

# FINAL TRANSCRIPT

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## **GGG - Q3 2009 Graco Earnings Conference Call**

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Oct. 22, 2009 / 3:00PM, GGG - Q3 2009 Graco Earnings Conference Call

## CORPORATE PARTICIPANTS

**Caroline Chambers**

*Graco Inc. - VP, Controller*

**Pat McHale**

*Graco Inc. - President, CEO*

**Jim Graner**

*Graco Inc. - CFO, Treasurer*

## CONFERENCE CALL PARTICIPANTS

**Kevin Maczka**

*BB&T Capital Markets - Analyst*

**Michael Schneider**

*Robert W. Baird - Analyst*

**John Franzreb**

*Sidoti & Company - Analyst*

**Charlie Brady**

*BMO Capital Markets - Analyst*

**Ned Borland**

*Next Generation Equity Research - Analyst*

## PRESENTATION

**Operator**

Good morning, and welcome to the third-quarter 2009 conference call for Graco Inc. (Operator Instructions) Graco has additional information available in a PowerPoint slide presentation, which is available as part of the webcast player.

At the request of the Company, we will open the conference up for questions and answers after the opening remarks from management.

During this call, various remarks may be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for the purposes of the Safe Harbor provisions of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as a result of various risk factors, including those identified in Item 1A of an Exhibit 99 to the Company's 2008 annual report on Form 10-K. This report is available on the Company's website at [www.Graco.com](http://www.Graco.com) and the SEC's website at [www.SEC.gov](http://www.SEC.gov).

Forward-looking statements reflect management's current views and speak only as of the time they are made. The Company undertakes no obligation to update these statements in light of new information or future events.

During today's presentation, all parties will be in a listen-only mode and following the presentation, the conference will be open for questions. (Operator Instructions).

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

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

Good morning, and welcome to everyone. I am here this morning with Pat McHale, President and CEO; and Jim Graner, our CFO. I will briefly review our third-quarter results, and Pat will follow with additional comments. PowerPoint slides are also available to accompany this call and can be accessed on our website. Following these opening comments, we will open up the call for your questions.

Net earnings were \$17 million in the third quarter on sales of \$147 million. Sales for the quarter were steady compared to second quarter of 2009 and up 7% from the first quarter. However, as compared to the third quarter last year, sales decreased in all segments and regions, with little impact from currency exchange rates.

By region, the sales decline was 25% in the Americas, 39% in Europe and 25% in Asia-Pacific.

Gross profit margin as a percentage of sales was 53% this quarter, an improvement from 49% in the second quarter and 47% in the first quarter. The 53% is equal to last year.

While we continued to be affected by low production volumes and increased pension costs, we are also seeing the favorable effects of pricing, product mix, lower material costs and effective cost-reduction activities initiated earlier this year. We are seeing a shift to a higher proportion of part sales, cost reductions on some important product lines and the effect of discontinuing several low-margin products.

Gross margins in the prior year were affected by factory integration costs, lower factory efficiencies, especially in the [LED] factory, rising material costs and product mix.

Total operating expenses were lower, down 10% in the third quarter as compared to last year, primarily due to lower incentive and bonus provisions in 2009 and other spending reductions.

The effective tax rate for the third quarter was 30%, down from last year's rate of 34%. The higher-than-expected benefit upon filing of the prior year's tax returns contributed to this lower quarterly rate. Also, the R&D tax credit was not renewed until the fourth quarter of 2008, and no credit was included in the third quarter last year.

We continue to have strong cash flows, with positive cash flows from operations of \$110 million year to date. We are focused on managing working capital and have seen a decline in accounts receivable of \$21 million and a decline in inventories of \$31 million this year. A pension contribution of \$15 million was made for this quarter. We have reduced long-term debt by \$73 million this year.

I will now turn it over to Pat for additional comments on the quarter.

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

Good morning. Business conditions in the third quarter continued to be challenging, but we did see a few positive signs. Our revenue was flat to Q2, which is typically our peak revenue quarter. Profitability also improved significantly over Q2, with return on sales for the quarter reaching 12%. Strong gross margins, the impact of prior expense actions, currency translation, product cost reduction efforts and a lower effective tax rate all contributed to the improvement.

