However, from a growth rate perspective, our comparisons become much more difficult due to the large increases experienced in the second half of last year.

The Industrial segment grew substantially during the quarter and for the year with sales volume either near or exceeding pre-pandemic levels in all regions. Quoting activity increased throughout the quarter as many of our key end markets continued to recover. Incoming order rates remain elevated as the pace of business accelerates worldwide.

Process segment's sales grew 29% for the quarter and 17% for the year. Similar to Industrial, sales volumes were also either near or exceeding pre-pandemic levels in all regions. End market growth remains broad-based with key product categories up for the quarter. The strong recovery in both our lubrication and process pump businesses drove sales and earnings growth for the quarter in the segment.

Moving on to our outlook. We have reinitiated our revenue guidance for the full year 2021 and are projecting mid- to high teens revenue growth on an organic constant currency basis. Incoming orders continue to be robust in all regions with the Industrial and Process segments now on a solid footing and should finish the year strong. Favorable operating conditions remain in Contractor, however, second half comparisons are challenging.

Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Matt Summerville with D.A. Davidson.

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

Given some of the some of the supply chain concerns out there, Mark, are you seeing customer behavior indicative of over ordering, overstocking? Can you maybe speak to that? And then also maybe comment where exactly you have the largest supply chain-related bottlenecks right now, what your greatest areas of concern might be?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, Matt. It's hard to say that there's none of that happening in terms of people ordering in advance and trying to get ahead of the curve. So I would speculate that some of that is happening, but we haven't been able to quantify it. I don't think that's a real big concern for us. The -- I think we're experiencing really the same things that all other industrial companies are experiencing. We haven't really seen anything with respect to Graco that's too dissimilar from what we're hearing from our competitors and what we're picking up from the channel partners that we deal with around the globe. We're having supply chain issues across the business. So I don't want to understate what's happening in terms of like Industrial and Process.

But for sure, in the Contractor business where the demand, even out-the-door sales demand, has still been very robust. That's an area where I think we've seen the most pressure year-to-date. The channel partners that we deal with, I think, at this point are still hoping to get their inventories up a little bit from where they are at today. And so as we're able to deliver more product to them, hopefully that situation gets better.

Operator

Our next question comes from Deane Dray with RBC Capital Markets.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

I'd love to stay on this topic. And we got the qualitative commentary that's helpful, but can you provide any specifics on input costs? And broadly, the price cost, you've always been good about getting price between 1.5% and 2%. How much of that has come through? And then how does that -- how much of a headwind has higher input costs been in the quarter in terms of the margin impact this quarter?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, I'll take a shot at it and then Kathy and David are here as well, and they are welcome to join in. We are realizing pricing, and I would say more or less in line with what we had expected to realize when we put our price increases through.

And overall, I think as Kathy said, for the year, we expect that price costs were going to be in good shape. We're seeing the same cost pressures that everyone else is. They're coming everywhere, steel, aluminum, copper, plastics. Those are key components in Graco products. And some of the components that we buy also like electronics and motors and engines and even like subcontract premiums that we pay to folks that help us out when our demand spikes up. Those are all much higher. Freight costs are higher as well.

So I think that as we head into the second half of the year, the real thing that we need to have happen is the continued strong business demand and that's -- right now, it appears to be the case. If there's a tick up or tick down in our factory volumes, well then cost could be not as big of an issue if it ticks up or it could be more of an issue if volumes tick down. But we feel like we're in pretty good shape. And I don't know if you guys have anything else you'd like to add, but...

Kathryn L. Schoenrock - *Graco Inc. - Executive VP, Corporate Controller & Principal Accounting Officer*

No, I think that summarizes it really well.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. This is David Lowe. I would agree that I think the challenges that we have are manageable and that the areas of pressure are not unique to us. I guess the only thing I would add is: our business model is, as all of you know, is a, I'll call it, a lower volume, high mix model and with 65,000 SKUs or more. Our sourcing people and our manufacturing people are used to being and have a lot of experience being nimble to meet the kind of service levels that we want to have. So this is more challenging than usual, but not unknown to the organization.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

