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OVERVIEW:

Company Summary

CORPORATE PARTICIPANTS

Christopher Knutson

David M. Lowe *Graco Inc. - CFO & Treasurer*

Mark W. Sheahan *Graco Inc. - President, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Lawrence Tighe De Maria *William Blair & Company L.L.C., Research Division - Group Head of Global Industrial Infrastructure*

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

Tyler James Voigt *RBC Capital Markets, Research Division - Senior Associate*

PRESENTATION

Operator

Good morning, and welcome to the Third Quarter Conference Call for Graco Inc. If you wish to access the replay for this call, you may do so by visiting the company's website at www.graco.com. Graco has additional information available in the 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 purpose 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 the Item 1A of the company's 2022 annual report on Form 10-K and in the Item 1A of the company's most recent quarterly report on Form 10-Q.

These reports are available on the company's website at www.graco.com and the SEC's website at www.sec.gov. Forward-looking statements reflect management's current views and speak only as of the time they are made. The company undertakes no obligation to update these statements in light of new information or future events. I will now turn the conference over to Chris Knuston, Executive Vice President, Corporate Controller.

Christopher Knutson

Good morning, everyone, and thank you for joining our call. I'm here today with Mark Sheahan and David Lowe. I will provide a brief overview of our quarterly results, before turning the call over to Mark for additional discussion.

Yesterday, Graco reported third quarter sales of $540 million, a decrease of 1% from the third quarter of last year. The effect of currency translation increased sales by 1 percentage point or approximately $5 million. Based on current exchange rates, currency translation should have no effect on full year net sales and an unfavorable impact of approximately 1 percentage point on net earnings for the full year.

Reported net earnings increased 15% to $133 million for the quarter. Diluted net earnings per share was $0.77, an increase of 15% over last year. During the quarter, we recognized a noncash goodwill impairment charge of $8 million and a $9 million gain from the reduction in the fair value of contingent consideration, related to the reorganization of a business acquired in 2020.

Both of these items were included in unallocated operating expense. Excluding the impairment charge, contingent consideration adjustment and tax benefits from stock option exercises, adjusted net earnings per share was $0.76. The gross margin rate increased 490 basis points in the quarter. Strong price realization and lower product costs were more than enough to offset lower factory volumes.

While material costs have somewhat moderated compared to what we experienced last year, lower factory volumes and increased operational spending continue to be headwinds for the quarter and year-to-date. Total operating expenses increased $3 million or 3% in the quarter, primarily from volume and rate-related increases of $1 million and incremental share-based compensation of $2 million.

Gross margin rate improvement more than offset these increased operating expenses during the quarter, resulting in operating margin rate growth of 4 percentage points. Contractor operating margins increased 5 percentage points to 30% and Process operating margins increased 7 percentage points to 31% compared to the third quarter last year. At current volumes, we believe these operating margin rates are sustainable for the remainder of the year.

Nonoperating expenses decreased $2 million as a result of increased interest income on cash held. The adjusted effective tax rate was 19% for the quarter, which is consistent with our expected full year tax rate of approximately 19% to 20% on an as-adjusted basis. Cash provided by operations totaled $491 million for the year-to-date. An increase of $219 million from last year, mostly driven by higher net earnings and a reduction in inventory purchases.

Cash provided by operations as a percentage of net earnings is 124% for the year. Through the end of the quarter, we repurchased 427,000 shares for $31 million. We have continued to repurchase shares in the first week of October. And as of market close yesterday, we have repurchased 1.3 million shares for $93 million year-to-date.

During the quarter, we repaid $75 million in private placement notes plus a prepayment fee of $700,000. This represented the final series of the private placement debt we entered into in 2012.

