

FINAL TRANSCRIPT

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GGG - Q2 2011 Graco Earnings Conference Call

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CORPORATE PARTICIPANTS

Caroline Chambers

Graco, Inc. - VP and Controller

Pat McHale

Graco, Inc. - President and CEO

Jim Graner

Graco, Inc. - CFO

Christian Rothe

Graco, Inc. - VP and Treasurer

CONFERENCE CALL PARTICIPANTS

Tom Brinkmann

BMO Capital Market - Analyst

Kevin Maczka

BB&T Capital Markets - Analyst

Chris Wiggins

Oppenheimer and Company - Analyst

Matt Summerville

Keybanc - Analyst

Eddie Suttle

Goldman Sachs - Analyst

Ryan Meyer

Robert W. Baird - Analyst

Marc Heilweil

Spectrum Advisory Services - Analyst

PRESENTATION

Operator

Good morning and welcome to the second quarter 2011 conference call for Graco, Inc. If you wish to access the replay for this call, you may do so by dialing 1-800-406-7325 within the United States or Canada. The dial-in number for the international callers is 303-590-3030. The conference ID is 4454163. The replay will be available through August 2, 2011.

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 provision of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as a result of various risk factors, including those identified in the item 1A and Exhibit 99 to the company's 2010 annual report on form 10K and in item 1A of the company's most recent quarterly report on form 10Q. These reports are available on the company's website at www.Graco.com and the SEC's website at www.SEC.gov.



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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.

(Operator instructions)

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

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

Good morning everyone. I'm here this morning with Pat McHale, Jim Graner and Christian Rothe. I'll provide some comments on the financial highlights of our second quarter, and Pat will follow with additional comments. Slides are available to accompany this call and can be accessed on our website. The slides include information about our consolidated financial results and each of the segments. After our opening comments, we will open up the call for your questions.

Sales increased by 22% for the quarter, including 4 percentage points from currency translation with strong growth in all segments and regions. Changes in translation rates also increased net earnings by \$4 million for this quarter. With the strengthening of the euro and various Asian currency against the US dollar for the quarter, I will provide some additional detail on effective translation by regions and by segment.

By regions, sales increased in the quarter by 14% in the Americas, 32% in Europe, or 21% at consistent translation rates, and 34% in Asia Pacific, or 27% at consistent translation rates.

When we look at the segments this quarter, sales increased in the industrial segment by 29%, or 24% at consistent translation rates. Contractor segment sales increased by 9%, or 6% at consistent translation rates. And the lubrication segment grew by 38%, or 34% at consistent exchange rates.

Gross profit margins were 56.5% for the quarter, up 3 percentage points from the prior year. A favorable effect of higher volume, translation, and selling price increases were slightly offset by higher material costs.

Operating expenses increased by \$11 million, including \$3 million related to transaction costs associated with the pending acquisition of ITW finishing businesses, and \$2 million related to the effect of currency translation.

Other increases in operating expense include headcount additions and product development and in Asia Pacific and Europe, as well as higher marketing and promotion costs.

The effective tax rate for the quarter was 32% compared to 35% last year, reflecting the federal R&D credit that was not available in 2010 until the fourth quarter. This rate is lower than our Q1 rate based on current estimates of profitability in our international subsidiaries and the effect of currency translation.

Year-to-date cash flow from operations was \$44 million compared to \$28 million last year. Our working capital requirements increased in line with our increasing volumes.

Accounts receivable have increased \$35 million year to date, with DSOs remaining stable. Inventories have increased by \$22 million year to date with support-- to support service level improvements and new product introductions.

Other primary uses of cash include capital expenditures of \$10 million and dividends of \$25 million year to date. The second \$150 million of the previously announced \$300 million long-term debt has been drawn in July in accordance with our credit agreement.

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A few other items to note --

We expect to see material cost pressures continue through the year at the same level that we saw during the second quarter. At this point, our factories have also largely met their target service levels and factory production levels are expected to be relatively in line with sales growth going forward.

