

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

GGG - Q1 2015 Graco Inc Earnings Call

EVENT DATE/TIME: APRIL 23, 2015 / 3:00PM GMT



CORPORATE PARTICIPANTS

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

Pat McHale *Graco Inc. - President and CEO*

Jim Graner *Graco Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Charlie Brady *BMO Capital Markets - Analyst*

Kevin Mackza *BB&T Capital Markets - Analyst*

John Franzreb *Sidoti & Company - Analyst*

Matt McConnell *RBC Capital Markets - Analyst*

Walter Liptak *Global Hunter Securities, LLC - Analyst*

Joe Ritchie *Goldman Sachs - Analyst*

Liam Burke *Wunderlich Securities, Inc. - Analyst*

Jim Giannakouros *Oppenheimer & Co. - Analyst*

Jim Krapfel *Morningstar - Analyst*

PRESENTATION

Operator

Good morning and welcome to the first-quarter 2015 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 1366681. The replay will be available through April 27, 2015.

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 up the conference 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 2014 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. This call is being recorded.

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, Corporate Controller and Information Systems*

Good morning, everyone. I'm here this morning with Pat McHale, Jim Graner, and Christian Rothe. I'll provide a brief overview of our quarterly results and our updated segment reporting before turning the call over to Pat for additional discussion. Our conference call slides and our first-quarter Form 10-Q are on our website and provide additional information.



Starting this quarter, we've created a new reporting segment that includes our process, oil and natural gas, and lubrication divisions. This change reflects our increased focus on growth driven by product and channel development initiatives in the process area as well as recent acquisitions. The segment includes vehicle servicing and industrial lubrication equipment, diaphragm pumps, and high and ultrahigh pressure valves.

The process and oil and gas operations were historically included in the industrial segment. Although we will not talk specifically about lubrication equipment in future quarters, to help with understanding this first quarter and our new structure, our sales in our lubrication division were up 2% at constant exchange rates and operating earnings were down approximately 4% as compared to a year ago.

The industrial segment reflects our liquid and powder finishing equipment, spray foam insulation equipment, plural-component proportioning systems, and other equipment for a variety of industrial customers and specialty contractor end user customers.

The contractor segment remains unchanged. The contractor segment markets sprayers for architectural coatings and paintings, texture, and line striping equipment.

Additional information regarding our updated segments is included on page 9 of our slide deck. We have also included historical results by quarter for these segments for 2013 and 2014 in the appendices found on pages 20 and 21 of our slide deck.

Before Pat comments on our sales, earnings, and outlook, a few comments regarding cash flow and liquidity. Cash provided by operating activities was \$47 million in the first quarter. The increase in inventory and accounts receivable reflects organic growth as well as the effective acquired operations. In the quarter, capital expenditures were \$10 million, dividends paid totaled \$18 million, and share purchases, net of shares issued, totaled \$34 million.

Debt, including notes payable, totaled \$819 million at the end of the quarter, with approximately \$500 million of debt repaid subsequent to quarter end. We expect capital expenditures to be in the range of \$30 million to \$40 million for the full year.

Excluding any impact from post-tax dividends from the liquid finishing businesses or gain on sale of the investment, the annualized tax rate is expected to be approximately 32% to 33%.

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

Pat McHale - Graco Inc. - President and CEO

Thanks, Carol, and good morning. Our reported figures of 6% sales growth and 41% growth in diluted earnings per share included \$30 million in dividends from the hold separate business. Stripping away the dividends, diluted earnings per share were down 13% year over year.

Foreign currency was a big driver of unfavorable performance in the quarter, reducing sales by 4% and diluted earnings per share by 10%, in line with the expectations we put forth in late January.

Acquisitions added 5% to our sales growth in Q1. The purchase accounting inventory step-up cost for the acquisitions that closed within the last few months reduced the earnings impact from acquisitions to zero for the quarter. If you exclude the inventory step-up, acquisitions would have added about \$3 million to pre-tax earnings.

I continue to be excited about the new opportunities we have with the acquired businesses and we'll talk more about the performance of the acquisitions later.

There was a lot of noise in the quarter, but adjusting for the impact of acquisitions, the hold separate dividends, and foreign currency, organic sales grew 5% in the first quarter, but diluted earnings per share were off about \$0.03 per share. This negative earnings leverage is unusual for Graco and I'll walk you through what happened as well as try to give you some insight as to what the next few quarters may look like.