We do have slides posted out on the web, as Caroline referred to, and I would refer you to take a look at those for details on the margin reconciliation.

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A few comments about the segments. First, Contractor North America. The home center channel revenue is up single digits versus Q3 of last year. That is really driven by our expanded store count from sales initiated -- excuse me -- sales initiatives during the past 12 months.

On the propane side, revenue is down double digits versus Q3 last year, as we continue to experience weakness in housing, commercial construction and the remodeling end markets.

The incoming order rate for our Contractor business in North America reflected an expected seasonal decline in order rate from Q2 to Q3 of around 15%. And we do anticipate a further reduction in Q4 based upon seasonality.

In the Industrial business, the comments are fairly consistent, both for worldwide and for North America. Both revenue and incoming orders improved compared to the second quarter. While the overall incoming order rate improved single digits compared to the second quarter's incoming order rate, bookings generally trended upward as Q3 progressed. So July, August and September show a little bit of a trend to the positive for us on the Industrial side.

While our customers continue to be cautious of capital spending, we did see a positive mix impact in some product categories as sales of repair parts and accessories improved from lows earlier in the year.

In the Lubrication Division, we made good progress during the quarter on our product cost reduction and our process improvement initiatives. On volumes that were down slightly from Q2, we were able to improve operating margins from the negative 12% in Q2 to a nearly breakeven this quarter. While it has taken us longer than planned, we are now about 80% complete with our original product cost goals. And with a return to 2007 volume levels, we are now positioned to generate operating margins of around 20% in Lube.

We expect our Lubrication markets to remain challenged for revenue over the short-term, and we do not expect substantial improvements to profitability without a revenue increase. We are continuing to fully fund new product development for our Industrial Lubrication market initiative and to fund our new specialized lubrication teams in both Europe and in Asia.

In Europe, while revenue was up slightly from Q2, our incoming order rate was actually down slightly from Q2, low single digits. Eastern Europe continues to be significantly weaker than Western Europe, and there is really no product line or geography within Europe that showed any particular strength during the quarter. Our team in Europe is seeing some signs of stabilization, and I'm optimistic that the worst is over in that region.

In Asia, our revenue was up double digits versus Q2, and our incoming order rate was solid. Our Asian contractor business was in line with Q3 of last year, although the rest of our business remains well below last year. Our business in Asia can be lumpy, as you know, and customers continue to be cautious with capital projects. But looking at the results by productline and by country does give me some optimism for continued improvement in the region.

During the third quarter, we continued to fully fund our organic growth initiatives of new product development, global expansion and new market initiatives. Product development spending of approximately \$9 million was down versus prior year, and it was down from our planned run rate of approximately \$10 million per quarter. This reduction was purely based upon project timing, and we expect our previously communicated \$40 million for 2009 spend is still a good estimate for you to use.

We are planning a large number of new product launches in Q4 2009 and in the first quarter of 2010, and we expect that 2009 fourth-quarter product development expense will reflect spending catch-up.

Although it is difficult to estimate the revenue in the near-term, we do believe the economy has likely bottomed and see gradual improvement through 2010 on the revenue front. We are happy with the decision we made last year to increase investment in our organic growth initiatives and to retain our key commercial talent in Europe and Asia. I believe the short-term hit to quarterly earnings will be more than offset by the benefit that we will have coming out of the recession.



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I expect the next couple of quarters could be bumpy as the economy sorts itself out, and I do remain cautious regarding our performance over the winter months. I am pretty confident 2010 will be better, and as you can imagine, we are looking forward to the new year.

With that, I will ask the operator to open up the question -and-answer portion of the presentation.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Kevin Maczka, BB&T Capital Markets.

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

Good morning, everyone. Pat, I guess first on the gross margin, some of the items there that helped you in the quarter, things like raw materials pricing and the cost reductions, can you maybe touch a little more on that, give a little more detail on how much raw material helped, what kind of magnitude of pricing increases you saw, for example?

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### Jim Graner - Graco Inc. - CFO, Treasurer

Kevin, this is Jim. I will try to respond to your question. As you know, we have stated before our pricing target for this year is three percentage points. We are realizing that. So that is probably the biggest contributor to the margin.