Got it. But you just -- it doesn't sound like you've got a number that you'll share on what -- if you roll up that input cost pressure, how much of that impacted margins this quarter.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Not by the quarter. I think what we've said is for the full year. We expect it to be neutral at current volumes.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

All right. So second topic is just get some further color, if possible, on the fall off in Contractor on a monthly basis. It really does jump off the page at you. And I also appreciate on a 2-year stack, you're still up 30%. So this is -- there's still good underlying growth versus pre-COVID. But just characterize the monthly progression, And what does that say about July?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think when we look at what we're actually seeing for incoming orders from our customers that are coming into the factory, it's been pretty consistent through June and July so far. From what we've experienced for the first part of the year, obviously, the comps just get tough. And so that's why the percentages look funny.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

And I think looking back at the schedule from second quarter last year, you see the point that Mark is making pretty dramatically. I don't have the chart in front of me now, but April and May were very soft. And then we saw a sharp something like 25 or 26 percentage points in Contractor revenue in the month of June last year.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

That's helpful. And just last, a comment for you. It's just great having you in the CEO seat. Well, I'll miss Pat, but nice transition and great to have you as CEO.

Operator

Our next question comes from Andrew Buscaglia with Berenberg.

Andrew Edouard Buscaglia - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

I wanted to follow up on that Contractor question. June -- like Deane said, June really kind of decelerated there. But is there anything around with where June should have been, maybe higher, but you're just having some trouble meeting that demand? I'm just trying to get a sense of going into July, if those sales will go negative, albeit at very high levels.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think that for the most part, what I said about the absolute level of orders coming into the shop have been pretty consistent. And our ability to get product out is constrained by some of the supply chain issues that we've talked about, and they have accelerated a bit. So when you look at our ability to actually deliver, that's something that the team is working very hard on, and I think it's going to remain challenging. But the encouraging thing and the thing that we were probably the most concerned about going into the year was what we see a significant step down or a step down in orders coming from customers around the world as we sort of lap the pandemic spike that we had last year. And as we sit here today, we have not seen that. So that's really encouraging.

Andrew Edouard Buscaglia - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Okay. Interesting. And sticking with Contractor, the margins obviously facing tough comps versus last year. But you really called out more so these adverse impacts in Contractor versus the other segments. So is there -- is there something specific in Contractor that's -- I don't know if that's different from the other segments that's impacting those margins.

Kathryn L. Schoenrock - *Graco Inc. - Executive VP, Corporate Controller & Principal Accounting Officer*

Yes. This is Kathy. Our other segments are what we would really point to as our low-volume businesses, high mix, low volume. And in Contractor, that's the one business where we do have higher volumes, meaning higher quantities of units that are being sold. So that's really the driver of the more significant impact in that business.

Operator

Our next question from Connor Lynagh with Morgan Stanley.

Connor Joseph Lynagh - *Morgan Stanley, Research Division - Equity Analyst*

Just wanted to stay on the topic of supply chain. So it certainly seems like you've been building inventory. Obviously, you've also been seeing substantial growth in the business. Just curious how you would characterize it. Are you building excess buffer inventory that you expect to monetize later this year or next year? Is that just a function of the higher cost of inventory? Or is there something else going on there?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

I think the inventory increase has been somewhat reflective of the business levels. And obviously, as our Industrial and Process businesses picked up compared to where they were at the beginning of the year or, let's say, in Q3 or Q4 when we were actually not seeing a lot of throughput in the factories and not producing goods. I mean the inventory levels have come up from that standpoint. So it feels to us like it's a natural increase. So is there anything really funny going on there? Of course, we're trying to get ahead of the curve like everyone else when it comes to some of the key components that go into our products. And I think we did a good job of that early on this year. Pre-buys in some of the categories that were mentioned to stay ahead of things. And given our cash position and ability to execute on those, I think that those decisions paid out well for us. Obviously, our inventory is high. We all know that, but we have really good levels of customer service and support that's needed, and there isn't really anything strange going on there from my view.

