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Conference Call Transcript

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PRESENTATION

Operator

Welcome to the RPM International conference call for the fiscal 2010 second quarter. Today's call is being recorded. This call is also being webcast and can be accessed live or replayed on the RPM website at www.rpminc.com. Comments made on this call may include forward-looking statements based on current expectations that involve risks and uncertainties, which could cause actual results to be materially different. For more information on these risks and uncertainties, please review RPM's reports filed with the SEC.

During this conference call references may be made to non-GAAP financial measures. To assist you in understanding these non-GAAP terms, RPM has posted reconciliations to the most directly comparable GAAP financial measures on the RPM website. Following today's presentation there will be a question-and-answer session, at which time if you wish to ask a question, you'll need to press star, then one on your telephone.

At this time I would now like to turn the call over to RPM's chairman and CEO, Mr. Frank Sullivan, for opening remarks. Please go ahead, sir.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you, Jasmine, and good morning. Welcome to RPM International, Inc.'s second quarter conference call for the period ended November 30, 2009. We are pleased with the results of our second quarter, which are ahead of our internal plan through a combination of the impact of the prior-year's expense reductions, related improvements in manufacturing efficiency, better product mix, and relief from the prior-year's record raw material costs. These elements resulted in a record second quarter net income performance. We also generated record levels of after-tax cash from operations in the quarter and year to date.

There are a number of elements underlying our relatively strong performance, despite continuing economic challenges. Many of our industrial businesses are more diversified in terms of market segments served and their geographic presence. This has allowed these business units to perform better than during past recessions. For instance, our Carboline subsidiary is manufacturing and selling products today in new European markets, India and China, and serving a much broader customer and market base than existed seven years ago. The same is broadly true in our expanding global leadership in polymer flooring with our Stonhard, RPM/Belgium and Flowcrete business units. While these businesses serving principally -- while those businesses serving principally North American new construction markets remain significantly under pressure, it does appear as if our OEM-related businesses, for instance, product areas including fluorescent color, powder coatings, marine coatings and wood finishes, have hit bottom and are beginning to generate positive year-over-year growth in sales and earnings from the depressed levels of last year.

Our consumer segment performance is a combination of positive unit growth in our small project paint, sealant and patch and repair markets, driven by a pickup in housing turnover and a focus on weatherization, as well as excellent execution and a return to a focus on market and customers after aggressively addressing internal cost structure last year. For example, new products such as Universal, which was introduced last year, are starting to take off. The same is true of DAP 3.0. The Rust-Oleum 2X spray paint product has been one of our strongest new product introductions and we are very excited about the recently-introduced new countertop finish product line. We are regaining share in specialty paint primers in a number of major accounts and are taking share in retail automotive chains. These are just a few examples of how we are generating relatively strong earnings despite the continuing economic uncertainty.

I would now like to turn the call over to Kelly Tompkins, RPM's executive vice president and chief financial officer to provide you with some of the details of our second quarter, after which we'll take your questions.

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Thanks, Frank. Good morning, everyone. Happy New Year. We'll look at the second quarter in some detail. I have a few comments on our year-to-date numbers and then I'll turn it back to Frank for some closing remarks before we take your questions. Looking at second quarter sales, down 3.5% quarter over quarter, unit volume declined 7.1%. Although our consumer segment experienced positive year-over-year growth, it was not enough to offset the as-expected top-line pressure that we had in our industrial segment. Favorable foreign exchange of 2.2% during the quarter, due to weakening of the dollar against the Euro and the Canadian dollar, partially offset these volume declines. Acquisitions in our industrial segment, combined with prior-period price increases in both segments, contributed 1.4% of the quarter-over-quarter revenue growth.

Looking at the industrial segment, net sales of $613.5 million, which accounts for approximately 71.4% of total sales, declined 6% from last year, largely driven by volume declines of 9.8%. Favorable foreign exchange of 2.5%, combined with acquisitions and prior-period price increases of 1% and 0.3%, respectively, partially offset these volume declines. In the consumer segment, net sales of $245.2 million improved 3.3% year over year, with foreign exchange contributing 1.5% and prior-period price increases, coupled with favorable unit volume, contributing 1.8%.

Looking at consolidated gross margins of 42.3% on the quarter, up 220-basis points from 40.1% last year, due to more stable raw material costs and to a lesser extent prior-period price increases. Looking at the segments, industrial gross profit of 43.5% increased 120-basis points from 42.3% last year, due primarily to -- excuse me -- more stable raw material costs. In the consumer segment, gross profit of 39.4% increased 550-basis points from 33.9% last year, due to more stable raw material costs, improved plant operating leverage attributable to last year's cost reduction efforts, and favorable product mix. It is worth noting, though, in our consumer segment the gross margins are still down from their historical peak of around 43%-plus in the 2004-2005 time period.

Looking at SG&A as a percent of sales, SG&A increased slightly to 31.5% from 31.4% last year, due to lower sales volumes. However, in absolute dollars, SG&A decreased $8.6 million, or 3.1% year over year. Industrial segment SG&A as a percent of sales remained flat at 31.4%, even with the 6% decline in sales, due primarily to the cost reductions last year and as well, in absolute dollars SG&A decreased $12.9 million, or 6.3% year over year. Consumer segment SG&A as a percent of net sales decreased to 26.4% from 27.3% last year on higher sales and an overall lower cost structure. Corporate/other expense increased year over year to $13.2 million from last year's $8.9 million, due primarily to higher pension and compensation costs this year, as well as a gain on early debt redemption last year.

