

THOMSON REUTERS STRETEVENTS

# EDITED TRANSCRIPT

GGG - Q3 2018 Graco Inc Earnings Call

EVENT DATE/TIME: OCTOBER 25, 2018 / 3:00PM GMT



OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

## CORPORATE PARTICIPANTS

**Caroline M. Chambers** *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

**Patrick J. McHale** *Graco Inc. - President, CEO & Director*

## CONFERENCE CALL PARTICIPANTS

**Brett Kearney** *G. Research, LLC - Research Analyst*

**Charles Damien Brady** *SunTrust Robinson Humphrey, Inc., Research Division - MD*

**Deane Michael Dray** *RBC Capital Markets, LLC, Research Division - Analyst*

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

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

**Walter Scott Liptak** *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

## PRESENTATION

### Operator

Good day, and welcome to the Graco Inc. Third Quarter 2018 Earnings Conference Call. Today's conference is being recorded.

And at this time, I'd like to turn today's call over to Ms. Caroline Chambers. Please go ahead, ma'am.

---

**Caroline M. Chambers** - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

Good morning, everyone. I'm here this morning with Pat McHale and Mark Sheahan. Our conference call slides have been posted on our website and provide additional information that you may find helpful.

We saw sales growth this quarter in all segments and regions, with an increase of 10% from the prior year, including 3 percentage points of growth from acquisitions. Reported net earnings totaled \$93 million in the third quarter or \$0.54 per diluted share. After adjusting for the impact of excess tax benefits from stock option exercises and the non-recurring tax benefit related to the \$40 million pension contribution made in the third quarter, net earnings totaled \$86 million or \$0.50 per diluted share.

Unfavorable currency translation reduced operating earnings by approximately \$2 million and exchange losses on net assets of foreign operations also increased other expenses by \$2 million. Overall, a headwind of \$4 million on pretax earnings this quarter. Gross margin rates remained strong, but slightly lower than the third quarter last year due to lower margin rates of acquired operations. Pricing continued to offset material price increases this quarter. Channel mix was unfavorable in the Contractor segment.

While tariffs did not significantly affect gross margin rates during the third quarter, we expect to see an acceleration of tariff-related cost increases, which could have an effect of 50 to 75 basis points on gross margin rates in the fourth quarter of 2018. There are a lot of moving pieces, and we are working closely with our supply chain to minimize the overall tariff costs for Graco.

Looking into 2019, we expect that pricing will fully offset the dollar value of tariffs, though gross margin rates as a percentage of sales could be slightly lower. Our factories are performing well and our year in, year out continues to improve on projects and will continue to provide opportunity to improve efficiencies and manage costs. Operating expense increased by \$4 million compared to the third quarter last year, including \$1 million from acquired operations.



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

Our as reported tax rate was 14%, down 7.5 percentage points from the third quarter last year. Adjusted to exclude the impact of excess tax benefits related to stock option exercises and the non-recurring tax benefit related to the third quarter pension contribution, the effective income tax rate was approximately 21% in the third quarter or 10 percentage points lower than last year, primarily due to the net effects of U.S. federal tax income tax reform.

Cash operations from operations totaled \$254 million year-to-date 2018 compared to \$246 million year-to-date last year. Share repurchases, net of shares issued totaled \$148 million through the third quarter, though we have been making opportunistic share repurchases in the fourth quarter. Capital expenditures totaled \$40 million year-to-date 2018. We expect usual capital expenditures for machinery and equipment of approximately \$35 million for the full year. Our current estimate for building projects to increase production and distribution capacity is expected to be approximately \$40 million this year as various projects move along.

An additional \$100 million to \$120 million is expected to be invested in building projects over 2019 and 2020. Unallocated corporate expense is expected to be approximately \$27 million for the full year in 2018. Our expected tax rate for the fourth quarter is approximately 21% and for the full year, we expect approximately a rate of 20%, excluding any effects from excess tax benefits related to stock option exercises or other onetime items.

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

---

### **Patrick J. McHale** - Graco Inc. - President, CEO & Director

Thank you, Caroline. Good morning, everyone. All of my comments this morning are on an organic constant currency basis. Caroline has covered the details on our third quarter and 9-month earnings adjustments, so any references to profitability will be on an as adjusted basis. The macro environment continues to provide growth opportunities in Q3, and despite tough comparisons, we delivered a good quarter with solid organic revenue growth, margin expansion, double-digit earnings growth and solid cash flow generation.

Some color on the segments. The Industrial segment delivered mid-single digit growth in the quarter, against difficult comp from Q3 of last year, where we had double-digit growth. As expected, there was an increase in finishing system sales and project activity in the quarter. Business remains consistent with our full year outlook for 2018.

