

GRACO INC
Form 10-Q
April 20, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15 (d) of the
Securities Exchange Act of 1934
For the quarterly period ended March 25, 2016
Commission File Number: 001-09249

GRACO INC.
(Exact name of registrant as specified in its charter)

Minnesota 41-0285640
(State of incorporation) (I.R.S. Employer Identification Number)

88 - 11th Avenue N.E. 55413
Minneapolis, Minnesota
(Address of principal executive offices) (Zip Code)
(612) 623-6000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer Accelerated Filer
Non-accelerated Filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

55,614,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of April 13, 2016.

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PART I Item 1.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited) (In thousands except per share amounts)

	Thirteen Weeks Ended	
	March 25, 2016	March 27, 2015
Net Sales	\$304,912	\$306,453
Cost of products sold	143,116	144,324
Gross Profit	161,796	162,129
Product development	14,686	15,290
Selling, marketing and distribution	52,701	51,424
General and administrative	33,460	30,184
Operating Earnings	60,949	65,231
Interest expense	4,493	5,303
Held separate investment (income), net	—	(29,523)
Other expense (income), net	(1,146)	710
Earnings Before Income Taxes	57,602	88,741
Income taxes	18,050	19,900
Net Earnings	\$39,552	\$68,841
Per Common Share		
Basic net earnings	\$0.71	\$1.17
Diluted net earnings	\$0.70	\$1.14
Cash dividends declared	\$0.33	\$0.30

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)

	Thirteen Weeks Ended	
	March 25, 2016	March 27, 2015
Net Earnings	\$39,552	\$68,841
Components of other comprehensive income (loss)		
Cumulative translation adjustment	(2,402)	(3,011)
Pension and postretirement medical liability adjustment	1,473	2,438
Income taxes - pension and postretirement medical liability adjustment	(569)	(902)
Other comprehensive income (loss)	(1,498)	(1,475)
Comprehensive Income	\$38,054	\$67,366

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Unaudited) (In thousands)

	March 25, 2016	December 25, 2015
ASSETS		
Current Assets		
Cash and cash equivalents	\$36,490	\$ 52,295
Accounts receivable, less allowances of \$11,400 and \$10,400	226,030	225,509
Inventories	212,331	202,136
Other current assets	20,993	29,077
Total current assets	495,844	509,017
Property, Plant and Equipment		
Cost	469,381	461,173
Accumulated depreciation	(285,170)	(282,736)
Property, plant and equipment, net	184,211	178,437
Goodwill	419,447	394,488
Other Intangible Assets, net	248,827	227,987
Deferred Income Taxes	58,674	56,976
Other Assets	23,995	24,447
Total Assets	\$1,430,998	\$ 1,391,352
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable to banks	\$14,508	\$ 15,901
Trade accounts payable	40,329	40,505
Salaries and incentives	27,886	44,673
Dividends payable	18,150	18,447
Other current liabilities	60,884	75,090
Total current liabilities	161,757	194,616
Long-term Debt	457,670	392,695
Retirement Benefits and Deferred Compensation	137,356	137,457
Deferred Income Taxes	28,577	22,303
Other Non-current Liabilities	8,730	8,730
Shareholders' Equity		
Common stock	55,566	55,766
Additional paid-in-capital	422,436	398,774
Retained earnings	264,901	285,508
Accumulated other comprehensive income (loss)	(105,995)	(104,497)
Total shareholders' equity	636,908	635,551
Total Liabilities and Shareholders' Equity	\$1,430,998	\$ 1,391,352
See notes to consolidated financial statements.		