Other than our lack of growth in the regions, the underlying business is actually performing reasonably well. The drivers of negative leverage on organic sales came from a number of contributors, all at modest levels, but when taken together, they hurt us in the quarter. Many of the expenses are directly related to decisions we have made to pursue new growth opportunities. Growth is our focus and we will continue to plow ahead.

Our contractor segment successfully launched a number of new and refresh products in the first quarter. Load in increased sales by about \$5 million, helping the segment achieve another quarter of very strong double-digit growth in the Americas. Frontloaded launch costs and incremental marketing spending were about \$2 million and had a negative impact on segment margin performance in Q1, but these products will drive growth in profits for Graco going forward.

In the Americas, both paint stores and home centers grew solid double digits in Q1. The growth rate in home centers, assisted by the new product load in, significantly outpaced pro paint, leading to unfavorable margin mix in our contractor business. When combined, launch costs and unfavorable mix took the contractor segment incremental margins to just over 20% in Q1.

As we look forward, we don't expect the launch cost to recur at the same level; however, the change in mix is a trend. Without an equal growth rate coming from the regions, incremental margins in contractor should be closer to 30% for the remainder of the year, although this will vary from quarter to quarter.

The next factor that impacted the quarter for all of the segments was a lack of growth in the EMEA and Asia Pacific regions. As you've heard us discuss previously, our regional operations are slightly more profitable than our US business. So flat to declining sales in the regions create a margin headwind, particularly painful in a quarter where our highest growth product category is our North American home center business.

Despite our slow start, I remain optimistic that we will see growth in the regions this year and the earnings leverage that comes with it.

Let's pause a moment and talk about the macro trends within the regions. In EMEA, the developed markets of Western Europe continue to perform well, growing at a mid-single-digit pace, while the emerging portion of EMEA declined high single digits organically, entirely due to sales declines in Russia.

Last year, Russia was 2% of Graco's worldwide sales. In the first quarter, Russia was 1% of worldwide sales. The business has been cut in half year over year -- a much stronger headwind than it was in any individual quarter last year.

We did have good growth in the central eastern emerging markets in EMEA as well as the Middle East, but it was not enough to overcome the dramatic weakness in Russia.

From an end market perspective, we are still seeing good activity levels for general industrial applications in the West, where we had sales growth in most countries. Our split of West versus East in EMEA now sits at 68% to 32%.

In Asia Pacific, we had double-digit growth out of Korea, but double-digit declines in China and Japan led to a double-digit organic sales decline for the region. Project activity and capital investment has been spotty, as we've discussed for some time now.

Due to the nature of our end markets in Asia, the business can move around significantly from quarter to quarter. However, the softness we saw across a wide swath of countries and product lines is something we are watching closely. That said, our team in Asia is anticipating improvement during the balance of the year.

Corporate costs contributed to our negative leverage in the first quarter, primarily related to pensions, stock comp, and some IT spending. For Q1, the incremental spend was a little under \$3 million.

Increased spending on regional and product growth initiatives also impacted earnings leverage in the quarter. During 2014, we increased spending on several initiatives, including expansion into the hot melted adhesive dispense market; establishment of an oil and natural gas engineering

organization; build out of an increased sales and engineering capability in our process division, which is part of the new process segment; and increased commercial headcount in South and Central America.

We will lap much of this expense as we move through 2015, but as we continue to see opportunities for growth, we will invest as appropriate.

In the first quarter, we opened a new warehouse in the Shanghai Free Trade Zone. This facility allows us to increase our product availability within China and convert a majority of our products to Chinese RMB pricelists.

As a result of the new facility, we will have additional inventory on the balance sheet and a slightly higher overhead cost in China. This investment will support future sales growth, allow us to expand our distribution channel, and enable us to better serve our customers in China.

To complement our recent oil and natural gas transactions, we have been ramping up an organic growth initiative to go after a product opportunity on the production side of oil and natural gas, which will utilize core Graco pumping and precision flow control technologies. We currently anticipate launching this product before year end.

Some of our investors have commented that Graco is a countercyclical investor. And at the moment, it may look that way. Expansion of our presence in South and Central America in a lousy macro environment, increased product availability in China at a time of declining growth rates, and organic investments and acquisitions in the oil and natural gas market when rig counts have been cut in half.