Looking at EBIT, EBIT dollars and margins increased to $92.9 million, or 10.8% of net sales this year, from $77.7 million, or 8.7% of net sales last year, due principally to higher sales in consumer, improved gross margins in both segments and prior-year cost reductions. Industrial segment EBIT increased from $71 million, or 10.9% of net sales, to $74.2 million, or 12.1% of net sales, due to improved gross margins based on raw material cost stabilization, as well as lower SG&A expense. Consumer segment EBIT increased from $15.6 million, or 6.6% of net sales, to $31.8

million, or 13% of net sales, due to improved absorption on higher sales, more stable raw material costs, and an overall lower SG&A cost structure.

Interest expense decreased from $15.2 million last year to $14.7 million this year on lower average borrowings, slightly offset by higher average interest rate of 6.3% compared to 6% last year. With the new $300 million, 6.125% bond that we issued in October, substantially all of our outstanding debt at November 30 is fixed.

Our tax rate for the -- effective rate for the quarter of 30.3% was slightly better than the effective rate last year of 30.9%, due to the overall jurisdictional mix of income from our foreign subsidiaries. Net income of $55.9 million, or $0.43 a share, improved over the same period last year of $41.7 million, or $0.33 a share. On a year-to-date basis sales decreased 5.4%, with unit volume down 5.8%, as the consumer segment's positive year-over-year growth, again, has not offset completely the top-line pressure that we've experienced in our larger industrial segment. Unfavorable FX of 1% year to date, due to the overall strengthening of the dollar primarily against the Euro, contributed to the decline. Acquisitions in our industrial segment, combined with prior-period price increases in both segments of 1.4%, partially offset the overall decline.

Gross profit margins, year to date, at 42.7%, up 220-basis points from 40.5% last year, due to more stable raw material costs, improved operating leverage due to last year's cost-reduction initiatives, favorable product mix, and to a lesser extent prior-period price increases. SG&A on a consolidated basis increased slightly to 30.7% from 30.4% last year, driven primarily from overall sales decline. In absolute dollars, however, SG&A declined $28.2 million, or 4.9% year over year. EBIT year to date increased to $213.5 million, or 12% of net sales this year, from $188.6 million, or 10.1% of sales last year, due to the improved sales in the consumer segment, gross margin improvement in both segments, and prior-year cost reductions.

A few comments on the balance sheet and cash flow. Looking at our asbestos cash costs for the quarter, were $18.9 million. $11.3 million of that related to indemnity or settlement costs and $7.6 million for defense costs. This compares to total payments of $16.4 million last year, with $10.3 million for indemnity, and $6.1 million for defense. As of November 30, we had a total of 10,531 active cases compared to 10,048 cases at the same period last year, with new case filings for the quarter of 493 versus 473 filings in last-year's second quarter. Our overall accrual for asbestos liability stands at $452.8 million. CapEx year to date at $8.3 million compares to $24.9 million during the same period last year, with, again, a full-year CapEx budget for this fiscal year of approximately $25 million. Depreciation and amortization combined on a year-to-date basis was $42.2 million, slightly lower than last-year's $43.4 million.

Accounts receivable DSO was relatively flat on a year-over-year basis at about 57 days. Days of inventory decreased about 4.4 days year over year, primarily to sales volume increases in our consumer segment and tighter inventory controls across both businesses. Cash flow from operating activities for the six months provided $184.7 million compared to $104 million last year, a 77.5% improvement year over year, largely attributable to not only higher net earnings, but as well balance sheet accrual changes, including compensation and benefits, accrued loss reserves and other accrued liabilities. Free cash flow, which is essentially cash from operating activities less CapEx and dividends, was $124.2 million compared to $28.7 million last year.

Wrapping up with some comments on our overall capital structure and liquidity, total debt at November 30 stood at $906.2 million compared to $962.6 million last year, for a total reduction of $56.4 million. Our net debt to cap ratio stands at 29.7% compared to 40.3% last year, and overall long-term liquidity at the end of the quarter at $854 million, with $364 million of that in cash and $490 million available through our committed bank revolver and AR facility.

So with those comments, I'll turn it back to Frank and look forward to your questions.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you, Kelly. Given the continuing economic challenges on a global basis, our outlook remains cautiously optimistic. While our consumer businesses should continue to show modest revenue growth and related earnings recovery, in general we will not be able to continue to generate positive earnings growth in our industrial segment in the face of continuing revenue declines. While we are seeing stability and positive signs across a number of our industrial businesses, those business units involved in North American new construction and in some cases, major North American capital spending, are still under pressure. We expect these business units to remain challenged for most all of calendar 2010.

Additionally, our second-half results will be burdened somewhat by the rebuilding of a number of balance sheet accruals related to benefits, such as higher pension costs and higher compensation expense, as the impact of last-year's compensation expense was dramatically lowered, due to the appropriate reduction or elimination in year-end bonuses, near-term and long-term -- and near-term and long-term equity incentive programs.

Having said that, our second quarter performance and cautious outlook make us comfortable increasing our guidance for the full fiscal year ending May 31, 2010 to a range of $1.30 to $1.45 per share. Lastly, with record levels of liquidity and a solid long-term fixed rate capital structure, we are in a very good position to resume a more aggressive approach to acquisition growth.