We also made year-to-date dividend payments of $119 million and capital expenditures of $146 million with $89 million related to facility expansion projects. Finally, our full year estimates for unallocated corporate expense and capital expenditures can be found in the conference call slide deck on Page 10. I'll now turn the call over to Mark for further segment and regional commentary.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Thank you, Chris. Good morning, everybody. All of my comments this morning will be on an organic constant currency basis. In the face of a modest 2% revenue decline, we reported record third quarter operating earnings and operating profit margin. We experienced another quarter of strong broad-based sales growth in the Process segment, which was up 9% and 13% for the quarter and year, respectively.

The Industrial segment was down slightly on lower project activity in our Gema Powder business, and our Contractor segment declined 8% from a combination of a difficult comparison in EMEA versus last year's record quarter and the softening of global construction markets.

Overall, we're pleased that the company achieved third quarter operating margins of 30% or more in each of our segments. This was driven by a significant growth from the Process segment, coupled with strong operating performance from both Industrial and Contractor. Realized pricing actions remained strong and our factories have rebounded nicely after a couple of tough years of getting product out the door.

Input costs remain elevated, but in general, commodity prices have stabilized and should provide less of a headwind for the remainder of the year. At the close of the quarter, our consolidated backlog was $300 million. A decrease of $30 million from the previous quarter and $55 million lower than at the beginning of the year. Backlogs have returned to normal levels within contractor but they remain slightly elevated in semiconductor products and our Gema Powder business.

Now turning to some commentary on our segments and regions. Contractor segment sales were down 8% for the quarter. Sales decline across all regions with the steepest contraction on a percentage basis being in EMEA. EMEA's results for the quarter were impacted by challenging year-over-year comparisons. In 2022, Contractor sales in EMEA were up 12% in the third quarter, as we were able to ship a considerable amount of our backlog, when supply chain constraints started to alleviate.

There is also a robust order activity in the third quarter of 2022 in advance of our October price increase. In Asia Pacific, strong growth outside of China was not enough to offset declines in China from weaker container and construction markets this year. New product introductions and Contractor have helped drive incremental revenue in a challenging macro environment.

Products like our new lightweight QuickShot, electric-powered architectural coatings gun package, and the Reactor 2 component proportioning system for spray foam and polyurea applications, have been well received by customers globally. Profitability has improved in Contractor, as pricing actions are now starting to offset the significant cost increases experienced in the last 2 years. And product mix is more favorable than it was a year ago.

Industrial segment sales declined 1%. Strong sales in Asia Pacific were offset by timing of project completion and acceptance in our Powder Coating business. Activity in key end markets such as alternative energy, electronics and battery has been good. Elevated backlogs are expected to decrease, as we work our way through the fourth quarter.

The Process segment grew 9% in the third quarter. Increases were posted in most business units and across all reportable regions, led by double-digit growth in vehicle services and semiconductor. Resilient volume, strong pricing and good expense management drove incremental margins of 102% for the quarter and operating earnings of 31%.

Our lubrication equipment, diaphram pumps, semiconductor equipment and environmental equipment businesses all posted revenue gains in the third quarter and for the year. We've been able to leverage this growth into record operating profit margins for this segment this year.

Moving to our outlook. Our sales results for the first 9 months were in line with our annual -- our annual guide of low single digits organic growth on a constant currency basis. While macroeconomic conditions worldwide are unpredictable and business tempo has slowed from a year ago, we're pleased with the improvements that we are making in the business and that are driving record levels of profitability.

Current order rates, along with backlogs, new product activity and strong pricing gives us confidence that we will attain our full year 2023 revenue guide. That concludes our prepared remarks. Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mike Halloran with Robert W. Baird.

Unidentified Analyst

It's Pez on for Mike today. I know that we -- I know we picked it this last quarter, but I'm going to take another stab at it. Obviously, Process has been a bright spot in the portfolio, both from a top line and a margin perspective. But can you maybe dig in about why the sustainability of demand has been so good, particularly why lubrication and vehicle services continue to be so strong?