Second in line is the factory performance. The factories have taken a lot of cost out of their fixed burden. And specifically, the Lube factory has made significant progress in improving their efficiencies from where they were this time last year. So that is a big contributor.

On the product cost side, we are seeing about a one percentage point favorable from material costs. Again, that is comparison to the bubble in commodities we were seeing at the end of last year, and some favorable numbers this year. As well on the product cost side, both the Contractor and the Lubrication factories have made significant progress on certain products to lower those costs, coming both from an engineering perspective and from a factory operation perspective.

On the smaller end of the scale, we are also seeing some improvement from discontinued products, specifically in the Industrial and the Lubrication segments.

And lastly, as Pat mentioned, we are seeing some improvement in the Industrial side from a shift to more parts, as factories are getting back to producing things. So a long list, but hopefully that helps, Kevin.

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

Yes, Jim, it does. And then on the materials side, so with most metals and commodities in general moving higher now, do you expect that one point benefit to go away in Q4, or should that still be favorable for you in Q4 and then maybe less favorable in the first half next year?



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**Jim Graner** - Graco Inc. - CFO, Treasurer

I would say the latter. We will still have a favorable comparison in Q4. It takes a while for those price increases to move through our channel. And while the commodities are up, they are not up anywhere near where they were a year ago. So still some favorable impacts going forward.

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

Okay. And then Jim, on the SG&A line, or the selling and marketing line, came down sequentially, even with flat revenues. That is typically, I think, somewhat variable, that line item, with revenues. Is that just the result of other previously-announced cost initiatives that have finally kicked in?

**Jim Graner** - Graco Inc. - CFO, Treasurer

Yes, I would say that includes those announced initiatives. And then I would say probably a very conservative approach from the sales and marketing teams for all of their variable costs, travel, other things like that. And it also reflects, of course, the fact that Europe is shut down for the month of August.

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

Okay, so another way of asking that, if you were to do a similar revenue quarter in Q4, would you expect that line item to come up, as maybe they're less conservative and they are not shut down? Or would it be lower because you haven't fully realized some other cost-cutting initiatives?

**Jim Graner** - Graco Inc. - CFO, Treasurer

My expectations are it will be closer to the second quarter than the third quarter.

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

Okay, I'll get back in line. Thank you.

**Operator**

Michael Schneider, Robert W. Baird.

**Michael Schneider** - Robert W. Baird - Analyst

Good morning, guys. First, the margins are incredible, and congratulations on that achievement. Guys, maybe you could just spend another second on the margins, and explain the difference, as you calculate it, between the unabsorbed manufacturing costs in the matrix you laid out and the volume effect on expense leverage.

**Jim Graner** - Graco Inc. - CFO, Treasurer

Sure. The unabsorbed manufacturing cost is really a calculation of -- based upon hours of production. So it is the delta in hours of production versus our capacity that hits the gross margin line. The volume effect on expense leverage is just the fact that our operating expenses -- and I'll create some numbers here -- are running at 30% of sales this year versus 25% last year.

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**Michael Schneider** - Robert W. Baird - Analyst

Got it. Okay. And in terms of unabsorbed manufacturing, I believe your goal was to take \$30 million on inventory out this year. You're already there. So does that four-point hit and -- well, I guess across the enterprise, it would probably be about a three-point hit on unabsorbed manufacturing -- does that go to zero in Q4 because you've already reduced the inventory you need?

**Jim Graner** - Graco Inc. - CFO, Treasurer

Well, where we exceeded our goal, as you noted, we still are progressing ahead with further reductions. We doubt that it will be in the line that we are able to achieve in the third quarter. So it won't go to zero, because our -- there is no way that represents that level of volume decrease to \$30 million relative to our 30% reduction in sale.

And then there is also the seasonality factor of our Contractor segment. You know, we produce less Contractor Equipment in the fourth quarter and first quarter than we do in the other two quarters. So, some improvement expected, but not rapid change.

**Michael Schneider** - Robert W. Baird - Analyst

Okay. And then looking into 2010 on pricing, as Kevin noted, materials are coming up across the board. Do you expect another -- or do you target another three points of positive price in 2010?