We would now be pleased to answer any questions that you have on our second-quarter results or our outlook for the balance of our 2010 fiscal year.

QUESTION AND ANSWER

Operator

(Operator Instructions). Your first question comes from the line of Jeff Zekauskas. Please proceed.

Silke Kueck - ***JPMorgan - Analyst***

Good morning. This is Silke Kueck for Jeff. How are you?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Good morning, Silke.

Silke Kueck - ***JPMorgan - Analyst***

A couple of questions. On the consumer side, the sales were up about 3% and operating profit about doubled and can you explain that? How you did that or maybe just talk about the larger components if you think about market share gains, new product introductions, cost savings, raw materials? Can you put some dollar numbers around that?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

I don't know that we can put dollars around it, but, our gross profit is improved from peak levels of raw material costs a year ago, in part through some price increases and in part through drops in raw material costs. As Kelly commented, we are still far below a normalized gross profit in that segment, which is in the low to mid 40s, so we would hope for some more recovery there down the road. We are gaining market share, both through the introduction of new products. Rust-Oleum 2X has been a big hit in the spray paint area. We've introduced a new countertop coating system, which is actually very exciting and doing quite well. We're picking up market share across many parts of the automotive retail chain.

And I guess the other two comments are both a function of just the relative easier comparison to last-year's very depressed results versus the prior year, going two years back, as well as the impact of our cost reduction activities, part of which were at the factory level. And so you're seeing part of the gross profit improvement a combination of mix, particularly at Rust-Oleum, where we got out of a service-related business, as well as better product mix and greater manufacturing efficiencies. So it's a combination of all those, but also in comparison to weaker comparative results from the prior year.

Silke Kueck - ***JPMorgan - Analyst***

And second as a follow up, in terms of raw materials, the comments about raw materials costs being stable, instead a comment on a sequential basis and are raw materials, in fact, on a year-over-year basis still lower?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Raw materials, as we speak today, are lower than they were at peak levels, but they're about where they were before last summer. So I think you're looking at more stable raw material costs versus a year, year-and-a-half ago, and still, as you know, we've been fighting a cyclical raw material increase trend for a number of reasons for the last five or so years, and while we're pleased with some of the margin recovery we're not nearly back to where we were five years ago.

Silke Kueck - ***JPMorgan - Analyst***

And then last question, the -- what is the magnitude of the higher pension and compensation expense in the fiscal second half?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Silke, it's Kelly. We're looking at about $7 million on a full-year basis of incremental pensions -- pension costs.

Silke Kueck - ***JPMorgan - Analyst***

And half of that was absorbed in the second half already?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Yes.

Silke Kueck - ***JPMorgan - Analyst***

Okay, thanks very much.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your next question comes from the line of Saul Ludwig with KeyBanc. Please proceed.

Saul Ludwig - ***KeyBanc - Analyst***

Good morning.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Good morning, Saul.

Saul Ludwig - ***KeyBanc - Analyst***

Kelly, what was the unit and price mix in the consumer segment? You lumped it, I think, at 1.8%, but what were the pieces and parts?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Yes, in the, in the quarter unit volume was up just over about 0.2% and price about 1.5%, but on a year-to-date basis, Saul, unit volume really dwarfs price in terms of contribution on about a four-to-one basis.

Saul Ludwig - ***KeyBanc - Analyst***

Right, I remember you had a very, very strong first quarter and at the time, Frank commented that you wouldn't expect that to repeat.

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

That's right. The other thing to keep in mind, Saul, is that we had an at-home services business at Rust-Oleum for a period of four or five years and we discontinued that last year and so comparatively, the revenues are gone.

Saul Ludwig - ***KeyBanc - Analyst***

Okay.

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

So you when look the --

Saul Ludwig - ***KeyBanc - Analyst***

Wonder if you could put some color around the new products and the share gains that you alluded to -- that's very exciting to hear about that, or a continuation of that momentum -- and I know last year -- if we go back a couple years ago there was a period of time where you guys really intensified your advertising spending and promotion spending to promote what was, at that time, new products and then last year you kind of cooled it on the promotion and ad spending. And what are you doing this year in terms of advertising and promotion with these new products, so it's a combination new products and spending related to promoting your brands?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Sure, Saul. Our -- I think a lot of our advertising related to a real ramp up, particularly in our consumer businesses, new product introductions. As you know, we were very excited about the 3.0 new product introduction at DAP and the Universal product introduction at Rust-Oleum. A number of other new products were in the pipeline and we started spending against that. That is we were spending into what turned out to be a pretty horrific recession, so we cut back most of that ad spending a year ago in face of the challenges, but that is going to be coming back and you'll see our spending coming back in that area. In terms of product categories, we are picking up share at automotive retail, we're regaining share in paint primers and we are picking up shelf space through new product introductions, which truly are new products, but they're going on additional shelf space, as opposed to cannibalizing existing shelf space.

Saul Ludwig - ***KeyBanc - Analyst***

Okay, that sounds great. And then, Kelly, what should we think about for interest expense, given the new financing in the third and fourth quarters?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Yes. Well, Saul, we're looking at interest expense for the full year at about $60 million for this year.