Connor Joseph Lynagh - *Morgan Stanley, Research Division - Equity Analyst*

Yes, makes sense. Just on that sort of low turn portions of the business. I guess what I'm wondering is as we think about back half this year or maybe it's 2022, basically, how long is the lag in most cases between your raw materials purchases and your sale? In other words, is there a margin pressure that we should think about in relation to that? Or are you feeling good about where the prices are versus where you purchase things?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

I think we're -- yes, I think we're pretty good. I mean our throughput is quick. For the most part, we don't let things sit around terribly long. As Kathy mentioned, I think in her opening comments, we have seen the impacts of the higher costs coming into the factory now that maybe we didn't see quite so much of in late last year and early this year. But as we roll forward our forecast and we kind of look at how we think the year is going to play out, we feel pretty good about where things will wind up.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. And I would just add to Mark and Kathy's comments that given, I'll call it, the Process and the Industrial divisions are skewed to the lower volume, higher mix and with the, I'll call it, the order trends that we see, the overall strength in those segments globally, it's very reasonable that we would be adding, getting ready to fulfill the demand that is -- seems to be very evident in the business and sustainable.

Operator

Our next question comes from Saree Boroditsky with Jefferies.

Saree Emily Boroditsky - *Jefferies LLC, Research Division - Equity Analyst*

The outlook, which is almost all green, is one of the most bullish you've been certainly over the last several years. Given your positive outlook and expectation for incoming orders that continue to be robust in some of the supply chain issues you talked about, could you tell us how you're starting to think about 2022? I know it's early, but I think given everything, you'll help us get a sense for demand profile from here.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

It's hard to know. But right now, things look really good. And I -- unless something changes in the world that we don't know about, I don't really see a major inflection up or down as we head into '22. I think it should be a decent year.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

I would just add, yes. We're -- as you well know, we're a pretty short-cycle business. And we serve a lot of different industries. So it's hard to generalize. But when you read the macro -- the back row picture in construction, certainly here in North America, and overall levels of economic activity and despite maybe hiccups from time to time related to pandemic, factories are open. Salespeople are out in the market calling on customers like they were doing before those problems began. And the overall feedback we get from the field is, as Mark alluded to, at least makes us feel very good as we look ahead as far as we can look ahead.

Saree Emily Boroditsky - *Jefferies LLC, Research Division - Equity Analyst*

That's helpful. Just another question on Contractor. Obviously, margins took a step down versus the first quarter. It's pretty inconsistent with normal seasonality. It looks like you had some elevated expenses and earning-based incentives. But could you just provide some color on the performance there? And how should we think about margin performance for the remainder of the year given the more challenging top line comparables in that segment?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think that we tend to look at things maybe on a bit longer-term basis than what our quarterly results might show. So there's always noise and volatility. But when I look at where they're at year-to-date, I feel pretty good about the absolute level of operating profit performance. And I think that they're set up for a good second half as long as the volumes continue to stay where they're at. For sure, when we started the year, none of us really knew: a), how strong the business would be and whether it would be sustained throughout the full year. And so as we got through Q1 and then into Q2, it became more apparent to us that volumes are strong. We need to make sure that we're reflecting that in our variable costs and expenses, which include incentives and rebates and programs that we do with our key distributors around the world. So as long as that kind of stays at the current pace, I think that we're in good shape, and we should be setting up for a pretty good second half of the year.

Operator

Our next question comes from Mike Halloran with Robert W. Baird.

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

So just following up on that, then, Mark, when you're thinking about the back half of the year here, does the incentive comp then start normalizing a little bit as those comps start normalizing, which means that the run rate from the second quarter isn't quite accurate, but maybe the combined 1Q, 2Q as you flatten things out, that maybe is a better thought process to think about how back part of this year and into next year starts playing out on the margin profile in Contractor?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

I mean I think we're in good shape right now as we sit here today, and none of us really knows what volumes are going to be, to be honest with you. As I think Pat once said, our crystal ball is like a bowling ball. We live and die by the weekly and monthly bookings and billings that are coming in. But as we sit here right now and what we see coming in and how we feel about the business and where we're positioned, I do think that we're in good shape. Of course, what's going to happen now in the back half of the year in terms of like a comparison to last year is that CED, as we all know, ran really hot in the second half of the year. So in terms of where their incentive accruals are and where the growth accruals are for our customers and those types of things really depend on where their volume comes in. And the other businesses are running hot. So we are anticipating that people are going to get back on the road. They're going to start spending money. We're going to do trade shows again. So there will likely be some incremental spending in the back half in Process and Industrial that wasn't there. But those should all be justified by the level of business coming in. And as long as we're seeing the kinds of orders and level of activity that we got going on right now, I think we're comfortable in spending those dollars.