And then additionally, I know you mentioned that backlog in semi continues to be good. Can you maybe talk about why you're seeing maybe more sustainable trends versus some of the broader -- maybe your broader peers in the semi space recognizing that your offering is a little bit different using peers very loosely there?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, sure. I'll take a stab at it. I mean a couple of things. Obviously, we did some nice pricing actions over the last, I don't know, 18 months or so, which I think we're still seeing the benefit of. So when you look at our headline numbers, the revenue growth does have pricing baked into it.

Notwithstanding that, though, when you look across the portfolio of things that we have in that segment, whether it's our diaphragm pump business, where we've got some really good new products that are contributing to the growth. In semiconductor, we have been working down back orders throughout the year, which were actually embarrassingly high a year ago, and the team has done a really nice job of getting some throughput in the factory and making a lot of efficiency improvements there.

The outlook for semiconductor this year wasn't so good, and I think our orders are kind of falling in line with that. But as you look into '24 and into '25, there is a lot of investment going on there.

And so we feel like this is a good catch-up year for us. And hopefully, business remains robust, as we kind of work our way through the backlog we've got left. And then as we roll into 2025.

Vehicle service team is just doing really well in Lubrication overall. Of course, we got VS, but we also have industrial lube and we're seeing decent growth in both of those categories. It's a combination of superior execution, the ability to deliver out of the factory, some new product launches, that we've had that have really taken a nice hold in the marketplace.

And that's and combined with the pricing actions they've done and watching expenses, they've really been able to drive profitability at an extremely high rate there.

Our environmental businesses are doing well. Of course, the QED business, where we manage the fluids in and around landfills. And also the Gas Analyzer business that we have that does that analyzes the methane gas that's coming off of the landfills.

It seems like after a couple of years where the big players in landfill weren't making investments. They have started to pick up a little bit there. And so we've got a great product line, and I think we're benefiting there. We have a strong team, good factory performance. I think that it's a combination of pricing, great execution in the factories, some nice new product launches and reduction of backlog, that's really driven our results this year.

Unidentified Analyst

That's really robust answer. Super helpful, Mark. And maybe switching gears a little bit. Obviously, Inga has been with the team now for a little bit of time. I know that working on M&A and building that pipeline has been a priority. Could you maybe comment on the progress with building that pipeline whether you feel like you're getting the appropriate traction and where you need to be? Any color on the pipeline development and kind of the process would be helpful.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. Thanks. Thanks for bringing it up to Inga's been on my team now for almost 2 years, I think it will be 2 years in January. And Inga and Ryan Patrick, who works with Inga have done a really nice job of working with the business units, in developing our M&A pipeline of ideas and companies.

It's interesting. I would tell you that a couple of years ago, I probably could have walked around the company and asked people to give me their M&A pipelines. And I might have come up with 100 companies. But I would say that less than half of them had been fully vetted, where we actually knew about the company.

We knew who to contact. We had a good understanding of what the strategic fit was and why they might be an attractive target. So -- what we've been doing in the last year or so, is really sorting through those pipelines and adding to them where it made sense and taking out some of the companies where we really didn't have a good strategic vision.

So as I sit here today, I think we have over 100 companies in our pipeline. They've all been fully vetted. Of course, there's a lot of things that go into whether you can actually do a deal or not, but I feel like we're in better shape today than we've been for quite some time in terms of the robustness of the pipeline, the quality of the pipeline and the quality of the discussions that we're having with companies that we're interested in.

Operator

Our next question comes from the line of Deane Dray with RBC Capital Markets.

Tyler James Voigt - *RBC Capital Markets, Research Division - Senior Associate*

This is Tyler Voigt on for Dean. My first question, just can you give us a sense for what the monthly cadence of sales were? Was it decelerated as the quarter went on? Or any color there, as well as how things are trending in October.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think the cadence was pretty stable, to be honest with you, it's been hanging in there. The comps are interesting, right, because of last year with all the pricing stuff that we did. And the supply chain constraints and people placing orders ahead of time just to get into the queue, that type of thing. But in terms of the absolute level of orders that we're seeing across Graco, I'd characterize it as stable at this point.