Saul Ludwig - ***KeyBanc - Analyst***

And you had, what, about $7 million -- $27 million so far?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Right. Yes, and that's -- again, with virtually 99% of our debt fixed at this point that's a pretty comfortable number to work with.

Saul Ludwig - ***KeyBanc - Analyst***

And how should we think about the tax rate?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

You know, it's -- as we allude every call it really so depends, Saul, on the jurisdictional mix of income, particularly contribution, positively or negatively from our foreign subs, but I think still looking at somewhere in that 31%, 31.5% rate, but it's really highly dependent on each quarter's mix of business.

Saul Ludwig - ***KeyBanc - Analyst***

And then just finally, you've made these acquisitions in Europe -- illbruck and Star Maling, some of these companies that you bought -- how is the pulse of business in Europe changing at all? Any inflection you're seeing there?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Yes. The UK, which went into the tank at the same time or a little bit before the U.S. and went a little bit harder has flattened out and we're starting to see some positive results in what's a larger UK base of business through some acquisitions that we've done in our consumer segment over the last couple of years, as well as our existing industrial businesses and so we're starting to see year-over-year improvement there. Again, to an earlier comment, much of that is just the result of starting to annualize weaker comps. Because of the impact of building envelope, weatherization issues that you read a lot about here, what are more related to actual building codes in Europe, in particular, our Tremco illbruck business has fought through this challenging economy in Europe with better performance than the underlying economic conditions and so we're in pretty good shape there. And then in developing countries, whether it's South Africa, where we've got a pretty nice Carboline presence; India; Latin America or China, while not big for us it's growing and all of those geographies have remained positive throughout this whole period.

Saul Ludwig - ***KeyBanc - Analyst***

Great, thank you very much, guys.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you, Saul.

Operator

Your next question comes from the line of Daniel Rizzo with Sidoti & Company. Please proceed.

Daniel Rizzo - ***Sidoti & Company - Analyst***

Hi, guys. I was just going through -- you mentioned the asbestos costs for the quarter, is that trending like you thought it would, or is it happening faster in terms of the expenses?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

It's trending as we expect. You'll note at the beginning of the year we increased our current liability reserve to about $75 million. We had commented earlier that we are in the middle of some changes there in terms of how we're handling defense and we believe that that's going to have a positive effect going forward, but it is pretty much right on target with what we expect.

Daniel Rizzo - ***Sidoti & Company - Analyst***

For the long term, for the ten to 20 years?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

That's correct, and also for this year.

Daniel Rizzo - ***Sidoti & Company - Analyst***

Okay. And you were mentioning -- you were talking about acquisitions into the different regions of the world, is there a particular region you're looking at for acquisitions like Western Europe, or Asia or whatever?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

As you know, acquisitions are opportunistic. We're looking much more aggressively, both in North America and throughout the rest of the world. Of that cash level that Kelly talked about, the vast majority of that is outside of the United States and so we've got $300 million plus of very low earning cash, which is pooled in Europe and pooled in Canada, which would be nice capital on an incremental basis in terms of basically taking capital that's earning little or nothing and putting it to work in acquisition activities. So I would expect to see some more European transactions in the next six months or so and we will continue to be on the lookout for acquisitions that, again, fit our criteria of product lines or freestanding businesses in the, let's say, $5 million to $200 million range.

Daniel Rizzo - ***Sidoti & Company - Analyst***

I think you said in the past that during the recession or during the deep part of the recession, people weren't willing to sell at the bottom. Are you finding that people are more approachable now and that evaluations are still relatively attractive?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Yes, I think that acquisition activity is starting to loosen up. I think in the past year, the two biggest factors that really halted the M&A markets were a combination of the lack of bank financing, as well as companies that had capital hoarding it and I think our $850 million plus liquidity is an example of that, as well as earnings being so unstable and declining that sellers were unwilling to sell their business on what they perceive to be, if not historic, at least decade low levels of earnings. That's changing for a lot of reasons. There's more stability in earnings, there's better outlook. I don't know that the capital markets have freed up a lot, but companies that do have liquidity are willing to put it to use and we are one of those. And I also think people have a greater sense of how quickly value and deeply value can be destroyed in a private business. And lastly, we would expect to see 2010 to be a very interesting year in North America in light of expectations of private company sellers of potential tax increases across capital gains and personal income tax, which may drive more private company transactions.

Daniel Rizzo - ***Sidoti & Company - Analyst***

Okay and final question. You may have already touched on this, but what are your assumptions for gross margin going forward in terms of your guidance? Are you expecting raw materials to remain flat, or are you looking for an increase?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Raw materials are relatively stable right now, but oil prices have been trending up and there are efforts by major raw material suppliers in some cases, particularly given their consolidation, which is an interesting issue, at trying to raise prices where they can. Those efforts so far have been unsuccessful, but I think the decline in raw material costs that we've experienced is over and so we would expect for the balance of the year for raw materials to remain relatively stable at their current levels.

Daniel Rizzo - ***Sidoti & Company - Analyst***

Okay. All right, thank you.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your next question comes from the line of Kevin McCarthy with Banc of America-Merrill Lynch. Please proceed.