The Process segment delivered double-digit growth in the quarter, demand continues to be broad based and favorable across most of our end markets. The Contractor segment delivered mid-single-digit growth in the quarter against the tough comp of high teens single -- excuse me, high teens double-digit growth in the third quarter of last year. There was significant variability between geographies, so I'll make a few additional comments on contractor by geography. In the Americas, Contractor sales were up 8%, fairly consistent with year-to-date results. Out-the-door sales in both the paint store and home center channels remains robust. In EMEA, the Contractor business was up against a huge Q3 of last year, where sales were up nearly 30%. Despite the tough comps, the Contractor EMEA was able to pull slight growth, with good growth in Western Europe largely offset by significant declines in emerging countries. Asia Pacific Contractor was down for the quarter and although up year-to-date, this continues our trend of inconsistent revenue performance for Contractor in that region.

Now I'll make some comments on overall regional performance. EMEA delivered low single-digit growth, with solid double-digit gains in our Process segment, offset by sluggishness in the Industrial and Contractor segments. Western Europe has outperformed the emerging countries this year, a trend we expect will continue for the near term. Africa, Turkey and the Gulf states have been particularly weak. In Asia-Pacific, we delivered double-digit growth, with the Industrial and Process segments leading the way. Demand in the region remained strong and end markets appear stable. The Americas had high single-digit growth in the quarter with growth in every segment. The economic conditions in North America remained broadly favorable, while South and Central America are a drag in our results.

A few comments about profitability. Sales growth and expense control produced positive leverage in worldwide operating earnings. Our incremental margins, excluding acquisitions, were 50% in the quarter and 40% year-to-date. Margin performance from the Contractor segment was challenged, due primarily to unfavorable product mix with higher growth coming from our lower priced, lower margin products as well as a significant planned



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

increase in product development spending. We anticipate this higher rate of new product spending will continue through Q4, as we get ready for 2019 product launches.

Moving onto our outlook. Incoming order rates across the segments continue to look good, as we head into the next quarter. We confirm our full year outlook of mid- to high single-digit organic sales growth on a constant-currency basis for the full year 2018.

While we expect to face headwinds from tariffs, material costs and currency translation in the fourth quarter, I believe we are well-positioned to deliver another year of record sales and earnings in 2018.

In closing, I want to say thank you to all of our employees, suppliers, channel partners and end-users for another good quarter.

Operator, we're ready for questions.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) Our first question will be from Deane Dray with RBC Capital Markets.

#### Deane Michael Dray - RBC Capital Markets, LLC, Research Division - Analyst

Maybe we can start with pricing because that was one of the sensitive spots last quarter, where you were consciously holding off on not disrupting the Contractor channel. And it sounds like this quarter, you're talking about the ability to put through price and that's on track. So maybe, just talk about how that decision came about? And the timing of price increases? And how much do you expect to realize?

#### Patrick J. McHale - Graco Inc. - President, CEO & Director

Yes, Deane. Yes, we don't view it as a sensitive topic. We've got a temple for our price increases, and we do those on an annual basis. It's disruptive to our channel, put through mid-year price increases, and we have continued to be focused on making sure that we put our price increase through in the early part of 2019, as we would've normally planned.

#### Deane Michael Dray - RBC Capital Markets, LLC, Research Division - Analyst

And any pushback on that in terms of how much you expect to stick? And did you quantify the pricing for the quarter? And what you expect to get for the year? Any color there would be helpful.

#### Patrick J. McHale - Graco Inc. - President, CEO & Director

Yes, so normally we realize 1.5 to 2 points on price on an annualized basis. We anticipate that we'll have to go a little bit more going into next year, due to the fact that we've got the pressure on tariffs. But we anticipate that we'll cover the dollar value of the increase in tariffs and material costs with pricing in 2019.

#### Deane Michael Dray - RBC Capital Markets, LLC, Research Division - Analyst

Got it. And we appreciate the precision on the gross margin pressure in the fourth quarter, the 50 to 75 basis points. Is there any way you can separate out what those -- how those impact each, the tariffs, material costs and FX? That would be helpful.



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

**Patrick J. McHale** - Graco Inc. - President, CEO & Director

Yes, Deane. That's mostly just our best guess at this point. A lot of things happen over the course of the quarter that can affect those numbers, they could be higher or lower. But it's the order of magnitude, so you can throw it into your model. We've got manufacturing opportunities to make improvement. We are working with our supply-chain to hold off impact as long as we can, so it's hard to say. We didn't see a lot in the third quarter. We're anticipating that it's coming, so we gave you a number.