Tyler James Voigt - *RBC Capital Markets, Research Division - Senior Associate*

Great. That's really helpful. And then do you mind just touching on how inventories are looking in the channel at both the home center and pro paint?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. When we probe our team on that topic, which we do frequently, particularly in the home center and at the retail paint stores, where we sell product to. The feedback that we're getting is that the pipeline of inventory is in good shape. It pretty much matches up with the level of activity that they're seeing in the marketplace.

I can't tell you that, that was the case a year ago. I think a year ago, they may have still been playing a little bit of catch-up in terms of trying to build up their inventory levels.

And this year, the feedback that we're getting is that folks feel like things are in pretty good shape. You probably know that the home center has been challenging this year. Foot traffic is down. The big retailers have reacted to that. But again, I think that they've worked through any excess inventory that they may have had as their foot traffic came down, I think we're in a good spot right now.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. This is David. I'd just like to volunteer that on the inventory side, you may know this, but others -- maybe you're newer to the story. It's helpful to remind them, when they read that other companies are talking about destocking and channel working off excess inventories because they have more confidence in the supply chain.

It really isn't a significant factor, excess inventory in our businesses because our channel partners in industrial and in process really don't stock much outside of the spare parts space.

So through good times and bad and through periods of greater or lesser demand, we have and continue to have a high level of confidence that wholesale equals retail. And there is not an inventory overhang in those 2 segments, that gives us any degree of concern.

Operator

Our next question comes from Saree Boroditsky with Jefferies.

Unidentified Analyst

This is James on for Saree. And I wanted to talk about contractor margins. So the margins improved like kind of significantly year-over-year and quarter-over-quarter, like despite lower revenue levels on a sequential basis. So can you please provide more color on the magnitude of benefit from price, product cost and mix? And also, can you talk about the sustainability of the margin level?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I don't think we are going to be able to fine-tune the different components there. But for sure, price has had a nice impact for CED. You might remember a year ago, when we were talking about all our input costs going through the roof.

And how contractor was really bearing most of that burden and things like electronic components that were very expensive and hard to get and you had to make special accommodations to suppliers to actually get parts in the door.

That has really freed up. So a lot of that hyperinflation that was going on and some of the things that they purchased is has subsided. Our pricing actions that we took, were really designed to offset the cost pressures that we had in the business, and we're seeing that happen. So you're seeing margin rates kind of go back to more of a normal level, I would believe in that business and what we had seen maybe over the last couple of years.

The team is doing a great job managing their expenses. They're not -- they understand the dynamics in the market right now are not as good as they were the last couple of years. And I think that I'm pleased with how they're making sure they're keeping an eye on spending and not adding to our fixed cost base. We do have some variable expenses in our P&L and contractor related to incentive payments that last year were higher than they are this year.

So there's a little bit of tailwind from that activity in addition to what you're seeing on the gross margin line in that business. But Overall, they're at 30% operating margins. I don't know if the business has ever been that high. I think in Q1, we might have touched that level.

But as we work our way through the rest of the year, I think as Chris said in his comments, we really believe that those rates of operating profitability are sustainable as long as we continue to run at the volumes that we're seeing, which we're pretty confident that we will.

Unidentified Analyst

Got it. Thanks for the detailed color. That's very helpful. And staying with contractor. So can you kind of talk about how different end markets within the Contractor kind of played out in the quarter since one of your large customers talked about kind of solid commercial performance, while new residue remains precious. And have you seen any pressure or headwind from interest on the commercial side?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. So I mean, if you were to look at the business in CED, I mean, there's a ton of moving parts, right? We've got the pro paint side. We have the tradesmen, high-end DIY side of the business. We have spray form. We have protective coatings. We have line striping. We have stucko and texture. We have all kinds of different segments within contractors. So in any one of them, they might be up or they might be down.