Alek Yefremov - ***Banc of America-Merrill Lynch - Analyst***

Good morning, this is Alek Yefremov for Kevin. Question about automotive accounts. You mentioned that you're gaining market share there, maybe can you tell us a little bit about how you are able to do that and what's driving those gains?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

In the small project paint area and the spray paint area I think it really is hats off to our Rust-Oleum team. They're very innovative, good marketers. They've used a lot of consumer research and have applied that to the automotive channel. We've been working on gaining share there for some time. Our Testor subsidiary is also now part of our Rust-Oleum group, so we really have within the same hands of the same people the ability to go at these major markets or customers in the automotive chain with spray paint, with quarter-ounce jars and small container touch-up paint, and then also brush-on goods. And so it's been -- it's really been a multi-year effort and I think a combination of being able to bring a full line of both the very small container brush-on touch-up paint, as well as a full line of spray paint. And if you go into the two largest automotive chains you'll find a very nice setup of Rust-Oleum-branded products there, which did not exist two or three years ago.

Alek Yefremov - ***Banc of America-Merrill Lynch - Analyst***

Great, thank you, and another question about consumer. You talked about new product, countertop finish product line; maybe can you talk a little bit about that product line and what other new products you have in the pipeline that you can tell us about now?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Sure. We've been working for some years on -- as I mentioned relative to an earlier comment, on really perking up our new product pipeline and then putting ad spending behind it. That effort got interrupted by the last 15 or 18 months, but this new countertop product is something we're very excited about, our major accounts are very excited about, and basically it's a kit that would sell for about $250, I think, $300, I don't have exactly the right price, but it's amazing that you can put a kit of that price into the paint aisle of our major customers. And basically it allows people to refinish a beat-up old countertop, a Formica top, something that is beat up and needs some refurbishment and for a few hundred bucks can make a countertop look like granite. And we've got a number of products coming down the pike related to those types of areas, which we're excited about, as are our major customers because it will allow homeowners and smaller contractors to really do kitchen and bath fix-ups. And it's our belief that people still have a desire to make things look new and fix them up.

But we're still a few years away from the $25,000 and $50,000 kitchen and bath renovations, and so to the extent that we can come out with products that will help people make certain areas in those categories look like new again or refurbish them, we're really excited about it and the

initial introduction in the countertop product was a big success. It was just introduced in the last couple months, so we'll have to see how that continues. But both the introduction and the takeaway initially have been quite strong.

Alek Yefremov - ***Banc of America-Merrill Lynch - Analyst***

Can you give us some numbers around the -- maybe sales targets or potential market?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

It's really too new and we, really historically, have not broken out individual product line sales, but it's something that we'll be happy to comment on in coming quarters as we get a better sense of the success of this and the takeaway and what the real legs are on that. But it's, again, a tribute to our Rust-Oleum folks. I believe this will be the first multi-$100 kit in the paint aisle and so, on the one hand, that's pretty challenging and exciting. On the other hand, if we could do something during these interesting times spending wise that can make countertops look like new without somebody having to spend $5,000 or $10,000 on new granite, that's also pretty exciting.

Alek Yefremov - ***Banc of America-Merrill Lynch - Analyst***

Great. Thanks a lot, Frank.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your next question comes from the line of Rosemarie Morbelli with Ingalls & Snyder. Please proceed.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Good morning, all, and happy New Year.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Good morning, Rosemarie.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Were there -- this was a very strong quarter and particularly in the gross margin category, was there any particular reason for it that you have not touched on? Did raw material costs come down substantially versus the first quarter? Versus your expectation? Were you filling a pipeline for new products and therefore this is an extraordinary quarter?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

No. I think we touched on all the items and I think you'll see the same thing in the third quarter and then it will start to even out a little bit. But raw materials, it's hard to recall, but not too long ago you're looking at raw -- oil prices at $140 and all the peak raw material costs around there, and so we have seen significant relief from those levels. We are still way above where we were four or five years ago in terms of our base raw material costs and so -- and I don't see us getting back there.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

I was thinking more, Frank, about the comparison of raw materials versus the first quarter on a sequential basis. Did they come down?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

They did, and a little bit of what you've seen in the second quarter and what you'll see in the third quarter. If you'll recall last year we were getting double-whammied. In the first quarter of a year ago we were dealing with record raw material prices, and by the end of the second quarter and into the third quarter, we were running revals through our P&L because raw materials had dropped from that $140 oil-related peaks to something lower, so we had some extraordinary hits there, as well. So I think some of the rebound on a comparative basis to last year is a function of really weeding out of record spike raw material prices, which from the spring of 2008, I guess, through the early fall of 2008 we were dealing with record raw material costs and it typically takes 75 or 90 days for that to flow through our P&L. When you read about record oil prices it hits our businesses, cost wise, 30, 45, 75 days later.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Excuse me. Okay.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

The other significant issue is just positive mix in terms of movement of higher margin items, as well as the decision to exit the service business at Rust-Oleum.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

All right. And looking -- so you are expecting your inventories are going to go up somewhat, I am guessing, over the next two quarters, at least over the next quarter and that could have a negative impact sequentially Q4 versus Q2 on the gross margin. Am I looking at this properly?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

I would expect our raw material costs to be about flat -- from where they are now. I think the biggest impact that you're hitting on will be cash flow. We will not have a strong cash flow in the second half of the year, particularly in the fourth quarter, hopefully, for two reasons. Number one, across the board, whether it's sales commissions or executive compensation, we'll have higher levels of incentive compensation across RPM companies and we have incentive compensation from sales forces right up to my level and not a lot of what was paid last year. And then secondly, and it will really depend on whether some of this economic uncertainty continues to clear up and we have a stronger fourth quarter, cash will be less than what we've experienced so far and even less than last year, if we have better-than-anticipated revenue growth. And that starts to work its way into higher investment in working capital and we are looking forward to that challenge.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Sure. And your cash flow could be negative, then, in the fourth quarter?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