Expenses associated with the pending acquisition are expected to be 2 to \$3 million in the third quarter, though timing of expenses will be affected by the timing of the review process. We expect that expense in total will be in the range of \$15 million for the transaction.

Interest expense for the third quarter is anticipated to be around \$3 million with the additional \$150 million of long-term debt that was drawn in July.

Based on the expected profitability of our international subsidiaries and the current exchange environment, we expect annualized tax rate to be approximately 33%.

With that, I'll turn the call over to Pat.

Pat McHale - Graco, Inc. - President and CEO

Thanks, Caroline. Good morning. I'll give a rundown of our Q2 performance by region and segment in a moment, but first I'd like to hit on a couple of points.

The first is a request for additional information from the FTC on our HSR application for the acquisition of the finishing businesses of ITW. As I'm sure you're aware, requests for additional information are relatively common in the current administration. Obviously, the scope and nature of the request from the FTC related to our application are varied and lengthy, but from our perspective, we would consider their questions to be as expected related to products and competitive conditions in our industry.

The legal teams for both Graco and ITW are working diligently to respond to these requests and are in frequent communication with the FTC to ensure that our responses are germane and precise.

We have received a number of inquiries from our investors for an update on our expected timing for the FTC to complete their review. Clearly I'm not in a position to answer that question. I can tell you, however, that we are expecting that Graco and ITW will fulfill their obligations to the FTC within the third quarter-- the earlier in the quarter the better-- and realistically, I don't expect that we'll have clarity on the FTC's positions until the fourth quarter.

We remain confident that we'll receive approval on this transaction, and as we get further in the process and where appropriate, we will issue updates.

Second matter I'd like to cover in my prepared comments is the performance of our contractor segment in the second quarter. I don't think that it's any surprise that the underlying economic environment for both residential and commercial construction in the US remains challenged. Domestic housing starts continue to skip along the bottom, as do existing home sales and commercial construction spending. The home remodeling market continues to be soft as well.

Worldwide, we have some bright spots, South America and Asia Pacific, and I've seen some modest improvements in residential construction in Europe.



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Contractor segment in year-over-year comps are challenged by last year's launch of our exciting new handheld product which represented about \$9 million in sales during the second quarter of 2010 and an additional \$12 million of sales in the third quarter of 2010.

Against that backdrop, our worldwide contractor business posted 9% growth year over year. When we break down the performance in the segment, we see nice double-digit organic growth in Europe and Asia and flat results year over year in the Americas.

Excluding the impact of the handheld, the propane channel in the Americas saw a high single-digit increase in base business, and the home standard saw a nice double-digit increase.

Regarding the handheld product, there was significant stocking of our handheld line that occurred in both the second and the third quarter of last year. As we finished out 2010 and entered 2011, we were expecting somewhat stronger out-the-door sales of the handhelds from our channel.

While the market acceptance has been good and revenue has been quite high compared to other important Graco product launches, the 2010 channel pipeline's build was overly optimistic. The reorder rate has lagged our plan for 2011 as the channel works off the excess. We are expecting channel inventory levels to stabilize later in Q3, and our sales should increase to match out-the-door sales. Currently we expect annual run rates in the handheld to be in the 25 to \$30 million range globally.

While contractors' top line was somewhat below my expectations for the quarter, we are well positioned for significant gains when the US market improves. We have difficult comps in contractor in the second half of the year, particularly in the third quarter, where we expect sales of the handheld to be lower than the third quarter of 2010's pipeline's build. And we expect the fundamentals to remain challenging for the near term.

Turning to my broader comments on the quarter, I'll begin with Europe. Revenue in Europe increased 32% versus the second quarter of 2010. As with the first quarter, sales increased at double-digit rates throughout the region and were strong across product groups. The developing countries in Eastern Europe, Russia, the Middle East and Africa, continue to be very strong.