I would say that generally speaking, when you read all the headlines about how bad it is in the housing market and the uncertainty around all that, I feel pretty good about how our businesses performed this year. For sure, protective & marine, protective coatings, spray foam, anything in what we call our high-performance coatings and foam business has been good.

The Pro business has held in there better than what I think most people would have expected. And the home center has been tough. So when you get outside of North America and you start talking about Europe, I think the Pro business has held up pretty well on a year-to-date basis.

And when you look over in Asia, I think it's really limited -- the weakness that we've seen has really been limited to China. And there's 2 things there. One is the container business where they put coatings on to containers for -- they go on to ships for cargo. That business has dropped pretty significantly. So we're just not selling as much equipment there.

I actually ran the business for a while. So you live through these periods where it's up and then it's down at kind of in a down period. And then in China, I was over there about a month ago, and the construction market over there has really softened quite a bit. You drive around the city and you'd see cranes, but you would see no activity at all around the cranes, which is vastly different than what it was when I was over there 4 years ago.

Unfortunately, it had been that long because of the pandemic. But 4 years ago, you'd see cranes, but you'd see all kinds of stuff happening. So it's really not too surprising that our business has kind of played out the way that it has.

Operator

Our next question comes from the line of Jeff Hammond with KeyBanc Capital Markets Inc.

Our next question comes from Matt Summerville with D.A. Davidson.

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

Can you, Mark, can you maybe help me kind of square the comments you made just on the Powder finishing business, Gema as you kind of talk about backlog being healthy, but projects may be pushing to the right adverse timing. Can you just provide a little bit more detail as to what you're seeing there?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. Good question. So there's really -- at a really high level, there's kind of 2 big pieces to the Gema business, one is our Powder systems. And the other are the equipment side, packages and guns and accessories and those types of things. And what -- we acquired a business, I don't know, half a dozen years or so ago, that really focuses on the Powder systems side of the business.

And in particular, they make conveyor systems for vertical line coatings. And these are aluminum extruded materials that are used in a lot of different applications. And those extruded aluminum pieces get coated with Powder Coatings, and they're a large user of Gema equipment. And their business has been softer than what we experienced over the last couple of years.

So there's a little bit of volatility there in terms of the overall results within the Gema Powder business. I would say that the other side of the Gema business has been actually pretty good. Anything standard equipment, distributed product, parts and accessories is sort of mirroring what we see on the other side of the Graco Industrial businesses, which are liquid finishing and Sealants & Adhesives. But the systems business can be kind of lumpy.

And we still have some orders in the backlog that hopefully will ship between now and the end of the year. But it does create some -- a little bit of volatility on a quarterly basis. We do try to factor all this into our annual revenue guide outlook. And so knowing what we know about the backlog and what's going to ship out of Powder for the rest of the year, we feel pretty confident that we're still going to be able to hit those numbers.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. Excuse me, this is David again. I would underline Mark's point about the, call it, the lumpiness of closure or in sign-off of systems, tends to be more active based on our history in Q4. So we're confident that we'll see a more elevated level in Q4. We don't have a sense of the absolute number.

And there are complexities in a systems business that we don't see as primarily a component supplier in most of our businesses. And sometimes, a final sign off of our system is held up by factors not related to us but related to the project, meaning the conveyor supplier or the robot supplier or the HVAC supplier, hasn't gotten their work fully fleshed out and completed yet.

And with the supply chain challenges of the last couple of years, frankly, coupled with COVID too, those are, I'd say, particularly sophisticated and complex logistical problems, especially in the markets in South America and in Asia and in Eastern Europe, where a lot of the new powder systems are installed.

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

And then just as a follow-up. Obviously, it's a little bit early, but I'm sure it's top of mind. Mark, how are you thinking about pricing as you go into '24?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. I think it's going to be more of a normal year for us. We try to realize 1.5% to 2% pricing in a normal environment. Inflation is still running higher than it was a few years ago. So in terms of like the absolute level of price increase, lift to lift. I think we're going to be higher than what we would have been, let's say, in the 2018, 2019 time frame.