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

And then a lot of moving pieces here. Comps are wonky, obviously, which almost make it seem like not real numbers. So when you strip back the noise a little bit and you think about how sequential patterns have worked through the quarter and how you're envisioning things are working through the back half of the year on a sequential basis, when you think about the 3 segments, how would you compare that to what a normal seasonal curve would look like from an outlook perspective, pretty in line? What kind of variances are you seeing, anything along those lines?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think pretty normal if you were to strip out all of the noise that's in there. Obviously, our outlook is probably from a growth rate perspective is probably stronger in the businesses that were weak last year versus what we might experience for CED. CED is really the only business that I would characterize as being seasonal, and they typically do have their strongest quarters in Q2 and Q3 if you look back historically. And at least as we sit here right now, like we said a couple of times, quarter rates look pretty decent and absolute demand sort of fits that overall pattern.

On the other businesses, there isn't a ton of seasonality. It might be like 1 or 2 percentage points if you went back historically and looked at how much Industrial contributed first half versus second half. Second half is a little bit stronger. But it's probably not worth even screwing around with the math.

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

And then last one for me, if you don't mind. The CapEx side, capital deployment side in general, how are you thinking about it? Obviously, CapEx seems like you pulled a little bit forward into the facility side? And then any comment on that? And then also how you're thinking about the M&A outlook, just capital in general?

David M. Lowe - *Graco Inc. - CFO & Treasurer*

All right. This is David. I'll try to comment on both those topics. On the CapEx side, yes, the company, as you know, has been aggressively investing in really in new facilities and plant and equipment to improve productivity, et cetera, for several years now. We announced our investment in a new manufacturing facility next to Rogers, Minnesota. And we're in the process of breaking ground on that. And we're hopeful that, that can all come together in the next 12 to 15 months. So that is going to be a very big investment for us and where most of the money that Kathy is talking about is going.

But along with that, the -- throughout the last year, all of the operations have continued to come forward with investment proposals that make sense. They have offered improvements to the business that generate ROIs that we feel are justifiable. And it's been -- quite frankly, it's been a busy time reviewing all the proposals from the facilities. So I think that what we're communicating is really consistent in bringing our expectations up to date.

I guess I would add, switching gears to the M&A environment that you folks know a lot about. And I guess I've been involved in recently from the operating side. It's an extremely active market, as you're aware. There's lots of proposals floating through some smaller ones that we look at and act on, on an ongoing basis and some bigger ones. As -- I guess, as a former operating person, I would say that the challenge to the current process is, of course, we're willing to move forward, but when we look at the processes on the -- especially on the bigger transactions, they tend to be auction environments, which is usually a seller-friendly decision in the process. People expect to move very, very quickly, which is fine when we're familiar with the market, maybe not so fine when we have to go to school and learn some things.

And then I think lastly, we continue to be, I'll say, impressed by the multiples of some transactions that we see in the marketplace, and we understand the dynamics of the marketplace, cost of capital and so forth. But historically, we've been, I think, reasonably disciplined and that's something that I would expect would continue to be the case.