It's not that we are countercyclical, but rather, we're driven for growth over the long term. We've identified attractive opportunities and we have a bullish view of the future of these markets, so we're taking action.

We took a similar approach to increasing spending in product development and engineering marketing resources during the 2009 recession and emerged stronger for it. I have confidence in our leadership team and they are working their plans, although the waters are a bit choppy at the moment.

Incremental investment and product and regional expansion in Q1 was about \$2.5 million. For the full year 2015, I'm expecting about \$7 million of incremental growth investment spending as we build out a commercial organization in oil and natural gas in preparation for the launch of our internally developed product line later this year and make some selective investments in process in Africa.

To summarize our view for the remainder of the year, the contractor launch costs should mostly be behind us. Regional and product expansion initiatives will continue, although we are beginning to lap investments made during 2014.

On the unallocated corporate costs, particularly pension, we are holding our outlook of a headwind of \$10 million for the year. The decremental margins on the mix effect from the flat organic sales in EMEA and the negative organic sales growth in Asia Pacific should disappear when the regions return to organic growth.

Now for an update on the recent acquisitions. The five acquisitions we have completed in the last 12 months generated \$15 million in sales and adjusted EBITDA margins of more than 30% in the first quarter. Inventory step-up, transaction costs, and amortization expense reduced the net earnings impact to zero for the quarter. If you adjust out the one-time items, we're tracking towards our expectation of \$0.15 of EPS accretion from these transactions in 2015.

We are pleased with the multiyear opportunities we see in front of us to invest in manufacturing improvements, expand into new geographies, invest in new products, and integrate where it makes sense. Our transactions in the oil and natural gas market are going to be revenue challenged in the near term, of course, but when the market turns, we hope to be well positioned to capitalize on it.

Outlook for the full year 2015 remains unchanged. We are looking for mid-single-digit organic sales growth worldwide, excluding the impact of currency.

In the Americas, contractors poise for another year of double-digit sales growth, while the process and industrial segment should achieve mid-single-digit organic growth. We are looking for the EMEA and Asia Pacific regions to give us low-single-digit organic growth for the year, improving as the year progresses.

Acquisitions will add 5 percentage points to our growth in 2015, while foreign currency is now expected to be a headwind of 5% for the full year and 11% on net earnings. This is somewhat worse than our discussion in late January due to a broader unfavorable change in rates since the date of our earnings release last quarter.

A final note -- we did complete the sale of the liquid finishing business to Carlisle Companies on April 1 for \$590 million. Net proceeds will be approximately \$580 million. This is a cash number and includes the \$30 million of hold separate dividends we received in the first quarter. We will recognize the gain in the second quarter.

With the balance of \$550 million received in Q2, we are currently sitting right around where we expected to be on cash and debt. We have our \$300 million in private placement debt still in place, with an average interest rate of 4.8%, and we have a cash balance of about \$75 million.

From a capital deployment perspective, we continue to look for additional acquisitions and have an active buyback program, with 1.7 million shares available under the current authorization. We've had a relatively steady cadence on our buybacks over the last year and a half, but that pace could increase opportunistically.

In summary, although it was a messy quarter, the underlying business fundamentals remain sound. We are achieving our planned price increase, our factories are managing costs well, and the margin performance of our newly acquired businesses is healthy. We had an unusual number of items that stacked up against us during this quarter, but most of these items were deliberate management decisions related to the pursuit of profitable growth.

Despite our slow start, we are still optimistic that we can have a decent year and we will work hard towards that objective.

Operator, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Charlie Brady, BMO Capital Markets.

Charlie Brady - BMO Capital Markets - Analyst

I just want to focus on the -- just to make sure I'm clear -- contractor. That incremental launch cost thing -- that's done completely or is there a little bit left in Q2?

Pat McHale - Graco Inc. - President and CEO

There could be a little bit spillover, but it shouldn't be significant. We got most of our launches in North America done here in the first quarter this year.

Charlie Brady - BMO Capital Markets - Analyst

Okay. And is the loading part -- does that continue into Q2 or are you fully loaded now?



Jim Graner - *Graco Inc. - CFO*

I think we're fully loaded at this point. Of course, we hope to have some great sellthrough on these new product launches as well.