As we've discussed before, we're investing significantly in our people and channels in these developing economies. Second quarter shows that those investments are providing a return. Our industrial business in Europe continues to show strength with growth of 33% compared to the second quarter of last year.

Contractor equipment sales in Europe were up 29% versus the second quarter of 2010. New products remain a good contributor in this region, and we're expecting a modest improvement in residential construction in the second half, while commercial construction will be flat to down.

Our core growth strategy in contractor Europe continues to be end-user conversion from manual application methods to equipment.

Lubrication posted the highest year-over-year growth in Europe, albeit from a small base. This growth was driven by some nice customer gains by our European team. Overall for Europe, we continue to be positive regarding our growth prospects for the second half of the year.

Switching to Asia Pacific, Asia Pacific remained Graco's strongest at 34% growth compared to the second quarter of 2010. We had double-digit increases in both developed and developing countries and across product categories. We remain bullish on our growth prospects in Asia Pacific.



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As highlighted in prior calls, we have a strong and ongoing program in place to add to our headcount, training, and customer support in Asia to capture growth throughout the region. These programs are working and should yield results for us both in the near term and well into the future.

Now on to the America's. Our industrial segment continued to perform well with solid double-digit growth in all major product categories. We're seeing strength in rail, truck and trailer, sanitary, energy, and industrial applications.

Residential insulating foam also remains a bright spot. The lubrication segment actually had the highest year-over-year revenue growth of all segments in North America in the second quarter.

As with the first quarter, growth was double digits in both our vehicle service channel and our industrial lube channel, with industrial lube growing faster. From an operating margin perspective, lube posted good year-over-year margin improvement but was 500 basis points below the first quarter of this year. We had expected some moderation from the Q1 operating margin performance due to a combination of a few non-reoccurring favorable events that we called out in Q1 plus our ongoing investments to grow the lube business. For the second half and the full year, we're expecting lube operating margins in the high teens.

Moving on to contractor, contractor sales in North America were flat year over year, as I explained earlier. Paint channel growth comparisons were impacted by the second quarter of 2010's launch of the handheld product. If you exclude handhelds, sales into the North American paint channel would have been up high single digits.

To the second quarter, we continue to see favorable mix between larger and smaller units that we called out in the Q1 conference call as a positive change for the segment. Call center sales were up double digit as we continue to benefit from the expansion in outlets. This should continue to help us through the remainder of 2011.

In Latin America, our total combined divisional sales grew more than 30% in the second quarter, reflecting continued strength in infrastructure, ag, and automotive.

Regarding our outlook, we remain positive on the general trends and the end markets in geographies that we serve worldwide. We expect that quarter-over-quarter year growth percentages will be lower as we're approaching and in many cases exceeding our pre-recession peaks and are coming up against tougher comps.

Incoming order rates for our industrial lubrication businesses worldwide are stable. We're anticipating normal seasonal order patterns in contractor. I'm excited about the opportunities in front of us for the second half of 2011.

Before turning the call back to the operator, I'd like to take a moment to underscore the commitment of all the Graco employees, and well as our board of directors, to creating sustainable shareholder value. I think that we've been pretty clear about our strategies to win. We're going to build out a solid global footprint. We're going to lead in new products, innovation, and technology. We're going to execute solidly in manufacturing and all support departments, and we're going to have outstanding sales and distribution coverage globally.

Through what's been a challenging economic environment, we remain confident in our plan as we continue to make long-term investments to drive profitable growth. While this approach does not necessarily maximize our performance during any given quarter, we believe these actions generate a very significant ROI for our shareholders, and we will continue to push these initiatives forward.

With that, I'll turn it back over to the operator so we can begin Q and A.



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QUESTIONS AND ANSWERS

Operator

Thank you. The question and answer session will begin at this time. (Operator instructions) Please stand by for our first question. Our first question comes from the line of Charles Brady with BMO Capital Markets. Please go ahead.