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

Mike, I think we will probably be a little bit more conservative in terms of what we are targeting for next year. And I would say that going back to more and more historical number of 1.5% to 2% would be a good number for you to think about.

**Michael Schneider** - Robert W. Baird - Analyst

Okay. And then final question, within industrial, Pat, you noted the shift to more parts. Is that just because new equipment sales are down or indeed is the quantity of parts sold at this point rising?

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

We think that there is just some equipment coming online that has been kind of mothballed during the big downturn here. And as people are starting to stop producing inventory and producing a little bit more, that we are starting to see parts business in certain lines coming back. So it is not a dramatic shift.

**Michael Schneider** - Robert W. Baird - Analyst

Okay.

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

(multiple speakers) positive for us, obviously.

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**Michael Schneider** - Robert W. Baird - Analyst

Okay. Thank you again. I'll get back in line.

**Operator**

John Franzreb, Sidoti & Company.

**John Franzreb** - Sidoti & Company - Analyst

Hi, Pat. You kind of noted the order trend in Industrial was sequentially better throughout the quarter. Historically, Q4, we would expect that to tail downwards. But is that the case, or should we start thinking about maybe your jobbers are restocking and Q4 might be a little bit better than historically it's kind of played out?

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

You know, it is really hard for me to predict revenue at this point. It has been kind of a crazy roller coaster the last four quarters here. But I did point out the sequential improvement in the incoming order rate, just because it is three months in a row. It is a data point. Make what you want of it. But it does give me some optimism going into the fourth quarter.

**John Franzreb** - Sidoti & Company - Analyst

Okay, great. And in the Lube side of the business, you know that car dealerships are down, but what about aftermarket players, the Jiffy Lubes in the world? Have they increase their spend rating? Have they kind of stepped up to the plate? What do you hear on that side of the market?

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

It has been soft, as well. It seems like the aversion to doing capital spending projects has kind of been across most of the segments.

I guess the one segment in Lube that stands out as looking to have more short-term upside is anything related to government spending -- municipal or state or federal, there is monies coming through. And as they build new service centers or fleet maintenance facilities, there is opportunity for us there. But pretty much both the car dealership and the normal quick-lube site are pretty depressed on capital spending right now.

**John Franzreb** - Sidoti & Company - Analyst

Okay, great. And on product development, you said that you expect some substantial rollouts, I guess, in Q4 and Q1. Could you give us a number of how many products you expect to roll out, put a little color around that?

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

You know, I haven't actually counted up the list. We don't launch one product and get 50 million; we launch a bunch of products and get a few million each, if things are going well.

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But the number of products that we've got coming for Q4 and Q1, that six-month period, I think, is reflective of our investment, our increased investment. So if you would say what would historically you would expect to see, you might expect to see 20% or 25% more in that timeframe.

In terms of the success of our new products, that has been interesting this year. The products that we've launched into the Contractor business, particularly in North America, they have not had much impact this year. We have seen much better impact on the products that we've launched on the Industrial side. And really, we think that is more related to the channel's acceptance of inventory stocking, that the Contractor business, especially on the pro side, they've been managing inventories pretty aggressively, and so the new products haven't had a lot of impact through the first nine months of the year. But we are seeing better play on Industrial.

So I think going forward here in the next six months, it should be a good test for us to see how much traction we are getting on that incremental expense that we decided to put on the P&L.

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**John Franzreb** - *Sidoti & Company - Analyst*

All right. And I guess one last question. You said that things are noticeably weaker on Eastern Europe versus Western Europe. Can you talk about why that is the case?

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

Well, I think there is multiple factors. But, you know, they had some pretty major things happen with their currency as well that hasn't helped them. It has kind of compounded their problems. And of course, Eastern Europe is highly reliant on Western Europe for a lot of their economic activity. So with the big decline in Western Europe, that hits them pretty hard, and they don't have as much domestic consumption to pick up the slack. Where you see places like China, where they are able to pour more money into their local economy, things are a little bit better.

But -- and I can't really put my finger on it beyond currency and beyond their linkage to the West. Jim may have a comment here.

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**Jim Graner** - *Graco Inc. - CFO, Treasurer*

There are some huge capital flows that were being funded by the Western European banks in Eastern Europe. And it's my understanding that all of that funding has stopped. So I think there is the currency thing and then just the availability of capital.