Charlie Brady - *BMO Capital Markets - Analyst*

Right. And just on process, the incremental costs, those are going to continue, but are they going to continue at the same pace as we go through the rest of the year or how is that going to be slotted in?

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

So for the growth investments, we were about \$2.5 million in the first quarter. And I'm predicting in that range of \$7 million for the full year.

Charlie Brady - *BMO Capital Markets - Analyst*

Kind of spread out pretty evenly then?

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

No, I think we'll start lapping some of our investment decisions for 2014. So we'll get more relief, I'd say, in the latter half of the year.

Charlie Brady - *BMO Capital Markets - Analyst*

Okay. One more and I'll hop in queue. Just on the M&A. Obviously, you guys have done a good bit of M&A in the past 12 months. You've got plenty of capital to go forward. Are there any specific areas you really targeting, given what you've already purchased?

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

Well, obviously with the development of what we called the process segment, we think there's a lot of interesting opportunities, both in process and the oil and natural gas base. For us, process focus right now on areas like sanitary we think are very interesting.

If you just step back a little farther than that, the more likely area for all of our future acquisitions is in the industrial and process segments. Due to our large market position in contractor, that becomes more problematic.

Charlie Brady - *BMO Capital Markets - Analyst*

Okay. Thanks, guys. I'll hop in the queue.

Operator

Kevin Mackza, BB&T Capital Markets.



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

Another question on process margin. So some of these costs go away. The transition effect doesn't. Can you just a little bit longer term talk about the way this business is configured now with the new acquisitions in there, kind of what you think the potential is here for margins? Can they come back up to that 24% level over time?

Jim Graner - *Graco Inc. - CFO*

I would say that, Kevin, we view this as an industrial segment like margins ultimately. A little bit lower with, I'll say, a third of the business coming from the legacy lubrication, but the process business and the oil and gas eventually should look a lot like our industrial segment.

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

We'll have the -- of course the accounting impact of the amortization that will go forward for an extended period of time. But if you take a look at what the margins would look like without that amortization, we expect they'd be pretty strong.

Again, the recent acquisitions with those costs excluded are in that 30% range. So good strong niche markets.

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

Okay. Shifting gears, can you address the decision to repay all but the \$300 million in private placement debt versus buybacks or some other use of that cash?

Jim Graner - *Graco Inc. - CFO*

Sure. Where -- what we paid off was on our revolving credit. So we still have our revolving credit line of \$450 million available to us. \$500 million -- Christian signals. (laughter) So that's available to us for the right transaction. And should opportunities come about on the share repurchases, we have that available with a telephone call.

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

Okay. And then finally from me, the translation effect here is a bit worse, as you called out. When I look at the organic growth in industrial and process, it doesn't look obvious that there's been any transactional effect, like losing out on sales versus just translating those sales back into fewer dollars.

Are you expecting that? Is that something that we ought to be watching out for? Or is that a smaller issue here?

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

Yes, I view that as a smaller issue. Generally in the past, we haven't seen that be a dynamic in the marketplace when currency shifts. It can shift to maybe on a project-by-project basis, but I think generally from the larger view of things, the end market pricing will remain stable.

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

Okay, got it. Thank you.



Operator

John Franzreb, Sidoti & Company.

John Franzreb - Sidoti & Company - Analyst

Just about the recent acquisitions. Given the continued weakness in the oil and gas sectors, are your expectations for the contributions from these businesses still the same as what they were three months ago?

Pat McHale - Graco Inc. - President and CEO

Yes, probably three months ago. Probably not six months ago. So you know, when we were in the midst of doing the two deals that we did out of the group that have some oil and gas exposure, that was kind of at the point of and just the beginning of the point when oil prices started to collapse. So obviously, our timing wasn't great on those. They are not huge, so it shouldn't be the end of the world.

I'll remind you that the high pressure equipment acquisition was only half oil and gas and Alco was about 70% oil and gas. So those, compared to what we were thinking six months ago, those will probably have some challenges. But I think that our guidance in terms of what we thought the EPS accretion would be for 2015 still looks like it's going to be okay.

John Franzreb - Sidoti & Company - Analyst

Okay. And as far as free cash flow, I guess typically, Q1 is the weakest and Q2 and Q3 kind of builds up substantially. Use of the cash -- would you prioritize the buyback -- just to piggyback on the last question -- the buybacks versus further debt reduction. Would you prioritize?