It's -- not likely. It's possible. You know, I hope so in terms -- if it's driven by strength in revenues, but it will certainly be weaker than the first half and it will likely be much weaker than last year, as well.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Okay. Could you touch on the trends during the quarter as you look at the different months, what you saw in November and whether -- anecdotally whether you have a feel for January?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Yes, I -- it's hard to discern anything from trends that we're seeing now because a year ago in October I think people were still not waking up, and we were part of that, to how deep and bad this would be. And as I said in some earlier conference calls in October, we had a bad month and I remember joking with one of the executives here that if we had 12 Octobers we would have a problem year. November was worse and December was worse. So any sequential comparison of what are seemingly more stable buying patterns and orders of this year versus last year, particularly in November, December, January, aren't going to mean much. I think that the real challenge for us and the real telling period for us will be our fourth quarter versus the prior year and sequentially in trends. Does that make sense?

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Yes, I'm sorry.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Again, December was a bad month last year, so the percentage improvements in December might be -- sound tremendous and pretty big, but you also have to keep in mind that we are very seasonally low in our third quarter, which is a December, January, February. We would expect significant improvements in sales and earnings results for the third quarter, but we also expect that we will still show a net loss of the quarter, although a substantial improvement over last year.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

A net loss, but at the net income level, obviously, but revenues up versus last year?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Revenues will be up and operating income, or EBIT, will be up versus last year, and it should be, again, materially up, but the percentage gains are misleading in our third quarter because both of the extraordinary period where you're in last year. We had $15 million of severance costs last year, and also just generally the seasonal low.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Could you touch on inventories? Many companies at the end of the first quar -- at the end of the third quarter, calendar quarter, were talking about the fact that people were just not buying anything and that they expected that December would be really bad, everyone would be leaving off of inventory prior to December and then shutting down plants for a long -- an extended period of time. Could you talk about your -- if this happened to your customers and where the inventory situation is, both at your customers, the big box, the industrial customers, and for RPM? Is the depletion over? Do you see any buildup? Could you give us a feel on that?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

We continue to generate good cash and good cash flow. We have seen some pickup in working capital. We're not seeing any negative trend in terms of what our results have been, and so I think, as we sit here today, the positive improvement that we've experienced this year in both our consumer business and in most of our industrial businesses, with the exception of those exposed to commercial new construction, seems to be continuing. But the economic environment still is very uncertain and I think there is a lot of concern about a double dip, about what is going to happen this spring. And so I think that has left people -- if I had to guess, both from our experience and what we see at inventory levels, they are certainly not what you would call full.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

All right. So you don't really have a good feel in any case for the level of inventory at your customers?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

I think they're at reasonable levels, but they're not -- they are not where they would have been a couple years ago.

Rosemarie Morbelli - ***Ingalls & Snyder - Analyst***

Okay. Thanks a lot.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your next question comes from the line of Edward Yang with Oppenheimer. Please proceed.

Edward Yang - ***Oppenheimer - Analyst***

Hi, good morning, and congrats on a great quarter.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Morning, Ed, thank you.

Edward Yang - ***Oppenheimer - Analyst***

On the consumer side you moved some revenues into industrial; I think it was around $25 million per quarter. Which businesses were affected, and what was the reason?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Yes, Ed, it's Kelly. The impact on the quarter was about $27.1 million, and you may recall, Ed, we had our RPM II Group and we had split that out between RPM II consumer and industrial, but with the sale of Bondo a year-and-a-half, two years ago and really the evolution of the markets, the remaining businesses served, they're really more appropriately classified in the industrial segment. So it was the $27.1 million reclassification of revenues in the quarter from consumer to industrial and the prior year was adjusted accordingly.

Edward Yang - ***Oppenheimer - Analyst***

And the reclassifications didn't affect the year-over-year organic growth comparisons?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

No.

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

No.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

And again, we -- you're looking at apples and apples.

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Right, we adjusted (inaudible) --

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

We adjusted (inaudible) last year's results.

Edward Yang - ***Oppenheimer - Analyst***

Okay, thank you for that. And the -- on the consumer side, that business has always been somewhat lumpy. In the second half of the year, are you still comfortable with organic sales growth running around 5% for that consumer business?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Yes, but, again, it really depends on the fourth quarter and whether there's -- it's typically a strong selling season. I think our year-over-year results in the third quarter will look comparatively very strong. I think a better benchmark of really how much recovery we're seeing is looking at our results versus two years ago in the third quarter. Because last year's third quarter was impacting negatively, both at the revenue line, extraordinarily, and at the earnings line, because of a lot of the extraordinary expense charges we took.

Edward Yang - ***Oppenheimer - Analyst***

Okay. And then talking about extraordinary items, last year, Frank, you had some hits to your captive insurance investment portfolio, which were fairly significant. At this point, are there any prospects that you could actually start reversing some of those marks?