Tom Brinkmann - BMO Capital Market - Analyst

Good morning. This is actually Tom Brinkmann standing in for Charlie Brady. Just to clarify real quick, you talked about the dollar amount of contractor sales from the new handheld product from the second quarter 2010, but can you clarify what that was, the dollar amount in this quarter, second quarter '11?

Jim Graner - Graco, Inc. - CFO

It was in the \$6 million range, down from \$9 million in the comparable quarter the prior year.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. And now what is the total amount of product you have out there in the channel at this point? Can you estimate?

Pat McHale - Graco, Inc. - President and CEO

What we think is excess to what they would normally stock, we figure that we're probably looking at sometime early September when that would be, I'll call it, at a stable level, where if they sold a unit, they'd buy a unit.

Jim Graner - Graco, Inc. - CFO

So, again, that's with certain distributors, certain stores. So we still expect to have some level of handheld unit sales to other accounts and other models.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. And then, I guess, did you add any more home center outlets in the quarter?

Pat McHale - Graco, Inc. - President and CEO

We completed our store sets for in second quarter for our previously announced rollout through one of the big home centers, where we now have 1,700 stores, and we're in the middle of a [pre-store] set, a little bit different look in product selection in another partner, but I would say for the most part, what we got was probably fairly consistent with what you're going to see going forward for the balance of the year.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. Then switching over to, I guess, the cost side, cost and price mix, you talked about in your slides how, you know, material cost pressures are going to continue at the same level as in second quarter. But you also disclosed that the product cost, mix,

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and price had no net effect year over year. So I guess can you just sort of break down maybe the basis points you're getting from pricing versus the basis points of margin hit you're taking on costs?

Jim Graner - Graco, Inc. - CFO

I'll address it from a little bit different perspective. So our comments are with respect to the second quarter as compared to the first quarter. So we had roughly, let's say, a full percentage point decline in gross margins. That came about half from material costs and half from lower volumes through our factory.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. The 1% drop in gross margin you were talking about, I'm sorry, did you said it was quarter over quarter?

Jim Graner - Graco, Inc. - CFO

It's the second quarter versus the first quarter of 2011. So, again, the comparison where you referred to earlier is the 2011 versus 2010, and I think we're still ahead of the game price versus cost, or our numbers show that we're ahead of the game. We thought we should make a comment on the sequential decline. And--

Tom Brinkmann - BMO Capital Market - Analyst

Got you.

Jim Graner - Graco, Inc. - CFO

-- relative level of the insignificance.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. And what materials are you having the most inflation in? I guess, did you renegotiate some contracts there during the quarter, or I guess just for our understanding of how that's going to slide going forward.

Jim Graner - Graco, Inc. - CFO

Yes. So it's generally with respect to the metals that go into our materials. So it's stainless steel, aluminum, copper. For those we pay a surcharge, so we don't really renegotiate our contracts. A number of vendors give us a surcharge, and we think those surcharges, as mentioned, are going to be relatively consistent in the third quarter as they were in the second quarter.

Tom Brinkmann - BMO Capital Market - Analyst

Okay. Last question then. Could you just give us some guidance where to think about the corporate expense for the third quarter, please?

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Jim Graner - Graco, Inc. - CFO

Oh, sure. We tried to do that with respect to the acquisition costs. So we see them coming down about a million in the third quarter versus the second quarter. Mostly those are related to professional fees, due diligence, and the application through the FTC. Otherwise, we expect without those costs for them to be relatively flat.

Tom Brinkmann - BMO Capital Market - Analyst

Great. That's all I had. Thank you.

Operator

Thank you. Our next question comes from the line of Kevin Maczka with BB&T Capital Markets. Please go ahead.