Jim Graner - Graco Inc. - CFO

For sure, there won't be any further debt reduction. We have the private placements in place. We intend to keep those in place. That's \$300 million, which is all outstanding today.

So we're going to be generating some cash and to the extent that we don't have any near- or long-term acquisition opportunities, buybacks certainly come to the top of the list.

John Franzreb - Sidoti & Company - Analyst

Okay, perfect. Thank you very much, Jim.

Operator

Matt McConnell, RBC Capital Markets.

Matt McConnell - RBC Capital Markets - Analyst

There was good clarification in the slides and some of this has come out in answers to your other questions, but you called out 5 percentage points of the operating margin headwind in 1Q. Can you quantify how much of that is expected to kind of repeat through the remainder of the year and what rolls off?

Jim Graner - *Graco Inc. - CFO*

Sure. So I'd give you a reference to slide 7 in the deck and I'll call out a couple of the numbers on there. So it shows effect of the inventory step-up a 1 point margin, \$3 million in operating earnings. That, of course goes, away. That gave you some guidance on the incremental investment in regional and product growth initiatives and the fact that they will continue, but should be a smaller trend.

The unallocated corporate expense pain stays with us. And we're expecting the volume effect on the expense leverage to get smaller. In other words, the profit from the growth volume increasing and the negative leverage expense of the 2 points.

But of course, we still, as we talked about, do have this translation effect with the exchange rates today that will continue. So it's -- a few points come off, but a few points of headwind remain.

Matt McConnell - *RBC Capital Markets - Analyst*

Okay, great, thanks. That's helpful. And on the reiterated target for a little bit of growth in EMEA for the whole Company, is that just because Russia, it is not going to be down 50% again?

I know it's only a modest acceleration, but are you seeing anything there that makes you incrementally more confident in your ability to accelerate here from the flat growth that came in the first quarter?

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

Yes, part of that should be because the impact of Russia will be less as we move through the year. You know, Russia was getting worse last year as we progressed. Our view is it shouldn't get much worse than it was in the first quarter, so that the incremental impact quarter over quarter should be less to us.

But we also have new product launches and we've got some other plans and programs that we think are positive. And we'll continue to work those for the next nine months.

We've been performing okay in Western Europe and we don't necessarily see anything on the horizon right now that indicates that we should back off from that. So again, we are feeling like we can make a comeback from flat and get some growth for the year.

Matt McConnell - *RBC Capital Markets - Analyst*

Sounds good. Thanks very much.

Operator

Walter Liptak, Global Hunter

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

I wanted to ask about operating leverage. And I guess for the rest of the year, all in with the three segments, where are you envisioning the businesses for operating leverage?



Jim Graner - Graco Inc. - CFO

So Walt, I'll take you on a little bit of a journey. Long term, we've always guided to about 40% operating leverage. That's, of course, predicated on a couple things. Stronger organic growth than when we've been reporting. You know, high single digits versus middle or low single digits. Organic growth.

And it also reflects a mix that's more geographically equal. So this quarter, we had a lot of growth in North America and negative in Asia and flattish in EMEA.

That hurts our incremental profitability. So again, when the world gets back to equilibrium and our new product performance is getting us to, I'll call it the 8% to 10% organic growth, and it's coming around the world, we believe the 40% is still appropriate. For sure this year, short term, we have the issue around exchange and we have the fact that we're not growing quite as rapidly -- or lack of growth would probably be a better term -- in Asia Pacific and EMEA.

So near term, we're going to be significantly less than that 40%.

Walter Liptak - Global Hunter Securities, LLC - Analyst

Okay. Thanks for that. Looking at the contractor segment, you mentioned in the comments double-digit growth. It sounds like that's going to come from your efforts on the contractor side rather than the pro painter. Is that right?

Pat McHale - Graco Inc. - President and CEO

No, in the first quarter, pro-paint and home center both grew strong double digit. It was just that the home center grew faster. But our outlook for in the Americas for both of those segments is strong and we think that we'll do better in the regions in the last nine months than we did in the first nine months.

Walter Liptak - Global Hunter Securities, LLC - Analyst

Okay.

Pat McHale - Graco Inc. - President and CEO

Or excuse me -- the first three months.

Walter Liptak - Global Hunter Securities, LLC - Analyst

Okay. Thanks for that clarification. And in the process business, you know, the growth rate was -- volume price looked good, mid-single-digit, but it was a little bit of a slowdown from the big pickup you had in the fourth quarter.