Kelly Tompkins - ***RPM International, Inc - EVP & CFO***

Ed, it's Kelly. You're right that we took some hits last year. Unfortunately, the accounting world seems to only work one way. So we got -- all we get is really a favorable comparison since we don't -- won't have the write-downs this year, but it's not -- doesn't really work the same way in terms of write-ups. But we've certainly recovered substantially in terms of the marketable securities that are in our portfolio and really don't anticipate any further OTTI write-downs that we experienced last year.

Edward Yang - ***Oppenheimer - Analyst***

Okay. And this might be a difficult question because it's still very early days, but all this talk about Cash for Caulkers, have any of your people at DAP or Dryvit done any contingency planning if that will go through? Do you feel like you have enough inventory on hand if another stimulus plan like that becomes proposed?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Absolutely, and if you go out and Google and Google Cash for Caulkers the first site that comes up is SealYourHome.com, that's a DAP site. We've been working with major retail accounts to talk about how best to market our merchandise, weatherization products, and so we're seeing some improvement in those product categories and are also working in Washington to make sure that we have some influence on any related

legislation associated with tax credits for home weatherization and things like that. So it's an area that we've been paying a lot of attention to since the end of the summer and I think we're in a very good position and are benefiting somewhat from it. Our DAP business, about a third of DAP's business was cases of caulk bought by home builders and there are not quite as many home builders buying cases of caulk. On the other hand, our DIY business, 3.0, which is a high-quality, high-performing caulk, which is a new product, didn't take off quite like we wanted because it was introduced right in the teeth of this mess. It's now starting to show good performance and so we're in very good position and have been working at state, federal and with major accounts related to any benefits that would come from Cash for Caulkers programs.

Edward Yang - ***Oppenheimer - Analyst***

Okay, thanks very much.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thanks, Ed.

Operator

Your next question comes from the line of John McNulty with Credit Suisse. Please proceed.

John McNulty - ***Credit Suisse - Analyst***

Good morning, just two questions. With regard to the margins, when we look at either the consumer segment or even the whole company, in the fiscal second quarter you had the highest margins you've had in ten years in terms of operating margins. And so what I'm wondering is how do you think about normalized margins going forward? Like how much leverage is there left in the system, do you think, when the volumes actually do start to come back? Where can we see the operating margins go for the divisions?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

I have to go back and look at those numbers, John. That would surprise me if they were the best margins we've had in ten years. I will tell you, on a consolidated basis our gross margins are still 250 to 350 basis points below where they were five or six years ago, and so most of that margin improvement versus, not the last year or two, where we're dealing with, certainly over the last year, very depressed comparisons, but if you look back four or five years is really related to SG&A improvements. In terms of both an ongoing effort over that five-year period our SG&A as a percent of sales went from 34% down to 30% and change, prior to the recession, and then, obviously, we backed up a little bit on that because of the revenue declines, but we took significant costs, appropriately, out of our businesses. If we are able to continue to maintain our gross profitability or in some of our businesses regain historic levels, then you'll see hopefully historic operating margins. The other thing that we're getting better at, over the last five years, is buying product lines and integrating them in a manner that is also helping us on the operating income line. Not necessarily the gross line, but on the operating income line because the incremental SG&A cost is not -- is below the RPM average.

John McNulty - ***Credit Suisse - Analyst***

Okay, great, that's helpful. And then the second question, historically when you look back over -- at least aside from last year when things were obviously way out of whack -- your fiscal fourth quarter tends to be at least as strong as every other quarter, if not, if not stronger. Is there any reason to think that your fiscal fourth quarter this year won't be the best quarter, or at least in line with your best quarter for the year?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Well, I'm pretty confident that our fiscal fourth quarter will be ahead of last year. I doubt that we'll have a record fourth quarter like we had a second quarter. We still have -- we are not hitting on all cylinders. Probably 20% of RPM's product lines and businesses are associated with North American new construction businesses, like Euclid Chemical, Tremco Sealants and Dryvit, and those businesses remain under significant pressure at the revenue and earnings line and we don't see that coming back until probably this time next year and it's for two reasons. Number one, you're still not seeing project financing or any pickup in commercial construction. And number two, when you do see that, many of our

products lag in terms of the construction cycle. So they won't show up for anywhere from six to 12 months until after you start to see a resurgence in new projects. So I think that factor is a reason that I wouldn't expect us to have record results in the second half of the year going back two years ago, but we should be materially ahead of last year's depressed levels.

John McNulty - ***Credit Suisse - Analyst***

Okay, great, thanks a lot.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your next question comes from the line of Jeff Zekauskas with JPMorgan. Please proceed.

Silke Kueck - ***JPMorgan - Analyst***

Good morning, I have a follow-up question. So if I heard this correctly, I think there was a comment made on the industrial business where I think, Frank, you said that you don't expect the positive earnings growth in the industrial business for the remainder of the rear -- for the remainder of the year. Did I hear that correctly?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

No, my comment was that I don't think we'll be able to continue to generate positive earnings growth if we keep generating negative revenue comparisons. Our more global businesses that are more diversified both in terms of geography and market presence are holding up pretty well. We're real pleased to see that portion of RPM's businesses that are associated with OEM products -- they're principally our RPM II Group companies -- actually show nice year-over-year sales and earnings growth. So if those trends continue they may be able to overcome the continuing deterioration in our construction and commercial construction-related businesses and product lines. If those trends don't continue, because we see, actually, a weakening of economic activity in the spring and we quit showing this improvement, which we've shown, for instance, from the first quarter to the second quarter, and I believe we'll show the same improvement in the third quarter.