Kevin Maczka - BB&T Capital Markets - Analyst

Good morning. I guess I appreciate the color on the contractor segment. But I do have a few more questions there. So I guess the first one -- so in North America, should we be expecting negative year-over-year growth in Q3 as this comparison for the channel fill gets even more difficult?

Jim Graner - Graco, Inc. - CFO

We don't think so, but it will be pretty similar to what we saw in the second quarter, so flattish with the respect to the total and the increase with respect to the, I'll call it, the continuing legacy products and a decline with respect to the handhelds. And that should be the end of our tough comparisons with respect to the handheld. We are expecting volume gains quarter over quarter going forward after the third quarter.

Kevin Maczka - BB&T Capital Markets - Analyst

Okay. And, Jim, you mentioned legacy products. Are you seeing anymore encouraging signs there in terms of a pick up in that business or should all the growth for the time being still be driven by new products and distribution and things like that?

Jim Graner - Graco, Inc. - CFO

No. I think we're seeing the growth that we saw in the first quarter. As Pat mentioned, without the handheld, our growth in North America Paint was up in the high single digits. And we're also seeing the continuing favorable mix to the bigger units. So we think that the end market is recovering without the corresponding recovery in the end markets, you know, home building and the commercial construction. So we're pleased with that, but we think the dynamics are there. When you look at, again, the positive impacts for the total business with respect to the handheld, the trend is favorable.

Kevin Maczka - BB&T Capital Markets - Analyst

And, Jim, can you talk a little bit about why was growth so strong in the rest of the world relative to North America? Do they not have the same timing of channel fill in terms of tough comparisons?

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Jim Graner - Graco, Inc. - CFO

Well, for one, we're launching the handheld geographically a little bit different, so they got a few million dollars of the handheld product impacting their businesses. Europe was launched late in the third quarter last year. Asia was launched in the first quarter this year. But even after you strip those out, again, the conversion efforts we're doing to convert people from manual to spray continue to bear fruit. The geographic expansion continues to bear fruit. Very strong percentages on a small dollar base in all of the emerging countries, so East Europe, Russia in particular, the developing countries in Asia, as well, and South America.

Kevin Maczka - BB&T Capital Markets - Analyst

And, Jim, why do you think the reorder rate was maybe lower than you might have expected? Is that just simply a function of allow the end market, or does it have something to do with some new competitive threat? Or can you just say a little bit more about why that might have been below expectation?

Pat McHale - Graco, Inc. - President and CEO

Yeah. We're not seeing anything on the competitive front that's changing our order rate. Really, it was a product that didn't exist before, and so when you've got something that's totally new, there's lots of question marks around how it's going to be received. And, you know, it has been received really well. We're talking about incremental 25 or \$30million for a product line, and those are pretty few and far between here at Graco.

So we're not disappointed with the overall amount. But in terms of where we thought we would be, it is less. I'm sure that the current market conditions are weighing on it just like they are our other product categories. The divisional teams do believe that the sales on this product category will accelerate as the US market comes back. But, again, I think it's just more of we didn't know what we were estimating, and we're off a little bit.

Kevin Maczka - BB&T Capital Markets - Analyst

Okay. Thanks. I'll get back in queue.

Operator

Thank you. Our next question comes from the line of Chris Wiggins with Oppenheimer and Company. Please go ahead.

Chris Wiggins - Oppenheimer and Company - Analyst

Hi. Good morning. If I could just revisit the price cost, are you comfortable that you'll be able to stick to your kind of annual January price increase this year? Or are you evaluating possibly having to do another price increase in the second half of the year?

Jim Graner - Graco, Inc. - CFO

No, again, as we tried to highlight here, the cost pressures are quite modest on the materials.

Chris Wiggins - Oppenheimer and Company - Analyst

Okay.



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Jim Graner - Graco, Inc. - CFO

But we're still favorable on pricing. We're starting to do our 2012 detailed plan executions, and all of the divisions are planning price increases and are all comfortable that the end market will be receptive.