I wonder is -- and what we're hearing from some other companies is capital projects pushing kind of generally in some markets because of currency or with the price of energy or whatever. I wonder if you just comment on what you're seeing from capital projects.



Pat McHale - Graco Inc. - President and CEO

Yes, you know, I've been doing a lot of traveling all over the place this year. And I would say that that's definitely a theme, especially outside of the US here. You know, other than a few selected areas, it doesn't seem like it's real dramatic. But definitely there's an impact there and there's a tendency for people to be pulling back. Oil and gas is the obvious one.

But you know, our exposure in oil and gas is still pretty small. We are exposed against a broad range of end markets and also a broad range of geographies. So it's a tough environment out there.

Brazil is very challenged. China, for sure, I think is still trying to sop up a bunch of excess capacity in certain end markets they had put in place when things were going hot and heavy here for a few years. So it's a challenging environment, but I didn't get the sense in all my travels that this is going to be a repeat of 2009.

Walter Liptak - Global Hunter Securities, LLC - Analyst

Okay, great. And then just a final one on the gain. I didn't think I heard you say what the gain was going to be in the second quarter for liquid finishing.

Jim Graner - Graco Inc. - CFO

So we still have some moving pieces on the true up that will come about in some of the expense category, so I think we'll -- we had \$422 million on the books from an asset point of view and we've got proceeds before these adjustment items of \$590 million. I'll let you get close on your own.

Walter Liptak - Global Hunter Securities, LLC - Analyst

Okay. All right, thank you.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - Goldman Sachs - Analyst

Apologies if I missed this. I missed the first couple minutes of the call. But can you just talk a little bit about the rationale for the resegmentation, whether there's any synergies associated with the new segments or really just more of a focus to grow that process segment?

Pat McHale - Graco Inc. - President and CEO

Well, we've changed a lot. Caroline had some opening comments on that. But from a business standpoint, we've changed a lot with the creation of a process division in early 2013 that we didn't have before.

We pulled that business out of our industrial group from a management perspective. It's got its own engineering team, its own commercial organization. Really trying to focus on growth in that space. That division has done some deals, so that business is getting bigger and more complex.

Then we also initiated our oil and gas business unit and we got two deals done there. We are working this year to build up our commercial organization, because we are going to launch organically developed product as well. So really, it was just time for us to take a look at what made sense.



From a management standpoint, the businesses will continue to run as they ran before. This is really an accounting exercise from a reporting standpoint, because we think that those businesses make more sense in a segment than they did the way we had them.

Joe Ritchie - *Goldman Sachs - Analyst*

And Pat, maybe just following up there. How do you think about the risk of getting into a new organic growth vertical, be it oil and gas and natural gas this point? And how do you think about the return hurdles and expected payback as you start to invest more into that vertical?

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

Yes, you know, if I look at Graco and I say look, we got a great machine and if we can get revenue in the top, we are going to make a lot of money. And we need some new places to go and apply our skill set.

So I'm excited about the fact that we're getting into new spaces. Our timing wasn't great in terms of the two deals that we did in oil and gas, if you just take a look at what we paid and then what happened in the marketplace.

On the other hand, they weren't big. They didn't break the bank. And the slowdown here in the end market, although it's going to be negative from a revenue standpoint, it's going to take us some time to get our manufacturing investments in place and to get the incremental sales force in place and identify some new product opportunities and do some of the things we want to do with these businesses.

So I don't anticipate that we're going to go out and be paying crazy prices for oil and gas assets right now. But I do think that the work that we're going to do over the next year or two to improve those businesses is going to be probably good timing for when the market comes back. So again, I tend not to look in reverse too much, just look forward. And I think it's going to be good in the long run.

Joe Ritchie - *Goldman Sachs - Analyst*

No, that's fair. I guess maybe following up on a comment you made earlier about Asia Pacific and the double-digit decline that you saw in China and Japan, can you give us any color on the verticals where you really saw weakness?

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

Well, you know, the large project spending in China was definitely soft, at least -- our billings to large projects in the first quarter was definitely soft. The economy over there still has a lot of activity, so it's not like it looks like it's dead, but there was a lot of capacity put in place. So I think that's just going to be a little bit challenging here, as it really has been, for them to use up that capacity with more production before they really need to start putting more CapEx in place.