Operator

Our next question comes from Jeff Hammond with KeyBanc.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Just on the new segment reporting change, can you just help us understand better what's driving that strategically? And I think you talked in the release about kind of lining up customers, distributors, et cetera, but maybe just expand on that change.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, sure. So we're really doing this to improve our ability to drive profitable organic growth. That's what it comes down to. And when you look at the pieces here, the move really is combining our contractor-focused businesses all under the contractor group. Historically, some of that's resided in the Industrial segment, and that has led to some overlap with regard to customers, salespeople, et cetera, and on the engineering front as well. So we think putting the teams together is going to create some synergies and some better collaboration. And obviously, both groups are important to us. But having them housed under one management team, I think, is a good move. And then the other pieces that are also being combined, I guess, that weren't necessarily called out, but they're the ones that are left in the businesses after we pull out HPCF or the advanced wood dispense part of our Industrial business, which is really our sealant adhesive, composite electronics type business along with our liquid finishing. And again, those 2 businesses, they really sell through common distributors. They have overlap on salespeople. The technical aspects of the product lines are actually quite similar. And the selling process is also similar. So we think that putting those 2 groups together, again, will help us energize some organic growth and get some more leverage out of the growth that we do get.

Jeffrey David Hammond - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay. That's helpful. And then just the second one. So Industrial margins, I think, stepped down sequentially, and I think you talked about mix. Just as you kind of look at the regions and look at the type of projects that are coming in, how do you kind of see mix into the second half for Industrial?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, the project business is good. The pipeline is solid. So I would expect that we'll have more project business both being booked and hopefully build as we work our way through the year. A lot of times, they are lower margin, but a lot of times, they also carry some high-margin Graco products in them. And then once they get installed, obviously, you get the customers coming back for health, parts, accessories, new projects, things like that. So this is a pretty healthy environment.

Operator

Our next question comes from Bryan Blair with Oppenheimer.

Bryan Francis Blair - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Somewhat of a follow-up on Matt's lead-off question. We know through the cycle, your parts and accessories mix is pretty consistent around 40%. Given the uniqueness of today's environment, the pervasive supply chain uncertainties, some of the order flow that's stemming from that, was that percentage notably different in the second quarter?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

No. It's the same. It's amazing how it hangs in there, but it's very consistent.

Bryan Francis Blair - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Okay. That is very interesting. Follow-up higher-level question. In terms of outlook, specifically for the Contractor segment, your team has been bullish on the housing market for quite a while and correct in that. And Mark, you detailed about the favorable macro factors last quarter. Some of them were reiterated on this call, even cited the Freddie Mac's study of $3.8-plus million undersupply in housing, all very favorable. Wondering if anything that's taking place now, specifically in terms of affordability and the -- literally the ability of the incremental buyer to move forward, whether that affects your team's outlook in that regard?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Not at this point. It's definitely worth keeping an eye on. Obviously, it costs a heck of a lot more to build a house today than it did a year ago. But again, the macro dynamics are still fairly favorable. And we haven't really seen anything translate into activity with our painting contractors or the other parts of our business. As I said before, the incoming order rates still look good. Most of the painters that we talk to, they've got a good backlog of jobs. I was recently actually trying to get somebody to do some work in my place, and it's their backlog, and you just can't get good people. And I think it's the same thing on the housing side. If you want to build a house now, you're looking out quite a ways. I believe there will be a break in some of the cost pressures that they're seeing for building materials. And I think you've already seen -- started to see a little bit of that. And as we work our way through the year, hopefully, that opens things up a little bit. But we're still very bullish long term cyclically on that part of our business.

Bryan Francis Blair - *Oppenheimer & Co. Inc., Research Division - Director & Senior Analyst*

Okay. Excellent. One final one, if I can. David alluded to limited due diligence time on certain M&A prospects. With the vaccine rollout, the ability to travel, et cetera, is that leading to more activity in your funnel and perhaps pulling forward some prospects?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

I don't know that we've seen that. I think what David was alluding to, and he can give you more color if he wants, was we were seeing last year during the pandemic that you would have companies come to the front and no due diligence, no boots on the ground. It was all done virtually. And unless you were intimately familiar with their organization or the industry that they're in or the competitive nature of their business and all those things, it would be very difficult to probably get yourself comfortable with the kinds of premiums that were out there in the marketplace. I think going forward as people get vaccinated and factories open up and companies are more welcoming, that should help the dynamic on the due diligence side going forward. But David, you...