But right now, we're thinking there will be one price increase. We'll be doing it in January, and it will be more in line with what we've done historically.

Operator

Our next question comes from the line of Larry De Maria at William Blair.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Group Head of Global Industrial Infrastructure*

First question, you mentioned semiconductors as an opportunity for kind of '24, '25. As we sit here today, are there some other big organic opportunities, you look through segments for '24 specifically because it sort of feels look a little bit of a sideways market as backlog comes down, and we have these headwinds to contractors.

So in other words, it seems to be things looking sort of flattish as we look out to the right as the backlogs come down. Just trying to see if there's anything besides price on the data side that could drive volume higher next year?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes, it's a good question. I think I would turn to the products that we have in the portfolio and some of the things that we plan to launch and some of the ones we already have. There's obviously big macro trends out there on the movement from air-operated pumps to electric drive pumps. And I think we're capitalizing on that advantage. We got some products coming out in the next 12 months, and I think we'll be even more able to capitalize on that opportunity.

The alternative energy space is still pretty hot. There's a lot going on in battery manufacturing. We're heavily involved with that. Solar panels are going up all over the place. And obviously, we're making equipment and fine-tuning our portfolio of products that we offer in that particular space.

So all in all, there are nice new products coming out within the portfolio, which are going to help us hopefully offset any kind of macro sluggishness, I'll call it, that people are expecting in '24.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Group Head of Global Industrial Infrastructure*

Okay. And then second, just 2 quick questions here. You pull back some stock, sounds like you're doing some more. Is there a target number to think about here for share repurchases for the full year? And also, can you give us and maybe -- so I apologize if I missed it, but what was price and volume in the quarter specifically?

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Yes. So I think we disclosed that. We will disclose that in terms of the absolute levels that we've purchased. I think Chris gave that information. What we try to do here when we evaluate when to buy stock and how much to buy is we really run a discounted cash flow analysis on Graco.

And we treat it like any other capital project that we might consider within the company. And long story short, we come up with a number. We look at the market cap of the company and the overall valuation. And to the extent that we feel like there's a mismatch there. We are active in the market. And of course, we become more active in the market when we think that mismatch is broader.

Historically, I think our approach has worked extremely well. The last number that I saw that I think David shared with me is that over the last dozen or so years, our own IRR on stock buybacks is somewhere around 13% or 14%, which I feel really good about.

So here in this quarter, obviously, there has been some weakness in the stock. We've gotten involved with it, and we'll continue to be opportunistic as the year goes on.

David M. Lowe - *Graco Inc. - CFO & Treasurer*

Yes. And I think that's the -- that really remains the key word is opportunistic. And the way Mark described, the discounted cash flow/ROI, process we go through really is the way we do it. And while I may not necessarily think of Graco as a classic cyclical. We serve cyclical markets, and so the Street tends to think of us that way.

And because of that, there will be opportunities from time to time to be more aggressive. And I think it's something we keep in mind because when days -- when times are dark, like they were in '09 briefly in '15 and certainly in '20, we were positioned strongly to move aggressively and take advantage of those short-term discrepancies that seem to appear every so often.

Lawrence Tighe De Maria - *William Blair & Company L.L.C., Research Division - Group Head of Global Industrial Infrastructure*

Good luck. And if you have the price volume number, that would be helpful.

Operator

(Operator Instructions) Our next question comes from the line of Jeff Hammond with KeyBanc Capital Markets.

There are no further questions, I will now turn the conference over to Mark Sheanhan.

Mark W. Sheahan - *Graco Inc. - President, CEO & Director*

Okay. Well, again, I want to thank everyone for participating in today's call, and thank you for your loyalty and continued interest in Graco. Have a great day.

Operator

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