Automotive sales over there are still okay, but you know, they did build capacity to build a lot of vehicles. So we got to watch that.

And ship building and aluminum profiles. And aluminum profiles are a big business for us and our powder business in China. And that is making trim and things that are used in the construction market. So as we see some domestic construction slowdown due to the big build in China, that business is impacted as well.

So yes, I think we just have to have a little patience there. But again, we are anticipating overall in Asia Pacific that we are going to have a much better finish to the year than we had start and that we are going to put up a positive organic growth number.

Jim Graner - *Graco Inc. - CFO*

Just a couple of points to add to that. We did have an increase in our backlog situation in China during the first quarter compared to the quarter the year before for about -- on our legacy business is about \$4 million or \$5 million. And if we were able to ship that, we would have had a flat kind of number there.

We are, as Pat mentioned earlier, putting in place a warehouse there and stocking of that warehouse, we believe, will help our growth prospects.

A little bit of disruption on the supply chain to that warehouse in the first quarter with the West Coast strike. So again, our team in Asia is expecting to have growth in the second quarter. In reviewing their numbers, they have some pretty good logic behind protecting growth in the second quarter. So hopefully, we'll move on from this low point and finish the year on a positive basis.

Joe Ritchie - *Goldman Sachs - Analyst*

That's helpful. Maybe one last comment on China. How is the pricing holding up today, given the environment has maybe been a little bit weaker to start the year? Are you seeing a little bit more competitive pressure and is FX impacting anything?

Jim Graner - *Graco Inc. - CFO*

It's been good. We actually put our price increase in place a month earlier than we normally do. We normally target February 1 in China. We moved it to the end of December.

As you might recall, we had a really nice finish to the year. Some of that, again, was driven by the fact that our distributors there are little bit more proactive in ordering ahead of the price change than they are in the rest of the world.

So in retrospect, we probably pulled a few million dollars worth of business into December that normally we would get in January. But the pricing is holding and as it is around the world, we feel good about our pricing and our ability to price year over year.

Joe Ritchie - *Goldman Sachs - Analyst*

All right, sounds good. Thanks, guys.

Operator

Liam Burke, Wunderlich Securities.

Liam Burke - *Wunderlich Securities, Inc. - Analyst*

Thank you. Pat, you talked about the various regions in the industrial segment. Could you shift over and talk about what product lines did well and didn't do well on the industrial business?

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

So when I looked at our performance in Asia Pacific, we had a couple of product lines that were better than others. But I'd say generally, in terms of our billings, they were soft across product categories. There wasn't, I wouldn't say, a bright shining star.

I'm feeling okay about global automotive, even though that China is little bit soft. I'm feeling good about that end market. I think aerospace is still going to hold up well. Construction markets here in the US, of course, are hot, but even in places like Southern Europe, in Spain, we are starting to see them creeping off the bottom.

Liam Burke - *Wunderlich Securities, Inc. - Analyst*

Now is the balance on new product introductions or is it just general end market improvement?

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

Are you talking about the US?

Liam Burke - *Wunderlich Securities, Inc. - Analyst*

Yes.

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

The US, it's both. Our contractor business, they've got a great track record of launching pretty exciting new products every year and they definitely get some incremental growth over that. But certainly, the construction market in US is continuing to strengthen and we are riding that wave.

Liam Burke - *Wunderlich Securities, Inc. - Analyst*

Great. Thank you.

Operator

(Operator Instructions) Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Sorry if I missed it. I know that there were questions asked about pricing. But if you can give any color from a price cost perspective on a per-segment basis, how things trended in 1Q.

And I would assume that that's going to be a gross margin benefit. How should we be thinking about price cost benefit to the margin for the coming quarters?

Jim Graner - *Graco Inc. - CFO*

Jim, our business model is still intact. So again, we are targeting 1.5 points of realized price increase. We are on our trajectory to meet that. Our mix is moving a little bit against this. I'll call it the lower featured units.

We are selling more of -- their rate of increase is a little bit greater than our higher-priced units. So that hurts us as well as the geographic mix, because in certain parts of the world, our prices are higher than the US. So the geographic mixes and product mix is hurting us.