Chris Wiggins - Oppenheimer and Company - Analyst

Okay. Great. And just wondering if you could provide any more color, or quantitatively speaking, as far as the discretionary growth investments you're making now in the quarter versus last year, and maybe some color outside of contractor on kind of where that money is going? Is it still, you know, focusing on distribution build in Europe or kind of the new products outside of contractor?

Pat McHale - Graco, Inc. - President and CEO

Yes, I think our investment in-- particularly in merging markets, but also in other areas in Europe and Asia has been on a relatively consistent path here the last few quarters. We are continuing to add a number of people in Europe and Asia, and that happens every quarter. I think we added about 15 people in Asia during the second quarter. And I think we're looking at something like 55 for the year. So I think that's sort of relatively straight-line kind of an increase throughout the last year and this year, and we expect to continue doing that as long as we believe that (A) we can get the people on board and then trained so that they're effective, and (B) that we're seeing a good return. It's been pretty positive for us the last two or three years, and we don't really see any major cracks in terms of the ability of those additional headcount resources to be able to go into those markets (inaudible) distribution and actually perform.

Chris Wiggins - Oppenheimer and Company - Analyst

Great, thanks. And then one last one, if I could. On the acquisition expense, you said 2 to \$3 million in the third quarter and you're expecting \$15 million. So I guess that means it leaves about \$9 million left over. Does that all hit in the fourth quarter, or is that spread out kind of fourth quarter and then some in 2012?

Jim Graner - Graco, Inc. - CFO

Well, our expectations are that we close in the fourth quarter. So we would expect all of those \$9 million to come in the fourth quarter.

Chris Wiggins - Oppenheimer and Company - Analyst

Okay. Great. Thank you.

Operator

Thank you. Our next question comes from the line of Matt Summerville with Keybanc. Please go ahead.

Matt Summerville - Keybanc - Analyst

Morning. Couple questions. Pat, you talked a little bit about the industrial business in terms of some of the areas you're seeing strength. Maybe can you hit on conversely areas of the industrial business where you're maybe not seeing strength, or where

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you've seen a change in trend either up or down in some of the end markets? And, specifically, can you speak to automotive in your comments there?

Pat McHale - Graco, Inc. - President and CEO

Yes, I'm watching North American automotive a little bit. It's not really clear what's happening there. I think there's enough uncertainty with the consumer right now that everybody ought to be watching that in the second half. You know, we are seeing still good investments in automotive facilities outside the Americas, and, of course, we're kind of tied to either model changeovers or big capital projects. So that might not coincide from a timing standpoint with anything that's happening in sort of pure production volumes.

From an end market standpoint, not seeing really any major differences. You know, things like boat building and RVs, particularly here in the US, still remain pretty weak. Things that are tightly associated with the construction housing markets, you know, window and door and some of the cabinet shops, are still a long ways down from where they were three or four years ago.

So I'm not seeing any major things to watch out for, other than maybe keeping an eye on automotive here in North America, and of course, it impacts our industrial business but, no, not dramatically. But, of course, there's some question marks going on about the construction markets in China and whether there's anything to worry about there. So I guess those would be the two things that are on my radar screen.

Matt Summerville - Keybanc - Analyst

If you look at some of the more significant emerging markets in which you participate, like China, have you seen a change in customer sentiment about their capital investments, either for the balance of 2011 or 2012? Are you seeing projects get pulled off the drawing board or delayed, deferred, anything like that at this point, Pat?

Pat McHale - Graco, Inc. - President and CEO

We have not at this point. You know, the smart people that write articles and post them out, there's a few of those folks out there that are expressing some concerns, particularly regarding maybe a real estate bubble in China and how that might flow through and impact the whole region. But when I take a look at what's happening with our order book, there's nothing showing up at this point.

Matt Summerville - Keybanc - Analyst

And then did you see reasonable linearity April, May, June, and thus far in July in your industrial order book? Or did you see any unusual level of volatility?