**Deane Michael Dray** - RBC Capital Markets, LLC, Research Division - Analyst

Got it, appreciated. And just, last one on Contractor. Maybe some color and APAC, what some of the dynamics in the quarter were there please?

**Patrick J. McHale** - Graco Inc. - President, CEO & Director

Yes, it was just down. That was primarily a China issue, we had other countries where we did well. And again, it's not different than the struggles we've had the last few years, having -- getting consistent growth, particularly out of China. We've been up and down quarter-to-quarter. We'd like to see some consistency there, but unfortunately yet, we haven't.

**Deane Michael Dray** - RBC Capital Markets, LLC, Research Division - Analyst

It's probably -- I can figure the answer, but since everyone is getting asked, is this related at all to just slowing in China? Slower demand or is this more product line specific in timing and channel and so forth?

**Patrick J. McHale** - Graco Inc. - President, CEO & Director

No, I don't think that what's happened with contractor in China has much to do with what's happening with the economy over there. The penetration rate of spray equipment in China is still pretty low. So the opportunity for us is to convert people to use an equipment from using brush and roller. There's also the dynamic in the marketplace over there of low-price copiers. But again, we believe that the opportunity for us remains good if we can execute, and that's what we're focused on, trying to execute conversion.

**Operator**

Our next question will be from Brett Kearney with Gabelli & Company.

**Brett Kearney** - G. Research, LLC - Research Analyst

Just wanted to ask on your project funnels and the project activity you're tracking, if you could provide by geography. I know you noted in the slide deck some spotty activity in Asia-Pacific region, but overall, how are your project funnels are looking across the business?

**Patrick J. McHale** - Graco Inc. - President, CEO & Director

Yes, I think generally what we see in most of our markets is activity that's consistent with our outlook and orders continue to be good here in the month of October, and we think that we're going to have a decent fourth quarter, as our outlook would suggest.

## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

**Operator**

Our next question will be from Jeffrey Hammond with KeyBanc.

---

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

Can you just talk about auto OE? We've been seeing some choppiness in Europe, Asia and just, kind of, this worry of peak auto in U.S., just how are you seeing spending there?

---

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Yes, I mean, activity is okay. Obviously, you can look at the same numbers that we look at, but in general, we're still seeing investments being made and, of course, about 40% of our legacy business is parts and accessories. So as long as volume pulls up, we're going to continue to see orders coming on that piece of the business. But in general, I'd say, it's okay.

---

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

Okay. And then, can you dig in a little bit more about the, kind of, downgrading outlook in EMEA? And how long do you think that will persist?

---

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Yes, really, what we're seeing there is, we're seeing, I'll say, not great growth in Western Europe, but certainly, the pain that we're feeling right now is coming from some of the emerging markets. Of course, South Africa has got its problems. Turkey, we're seeing declines in Turkey. Some of the countries in the Middle East, we're seeing declines in. So a little bit of tale of 2 stories. And then, we have some concern looking forward into what may happen with Russia. We're still doing okay there. But the team in EMEA is concerned with some of the topics going back and forth on the political front, that we could see some slowing happening in Russia. So I'm not overly concerned about Europe. I don't view that it's getting ready to go into the tank. But I think we're slightly less positive in aggregate than we would have been 3 months ago.

---

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

Okay. And then, just finally, it looks like mix was a headwind in Contractor. How do you think that trends into 4Q in '19?

---

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Yes, I think it's hard to trend. That bounces around quarter-to-quarter depending upon which one of the channels or which segment of the product line we happen to shift more in a particular quarter. So again, there I view it, a little bit more as noise than a trend, and I'm not expecting at this point, it to be something that's going to be long-term. I think you'll see that move around quarter-to-quarter.

**Operator**

Our next question will be from Charles Brady with SunTrust Robinson Humphrey.

---

**Charles Damien Brady** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

On the -- just back on the tariff question, yes, and echo the -- appreciated the quantification there. But if we look to '19, you previously said it was 100 basis point potential impact on tariffs in 2019. Is that number still an accurate number to go by? Or has that crept up a little bit? Sounds like



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

the 2018 number has gone up because it was 50 basis points for the second half and now it's a little bit higher than that. So I'm wondering if '19 has crept up as well?

**Caroline M. Chambers** - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

Let me just give you a little color on that. Part of the reason why it's creeping up in the fourth quarter, it's because we had actually so little realized pricing effect in the third quarter. So we brought down our overall estimate for the second half this year.

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Tariff effect.

**Caroline M. Chambers** - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

Tariff effects. Correct. And then for 2019, it's actually about the same. Our expectation, our estimate on the actual tariff cost, but at this point, we're taking a look at our pricing and seeing dollar-for-dollar, which should cover up with pricing.