On the cost side, we are getting favorable price exchanges. As you know, a big component of our input is stainless steel and copper and those costs are all moving favorable to us. So again, going back to our long-term model of a little bit of price every year and a flat cost manufacturing cost structure looks pretty solid for this year.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Got it, okay. And then on that mix, when historically we've talked about contractor margins and I know that it's come from the investor base and us asking hey, can you get back to previous peak margins in contractor.

But seeing that you are seeing a mix shift kind of headwind on the margin side there, one -- is the focus on the home center lower margin stuff, is that a strategic focus near term? If yes, why? And I guess second, how should we be thinking about the margin potential for the segment longer term?

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

So in terms of the folks at the organization up there, they are launching new products across a variety of categories. We are launching a lot of new products into the pro paint as well as into the home center market.

The home center has been a growth driver for us over the course of the last three or four years as we have been able to capture the major home center customers here in the US. We are pretty well positioned now, so it will be more challenging to put up big huge home center growth numbers if the underlying business isn't there. Because we've got shelf space everywhere.

From a strategic perspective, I like the home center business. It does a lot of good things, I think, for the organization, despite the fact that it's got lower profitability. It certainly has taught us a lot about how to manufacture and design products to hit lower price points in the market. And we can use that knowledge as we move up through our product line.

It also gives us volume and allows us to have component level quantities on some parts that can be shared across product lines that are much higher volume and more cost effective than they would be had we not had that business.

And really, finally, if somebody wants to try to attack our pro-business and we see the home center business and they have the ability to sell thousands of sprayers at lower price points in that market, it is likely only a matter of time before they expand their product range up. So there's a variety of reasons to be there, but I don't want anybody to think that we've lost our focus on the pro-business.

The pro-business is our bread-and-butter. And that's where we're launching all sorts of new products every year and actually doing very well.

Jim Graner - *Graco Inc. - CFO*

So just a couple additional points of clarification. Our pricing on the products is pretty equivalent -- or it is equivalent between the home center channel and the paint channel. It's just we sell more entry-level units in the home center channel.

We sell similar products in the paint channel and they are priced the same. So our gross margins generally increase as the features and functionality of those units increase.

So the other point I wanted to make that within the paint channel in North America, we've always guided to the fact that when the construction market got healthier, we would sell more of the big units. And they are the percentage of sales in that channel, I'll call it the largest units are increasing percentagewise at a faster rate than the middle and the lower priced units.

So the mix is changing in the paint channel back to more normal. The comparable issue here is that the fact that we've launched more and more entry-level products and that's changing our mix.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Got it. That's very helpful. Thank you.

Operator

Jim Krapfel, Morningstar.

Jim Krapfel - *Morningstar - Analyst*

So revenue growth has been consistently robust in the Americas region. But what do make of the more tepid growth in overseas markets really over the last three years, which appears to have underperformed in the regional economies, especially in light of the conversion opportunity in spray equipment? And is the competitive environment becoming more challenging in those markets?

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

So I'm going to hit region by region. Our performance in South America, I think, has been reflective of the underlying economies down there. Brazil, certainly, the last couple of years, has been a major headwind for us.

We are making progress in that geography in terms of market penetration with our contractor business building out channel and doing some end-user conversion. Again, it's a very small number and we have a long ways to go, but I see us making forward progress.

In Europe, I believe our business there has outperformed the economy. I mean the European, the Western European economy for several years has had really almost no economic growth. And if you take a look at our performance in the West, our performance in the West has pretty decent.

Certainly for the last year or so, Russia has offset a lot of our performance and sort of masked some good work that we are doing there. Asia Pacific has been, I'll say, a sore spot, particularly on the contractor side for us. We certainly are not meeting our own expectations in terms of market conversion. Our contractor sales in Asia Pacific -- not in every country, but in Asia Pacific as a region has been disappointing.

We have made some changes there. We have made some leadership changes in the contractor business. Those I would say are in their infancy here in terms of trying to see if those can have an impact.

We are doing some things on the product side. There definitely is more competition in China at the low end than there were a few years ago, but I think generally speaking, we feel that it's more of a Graco execution issue on our contractor business in Asia Pacific and that we need to get our act together.

Jim Krapfel - *Morningstar - Analyst*

Thanks for the color.

Operator

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

Pat McHale - Graco Inc. - President and CEO

All right. Thank you for everyone for joining us and we'll talk to you next quarter.

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.

©2015, Thomson Reuters. All Rights Reserved.