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**John Franzreb** - *Sidoti & Company - Analyst*

Okay. Thanks a lot, Jim. Thanks, guys.

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**Operator**

Charlie Brady, BMO Capital Markets.

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**Charlie Brady** - *BMO Capital Markets - Analyst*

Thanks. Good morning. On the slide when you break out product cost, mix and price, and if I look at the Industrial and the Lube business, can you give us a some granularity as to how much of that variance -- for instance, the 4% on Contractor and the 5% on Lube -- how it spreads across those three?

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

We would actually prefer not to do that for, I think, obvious reasons, but --. So I would refer you back to Jim's earlier comments in terms of which pieces are the biggest.

**Charlie Brady** - *BMO Capital Markets - Analyst*

Okay. And then just on the product development, as I look across Lube, obviously compared sequentially from the second quarter, the Lube and the Industrial business, there is a pretty sequential variance on the product development. You've talked about a catch-up. Would you expect the catch-up to fall into one of those segments more than the other?

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

No, it is really more related to which products are going to be launched. And I think that at least over the next two quarters, the amount of products being launched are significant in all the segments. So I don't think there is any reason to think it is going to be dramatically different between segments.

**Charlie Brady** - *BMO Capital Markets - Analyst*

Okay, thanks.

**Operator**

(Operator Instructions) Ned Borland, Next Generation Equity Research.

**Ned Borland** - *Next Generation Equity Research - Analyst*

Good morning, guys. Just one question on Contractor. Given commercial construction activity, you sell larger sprayers for commercial jobs. Does mix in that segment maybe become a slight headwind?

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

You would think that, but actually during the housing downturn, the large units -- and I think we've talked about this in the past -- the large units that we had been selling really crashed, as well. I would've expected that the large units would have held up better last year, as commercial was still strong for us last year. But that wasn't the case.

So I don't think you are going to see a dramatic mix shift in Contractor between the smaller pro units and the larger pro units, even though commercial is weakening. I think we have kind of already had the impact of that run through our numbers.



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**Ned Borland** - *Next Generation Equity Research - Analyst*

Okay. Thank you.

**Operator**

Michael Schneider, Robert W. Baird.

**Michael Schneider** - *Robert W. Baird - Analyst*

Guys, was there pricing put in late in Q2 or early in Q3 that would have just benefited this quarter?

**Jim Graner** - *Graco Inc. - CFO, Treasurer*

No, Mike. It was pretty much all done in the first quarter, either first of January or the first of February.

**Michael Schneider** - *Robert W. Baird - Analyst*

Okay.

**Jim Graner** - *Graco Inc. - CFO, Treasurer*

The impact should be fairly even between the second and third quarter. Again, part of the mix change and the discontinuance of those products I mentioned earlier probably influenced the third quarter more than (multiple speakers).

**Michael Schneider** - *Robert W. Baird - Analyst*

Okay, and if you look at the products that were discontinued, what would you guess the annualized revenue run rate was on those product lines in total?

**Jim Graner** - *Graco Inc. - CFO, Treasurer*

In total, it is less than \$5 million.

**Michael Schneider** - *Robert W. Baird - Analyst*

Less than \$5 million. And it is primarily in Industrial?

**Jim Graner** - *Graco Inc. - CFO, Treasurer*

Lube and Industrial.

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**Michael Schneider** - Robert W. Baird - Analyst

Lube and Industrial, okay. And then I guess just taking a step back now, the balance sheet is obviously strengthening every quarter now with the cash flow and the working capital reductions. Can you talk about just your M&A pipeline at this point and your appetite?

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

Our appetite hasn't lessened at all. We are putting as much work or more as we ever have into identifying opportunities out there. I think maybe we are starting to see some signs of life, but it has really been pretty dead, I'd say, most of the year. So we've got some work to do. But in terms of our appetite and our interests, certainly we have capacity to do something, we've got a desire; we've just got to find the right opportunity.

**Michael Schneider** - Robert W. Baird - Analyst

Okay. All right. Thank you.

**Operator**

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

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

All right. Well, thank you all for your time this morning, and have a good day.

**Operator**

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

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