Jim Graner - Graco, Inc. - CFO

No. I think our trends are fairly flat. I mean, month over month is continuing on a flat line, small increases depending on certain geographies. So again in our outlook, we said we expect the continuation of existing trends, so no surprises.

Matt Summerville - Keybanc - Analyst

Great, thanks, Pat, and thanks, Jim.



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Operator

Thank you. Our next question comes from the line of [Eddie Suttle] with Goldman Sachs. Please go ahead.

Eddie Suttle - *Goldman Sachs - Analyst*

Thank you and good morning. I just wanted to ask a question with respect to volume leverage in the second half. With the slowdown, albeit mostly from more difficult comps, how do you see kind of volume levering in the second half relative to what we saw in the first half?

Jim Graner - *Graco, Inc. - CFO*

Well, if you look at our slides that accompany the presentations, we break down the volume leverage really on the two separate lines. One was on the manufacturing cost, in particular on unabsorbed burden, and that we expect to continue slightly -- at a slightly less favorable. In other words, our factories are performing, and we expect them to continue to perform at the same level. But we were ramping up production in the second half of last year as well.

We'll continue to get some leverage on the operating expense. But as Pat mentioned, we do have some incremental investments going out and our volume growth won't be as large percentage-wise as we reported, especially in the first quarter.

Eddie Suttle - *Goldman Sachs - Analyst*

Okay. And then just one question with respect to contractor. You guys obviously mentioned that the construction markets are a bit weaker. Back-half growth, just thinking about that, that's-- would it be wrong to think about that as a mid-single-digit-type organic growth area for Graco?

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

No, we're short cycle, so it's hard to say. You know, we did that mid to high-single-digit here through the first half on what we would call base business stripping out the impact of new product. So I think that is a reasonable projection. Hopefully we can do a little bit better than that, but I think it's kind of an unknown at this point.

Jim Graner - *Graco, Inc. - CFO*

And again, I think, Eddie, if you look at our business and our history of business and growth outside of North America, we've been fairly consistent at significant double-digit growth, and we expect that to continue.

Eddie Suttle - *Goldman Sachs - Analyst*

Fair enough. And then, just lastly, moving on to the comment on price cost, your pricing, the surcharges that you have, the contracts, how long do those last? Because I would imagine that the fall-off in commodity prices, call it in the last month or two, should have a positive impact on margins going forward. But it seems-- you guys seem to indicate that that's not the case. Maybe it's a timing issue, but I just wanted to get a sense of the length of those contracts.

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Jim Graner - Graco, Inc. - CFO

Yes, those are really reset quarterly. But we did see and we are recognizing the drop-off in certain commodities, and that's factored into our guidance, that we're not expecting to see any bigger cost pressures in the third quarter than we saw in this quarter.

Eddie Suttle - Goldman Sachs - Analyst

Fair enough. Okay. Thank you very much.

Operator

Thank you. Our next question comes from the line of [Brian Meyer] with Robert W. Baird. Please go ahead.

Ryan Meyer - Robert W. Baird - Analyst

Hey. Good morning, guys. Just a few here. You know, first off on the margin profile, with the industrial margin this quarter closer to 35, last quarter 36 and change, it sounds like, based on what you've said, that kind of at the current volume level, your expectations at the 2Q number is more representative of the run rate going forward. Is that a fair characterization?

Jim Graner - Graco, Inc. - CFO

Yes, again, we're talking one percentage point difference in-- I'm not saying it's not going to bounce around up or down, but for sure I think that's a good number for the year.

Ryan Meyer - Robert W. Baird - Analyst

Okay. And then I guess next on contractor, in trying to strip out here the impact of the handheld, would you view the seasonality in North America as fairly normal in the legacy business from 1Q to 2Q?

Pat McHale - Graco, Inc. - President and CEO

Yeah. I would say. I mean, it's hard to figure out what normal is anymore. I've got to look back so many years to see normal now. But my view is it's reasonably normal.