**Charles Damien Brady** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Okay, that's helpful. And I just want to switch gears. On the Process business, I mean, there were some very strong results in that. Can you dive into a little bit deeper about what's really driving a lot of that growth? Is it coming off a lower year ago comp? But it sounds, I mean, it's pretty broad based. I'm just trying to get a better sense of what's really driving the process growth?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Yes, we have a bunch of businesses in there and looking across all the different product categories and the segments, whether it's our classic air-operated diaphragm pump business, our Lube business, some of the businesses that we've acquired. I would just say, it's fairly broad-based across a lot of those product categories. And as the revenues have come up there, in that segment, their margins are coming up as we had expected. So they are over 20% now, where a year ago, they were in the teens. And as long as they can continue to drive the top line, there is a lot more room there for them to improve their profitability.

**Charles Damien Brady** - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

All right. One more for me then. Just on the supply chain, there's obviously some constraints in the supply chain, freight being only one of many, but I want at least comment on what you are seeing in terms of supply chain? Is that crimping any kind of shipments, or how is that holding up?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

No, we're fine. And we're -- I think we have our normal amount of production problems, but nothing unusual.

**Operator**

Our next question will be from Walter Liptak from Seaport Global Securities.



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

**Walter Scott Liptak** - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Just a follow-up on that Process question. I think some of those businesses are a little bit longer cycle, I guess we have visibility on some things like offshore picking up or any other longer cycle projects. What are you seeing from those?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

In the oil and gas sector, for us, we're still seeing more of our improvement happen on the onshore piece. But we're pretty far down the pipeline of a project before we would actually get any business on the offshore stuff, so we're probably not the right people to ask on that. And then I would just reinforce what Mark said, that the rest of the product lines within that category seem to be generally healthy, as we look around the globe.

**Walter Scott Liptak** - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. And then, switching over to Contractor. Everything looks pretty good through the end of this year, but I wonder, with interest rates coming up, do you have any thoughts about what next year could look like? I know a lot of this is just rehab on the existing homes other kind of work. But weakness in -- potential weakness in the housing construction markets, how do you benchmark that?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

So, obviously, nobody really knows. But I've seen some of the comments about concerns that the housing market here may be approaching a peak, and we don't believe that, and I personally don't believe that. We've been pretty confident all along, coming out of the recovery that we ought to be headed back to \$1.5 million. And so, I think that there's still some runway to go. There's still some labor shortages out there. The supply of new homes still remains low. And I think that the concerns that the housing market is falling apart are premature and overblown, but that's just my opinion.

**Operator**

Our next question will be from Matt Summerville with D.A. Davidson & Co.

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

A couple for clarifications. Can you remind us, when you look at the EMEA region, how much revenue is being driven by emerging markets? And then, secondarily, the tariff comments you made regarding 2019, is that inclusive of the step up that we could see beginning January 1? Or do your comments not adjust for that?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

So I'll take the EMEA piece first. We generally don't break out the West versus East. I'll just say that they are both important. And Caroline can maybe address your 2019 tariff question again.

**Caroline M. Chambers** - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

So we've looked at that, we have considered that, when we were taking a look at what the overall effect could be. But again, there's a lot of moving pieces, and including exactly, where we source particular products and the tariff rates, et cetera. So it's still, at this point, really an estimate.



## OCTOBER 25, 2018 / 3:00PM, GGG - Q3 2018 Graco Inc Earnings Call

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

Got it. And then, I apologize if I missed it Pat. In your prepared remarks, did you comment as to the performance in the Pro paint versus the home center channels in the third quarter? And maybe, talk a little bit about how the new product pipeline in particular for Contractor looks for 2019, and if we have, should be expecting some major launches either in the first or second quarter of next year?

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

Yes, so the out-the-door sales in more channels here in the Americas were good. So we feel pretty good going into Q4 and into next year that we still have some opportunities there. In terms of the new product pipeline, that division has historically done a really nice job of launching pretty exciting new products every year, and we like what we've got coming for 2019. So we think we're pretty well positioned from a new product launch standpoint in 2019, to continue our momentum as long as end markets give us something to work with.

**Operator**

(Operator Instructions) All right, I'm showing no further questions in the queue at this time.

**Patrick J. McHale** - *Graco Inc. - President, CEO & Director*

All right. Thanks, everybody, for your time joining the call this morning. And we'll get back to work, and we'll talk to you again in the end of January. Thanks.

**Operator**

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may now disconnect.

### DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2018, Thomson Reuters. All Rights Reserved.