So it's really a function of what economic activity does, Silke, and there is enough uncertainty going on out there that we are hesitant to predict any type of strong economic, or continuing improvement in economic activity in the spring and into the summer. Just too many things in the air in terms of the banking market and everything else. Right now the trends are good and we would expect sequential improvement on a relative basis through our third quarter. The fourth quarter is anybody's guess.

Silke Kueck - ***JPMorgan - Analyst***

Okay. And so when I look at the earnings guidance of like $1.30 to $1.45, like $1.30 would assume that if trends don't improve on the industrial side probably would be on the lower end, and if things continue to improve, maybe you can get to the higher end of that range?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

I think that's exactly the way to think about it.

Silke Kueck - ***JPMorgan - Analyst***

Okay. Thanks very much for clarifying.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

(Operator Instructions). Your next question comes from the line of Jason Rodgers with Great Lakes Review. Please proceed.

Jason Rodgers - ***Great Lakes Review - Analyst***

Good morning.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Good morning.

Jason Rodgers - ***Great Lakes Review - Analyst***

Thanks for taking the question. Looking at your pricing, just wondering if you could provide an outlook for potential price increases? And then on the other side, if you're seeing any pressure for price givebacks on either the industrial or consumer side.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

We have not seen -- we have not taken any price increases really for -- until -- since about a year ago, and the battle over cost/price that exists every day continues between our desire to be properly paid for our products and regain what was a five or six-year negative trend in our gross margin, as well as a supplier base that has both become more consolidated, but also is still, in many instances, commodity driven and seeing significant fall-off in unit volume from record levels a few years ago. So at this point, the best we can tell you is, number one, we have not had new price increases in more than a year in our businesses. We have benefited from lower raw material costs and we believe, between that whole cost/price scenario, or we expect that we're now in a stable area for the next three to six months. And again, we're hesitant there because we're just in a strange world where geopolitical events can change raw material costs and availability pretty dramatically. But barring anything like that, we think we're in a pretty stable period right now.

Jason Rodgers - ***Great Lakes Review - Analyst***

Okay. And then looking at stimulus measures, you talked a little bit about the consumer side, I was just wondering if you're seeing any additional impact on the industrial side for highway and bridge coatings and things like that?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

We have not seen a lot of stimulus dollar projects, and we -- you would expect that we would because we're heavily involved in infrastructure, whether it's waste water, water treatment, highway bridge work, and I believe there's two factors there. Number one, you're likely to see a highway bill reauthorization next year for a lot of reasons. Number one, it was due to be reauthorized this year and didn't happen. It's one of those things that most politicians, regardless of their party, are supportive of. And that's where you'll see the biggest dollars on the highway/bridge area and other infrastructure areas. Number two, being somewhat frustrated that we haven't seen more of this statistically, I don't think that we've spent 25% or 30% of the stimulus dollars. And, again, for a number of reasons, including political, it's highly likely that you're going to see a much more significant percentage of that $787 billion stimulus package be spent in calendar 2010.

Jason Rodgers - ***Great Lakes Review - Analyst***

Okay, thank you.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

Your last question comes from the line of Saul Ludwig with KeyBanc. Please proceed.

Saul Ludwig - ***KeyBanc - Analyst***

Frank, when you guys raised the dividend last year in October it was a pretty modest increase of $0.02 for the year, which was very appropriate given the circumstances, and I know normally the dividend is considered in October. In the history of RPM, have you ever had an additional dividend increase outside the normal times? And I'm thinking now with your outlook being substantially better than it was back at the time the dividend was moved is there any thought to adjusting the dividend sooner than the normal period when it's considered?

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

There is two parts to that question, Saul, and I'll answer both of them. The first one is, about ten years ago we did have a spring increase to our dividend. The second part is, while this is clearly a board decision, I would not expect us to consider an improvement or increase in our dividend outside of our normal October year-end annual meeting timeframe.

Saul Ludwig - ***KeyBanc - Analyst***

Great, thank you for clarifying.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Thank you.

Operator

At this time, there are no further questions. I would now like to turn the call back over to Mr. Frank Sullivan for closing remarks.

Frank Sullivan - ***RPM International, Inc - Chairman & CEO***

Jasmine, thank you. Thank you for your participation in our call today. That RPM was able to tackle the huge economic and capital market challenges of the last year-and-a-half without having to cut any employment and employee retirement plans, our 401(k) matches, any of our healthcare benefits, and most importantly, were able to actually increase our cash dividend to shareholders for our 36th consecutive year, while enhancing our capital structure and increasing liquidity to record levels, is a testament to the dedication and commitment and perseverance of the more than 9,000 RPM associates worldwide. We also remain deeply grateful to RPM's long-term shareholders for your perseverance and trust. We are pleased with the 62% return to our shareholders that RPM generated in calendar 2009 from stock price appreciation and our dividend, nearly double that of the return of the S&P 500 over the 2009 calendar year, and are dedicated to continuing to deliver shareholder value through a growing business, a modestly increasing cash dividend, and the impact that these will have on our stock price in the future. Many thanks for your investment in RPM, and happy New Year. Thank you.

Operator

Thank you for your participation in today's conference. This concludes the presentation, you may now disconnect. Good day.

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