Ryan Meyer - Robert W. Baird - Analyst

Okay. Great. And then I guess one last one. You know, we've seen obviously a very impressive wave of new product launches here in the last 12 months. I'm just curious if you guys have an update on, you know, what's brewing for the next 12?

Pat McHale - Graco, Inc. - President and CEO

Yes, we feel good about what we've got in the pipeline really across the different divisions. We'll be launching products, I would say, on a staggered basis throughout the year into next year. We used to do all of our contractor product launches at the beginning of the year, but as the business has changed and become more global and we focused on more products that are truly incremental versus the upgrade projects, even those have been spread out.

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So I feel pretty good about it, and we ramped our investment up from that \$32million kind of annual run rate and product development up to the 40, and I'm comfortable with where we're at. We should do around that \$40million number this year, and I think that's going to be reflected in both the quantity and the impact that the new products are going to have.

So that's part of why I feel good about what we've got going in the second half. We've got new people on the ground. They're setting up new distributors. The emerging markets look good, and we'll continue to launch new products.

Ryan Meyer - *Robert W. Baird - Analyst*

Sounds good, guys. That's all I had. Thanks a lot.

Operator

Thank you. (Operator instructions)

Our next question comes from the line of Marc Heilweil with Spectrum Advisory Services. Please go ahead.

Marc Heilweil - *Spectrum Advisory Services - Analyst*

Good morning, guys. Thanks for the good work. I have a question about intellectual property. Has your more vigorous entry into the Asian market encountered any problem with protecting your intellectual property yet?

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

You know, I see that as--

Marc Heilweil - *Spectrum Advisory Services - Analyst*

Your ability to protect it generally?

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

Yes, I see that as an ongoing challenge for us, but I would say it's nothing really new. You know, we were in Asia pretty early. We were in Japan way back in the sixties, and we've been in Korea for a long, long time. And we've got-- we already have some copiers out there, and so we'll probably see some more of that.

One of the things that has held pretty true during my 21 years here at Graco is the people that have knocked off some of our products, they generally don't get to be very big. They end up being, you know, a 2 or \$3million company serving the local geography but not really with any ability to penetrate any significant international markets and generate the kind of volumes that would really put pressure on us. Plus, if they try to get into the major markets where IP can be defended more successfully than it can be in some of the emerging markets, we can get them shut down pretty fast.

So I'm not overly concerned about it. I think the best way for us to compete is to make sure that we're moving our product line forward and that we're developing new technologies. I think that makes it more difficult for the small copiers to get set up.

The other thing we've got is we've got a really nice channel. And somebody can develop a new widget, but if they can't get it to market, it's really difficult for them to get a good return on that. So, again, we haven't seen really a lot on that front either.



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Marc Heilweil - *Spectrum Advisory Services - Analyst*

You don't have to answer this question if you don't want to, but understanding that you expect the finishing business deal to go through, do you have a contingency plan since you've already begun the financing of it, if for some reason it is stopped in terms of what you would do with the notes or the cash that you've gotten to do the deal?

Jim Graner - *Graco, Inc. - CFO*

Oh, you know, there's two parts to that. One, we started the financing before this transaction was concluded and agreed to, so we're very comfortable that the financing we've got will prove to be at favorable rates over the up-to-15-year term that we've got in place. We think it's a really low cost of capital for us.

Our teams have other targets. While they're not of the size of the ITW finishing business, we have some other actionable targets. And then, of course, share repurchase is always a third option.

Marc Heilweil - *Spectrum Advisory Services - Analyst*

Sure. No, I agree the financing is terrific. Thank you very much.

Jim Graner - *Graco, Inc. - CFO*

Thank you.

Operator

Thank you. And I'm showing 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. Thank you very much for your participation this morning, and we'll talk to you again next quarter if not before. Thanks.

Operator

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

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