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)

	Thirteen Weeks Ended	
	March 25, 2016	March 27, 2015
Cash Flows From Operating Activities		
Net Earnings	\$ 39,552	\$ 68,841
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	12,010	10,810
Deferred income taxes	(2,688)	(4,044)
Share-based compensation	6,093	5,033
Excess tax benefit related to share-based payment arrangements	(3,300)	(300)
Change in		
Accounts receivable	3,100	(26,632)
Inventories	(8,127)	(13,545)
Trade accounts payable	119	6,088
Salaries and incentives	(17,191)	(16,910)
Retirement benefits and deferred compensation	669	3,171
Other accrued liabilities	(3,233)	4,947
Other	(1,426)	9,762
Net cash provided by operating activities	25,578	47,221
Cash Flows From Investing Activities		
Property, plant and equipment additions	(13,121)	(9,796)
Acquisition of businesses, net of cash acquired	(48,881)	(182,904)
Investment in restricted assets	876	—
Other	320	38
Net cash provided by (used in) investing activities	(60,806)	(192,662)
Cash Flows From Financing Activities		
Borrowings (payments) on short-term lines of credit, net	(1,461)	47,605
Borrowings on long-term line of credit	298,709	379,095
Payments on long-term line of credit	(233,734)	(227,055)
Excess tax benefit related to share-based payment arrangements	3,300	300
Common stock issued	20,111	12,746
Common stock repurchased	(48,050)	(46,935)
Cash dividends paid	(18,332)	(17,730)
Net cash provided by (used in) financing activities	20,543	148,026
Effect of exchange rate changes on cash	(1,120)	1,437
Net increase (decrease) in cash and cash equivalents	(15,805)	4,022
Cash and cash equivalents		
Beginning of year	52,295	23,656
End of period	\$ 36,490	\$ 27,678
See notes to consolidated financial statements.		

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

The consolidated balance sheet of Graco Inc. and Subsidiaries (the "Company") as of March 25, 2016 and the related statements of earnings for the thirteen weeks ended March 25, 2016 and March 27, 2015, and cash flows for the thirteen weeks ended March 25, 2016 and March 27, 2015 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company as of March 25, 2016, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2015 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Thirteen Weeks Ended	
	March 25, 2016	March 27, 2015
Net earnings available to common shareholders	\$39,552	\$ 68,841
Weighted average shares outstanding for basic earnings per share	55,394	58,981
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,315	1,484
Weighted average shares outstanding for diluted earnings per share	56,709	60,465
Basic earnings per share	\$0.71	\$ 1.17
Diluted earnings per share	\$0.70	\$ 1.14

Stock options to purchase 1,909,000 and 1,186,000 shares were not included in the March 25, 2016 and March 27, 2015 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Share-Based Awards

Options on common shares granted and outstanding, as well as the weighted average exercise price, are shown below (in thousands, except exercise prices):

	Weighted		Weighted
Option Shares	Average Exercise Price	Options Exercisable	Average Exercise Price

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Outstanding, December 25, 2015	5,165	\$ 48.16	3,583	\$ 38.49
Granted	642	71.54		
Exercised	(465)	37.78		
Canceled	(6)	67.46		
Outstanding, March 25, 2016	5,336	\$ 51.86	3,575	\$ 41.83

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The Company recognized year-to-date share-based compensation of \$6.1 million in 2016 and \$5.0 million in 2015. As of March 25, 2016, there was \$17.0 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.9 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

	Thirteen Weeks Ended March 25, March 27, 2016 2015			
Expected life in years	7.0		6.5	
Interest rate	1.4	%	1.7	%
Volatility	30.3	%	35.3	%
Dividend yield	1.9	%	1.6	%
Weighted average fair value per share	\$18.89		\$23.42	

Under the Company's Employee Stock Purchase Plan, the Company issued 170,000 shares in 2016 and 166,000 shares in 2015. The fair value of the employees' purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

	Thirteen Weeks Ended March 25, March 27, 2016 2015			
Expected life in years	1.0		1.0	
Interest rate	0.7	%	0.2	%
Volatility	19.3	%	18.9	%
Dividend yield	1.7	%	1.6	%
Weighted average fair value per share	\$17.49		\$16.51	

4. Retirement Benefits

The components of net periodic benefit cost for retirement benefit plans were as follows (in thousands):