David M. Lowe - *Graco Inc. - CFO & Treasurer*

No. No, that's exactly what I was talking about. It's definitely one thing to assess a business that we have a high level of familiarity with. We know the products and the channel and so forth. And maybe in the cases of certain businesses, certainly maybe the bolt-on businesses to some degree, if they're familiar to us, the level of the compatibility of the acquired management maybe has a different level of importance. I was thinking of one specific case where we looked at an industry that potentially was of great excitement. But it was definitely outside of my competency at least, coming from the Industrial and the Process side of Graco, and it was really going to be important to assess the compatibility and the staying power of the management group. And there simply was no time for me to, in those circumstances, go meet the people face-to-face and participate in any reasonable way on the timetable they were insisting that the process be conducted with.

Operator

(Operator Instructions) Our next question comes from Brett Kearney with Gabelli Funds.

Brett Kearney

Just had one this morning. And you kind of covered it in your comments early on, Mark, the broad-based demand outlook. But just curious, aerospace, in particular, if you could just remind what part of the business, I guess, from a sales perspective, that accounts for today? And whether that is included in kind of the growth profile outlook you have across the majority of the industrial businesses?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. Of course, we're in like a lot of different end markets. Aerospace is definitely one of them. And that business has been soft as you might expect. It's in our Industrial segment. It's really where we serve that industry primarily, our liquid finishing group. I think also our adhesive group gets involved to a lesser degree there.

Brett Kearney

Okay. And the outlook going forward, just kind of in line with the overall Industrial segment?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Well, I think that the outlook for aerospace is probably better today than it was a year ago with people getting back on airplanes and starting to place orders again. Again, I don't feel that it's a meaningful driver for Graco's business. It's one of many key markets that we participate in.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. And I guess the way I would say it, if a person is -- I don't know, if I'm speculating about the intermediate term, I think Mark's point is when we look at the strength of, let's say, automotive manufacturing, the tier 1s, farm, construction equipment, the wood market and so forth. On a relative basis, those carry a lot more weight than one single market space like aerospace.

Operator

Our next question comes from the Walter Liptak with Seaport Global Securities.

Walter Scott Liptak - *Seaport Research Partners - MD & Senior Industrials Analyst*

All right. I wanted to see if there is a way of talking about the project work as sort of like longer cycle systems and if during the quarter, you saw more projects kind of entering into sort of quoting or project development. And I'm trying to understand if these are longer cycle, do they -- is the stuff that you're working on that's longer cycles that ship in the second half? Or are you starting to build out project work for 2022?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think for sure, our quote activity is way up from a year ago, and I'm talking mostly in the Industrial and Process again and also our powder coatings business, the Gema business. And it really depends on the type of project. Some of them, they lap over from 1 year to the next. The majority of them, they're probably 3 to 6 months in terms of the timing and they haven't really gone through and done an analysis of how much is actually going to build in the back half of the year. But I think the takeaway from our standpoint is that there's more people out there, they're looking to deploy capital. There's a lot more good projects out there, and we should see the benefit of that.

Walter Scott Liptak - *Seaport Research Partners - MD & Senior Industrials Analyst*

Okay. And how do you protect yourself with material inflation on those longer cycle?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. We do a pretty good job of quoting and estimating, as you probably can imagine. And to the extent that we've got components or things that we're concerned about, we'll either buy those ahead or we build in some of that pricing into our project business. Project business is a little bit different than like our normal price increase, right? So our normal price increase that we do annually, that covers a lot of our standard components and those types of things. But when you're doing a project, you have a little bit more leeway in terms of building some of the price cushion in.

Walter Scott Liptak - *Seaport Research Partners - MD & Senior Industrials Analyst*

Okay. Got it. And I've always thought that the project work as being like high ROI like so far, powder system or adhesive system or whatever goes in that the customer gets a payback in a year or two. But with the price increases and inflation, is there a point at which the ROI has gone down enough where projects push out? Is there any concern about that?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

No, we haven't seen that.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

I would say that maybe offsetting the risk of that is the things that a new system would help a manufacturer with, maybe in the area of labor savings and material savings, that's where inflation actually may help the ROI.

Operator

If there are no further questions, I will now turn the conference over to Mark Sheahan.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

All right. Well, thank you so much for participating in this conference call, and we'll see you on the road or we'll talk to you next time.

Operator

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