	Thirteen Weeks Ended March 25, March 27, 2016 2015	
Pension Benefits		
Service cost	\$1,997	\$2,096
Interest cost	4,017	3,775
Expected return on assets	(4,637)	(4,917)
Amortization and other	2,300	2,353
Net periodic benefit cost	\$3,677	\$3,307
Postretirement Medical		
Service cost	\$150	\$150
Interest cost	262	226
Amortization	(138)	(101)
Net periodic benefit cost	\$274	\$275

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5.Shareholders' Equity

Changes in components of accumulated other comprehensive income (loss), net of tax were (in thousands):

	Pension and Post- retirement Medical	Cumulative Translation Adjustment	Total
Balance, December 26, 2014	\$(76,584)	\$(24,152)	\$(100,736)
Other comprehensive income before reclassifications	—	(3,011)	(3,011)
Amounts reclassified from accumulated other comprehensive income	1,536	—	1,536
Balance, March 27, 2015	\$(75,048)	\$(27,163)	\$(102,211)
Balance, December 25, 2015	\$(69,922)	\$(34,575)	\$(104,497)
Other comprehensive income before reclassifications	—	(2,402)	(2,402)
Amounts reclassified from accumulated other comprehensive income	904	—	904
Balance, March 25, 2016	\$(69,018)	\$(36,977)	\$(105,995)

Amounts related to pension and postretirement medical adjustments are reclassified to pension cost, which is allocated to cost of products sold and operating expenses based on salaries and wages, approximately as follows (in thousands):

	Thirteen Weeks Ended	
	March 25, 2016	March 27, 2015
Cost of products sold	\$528	\$ 938
Product development	204	383
Selling, marketing and distribution	486	703
General and administrative	255	414
Total before tax	\$1,473	\$ 2,438
Income tax (benefit)	(569)	(902)
Total after tax	\$904	\$ 1,536

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6. Segment Information

The Company has three reportable segments, Industrial, Process and Contractor. Sales and operating earnings by segment were as follows (in thousands):

	Thirteen Weeks Ended March 25, March 27, 2016 2015	
Net Sales		
Industrial	\$ 147,088	\$ 143,266
Process	64,285	67,681
Contractor	93,539	95,506
Total	\$ 304,912	\$ 306,453
Operating Earnings		
Industrial	\$ 45,794	\$ 42,940
Process	7,277	10,498
Contractor	16,743	19,375
Unallocated corporate (expense)	(8,865)	(7,582)
Total	\$ 60,949	\$ 65,231

Assets by segment were as follows (in thousands):

	March 25, 2016	December 25, 2015
Industrial	\$ 562,702	\$ 558,799
Process	532,447	481,677
Contractor	216,170	205,632
Unallocated corporate	119,679	145,244
Total	\$ 1,430,998	\$ 1,391,352

Geographic information follows (in thousands):

	Thirteen Weeks Ended March 25, March 27, 2016 2015	
Net sales (based on customer location)		
United States	\$ 153,001	\$ 159,328
Other countries	151,911	147,125
Total	\$ 304,912	\$ 306,453
	March 25, 2016	December 25, 2015
Long-lived assets		
United States	\$ 148,058	\$ 144,571
Other countries	36,153	33,866
Total	\$ 184,211	\$ 178,437

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7. Inventories

Major components of inventories were as follows (in thousands):

	March 25, 2016	December 25, 2015
Finished products and components	\$117,180	\$ 112,267
Products and components in various stages of completion	55,136	51,033
Raw materials and purchased components	84,556	82,894
	256,872	246,194
Reduction to LIFO cost	(44,541)	(44,058)
Total	\$212,331	\$ 202,136

8. Intangible Assets

Information related to other intangible assets follows (dollars in thousands):

	Estimated Life (years)	Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
March 25, 2016					
Customer relationships	3 - 14	\$218,227	\$ (41,010)	\$ (9,306)	\$167,911
Patents, proprietary technology and product documentation	3 - 11	22,222	(9,514)	(576)	12,132
Trademarks, trade names and other	5				