

GRACO INC
Form 10-Q
October 21, 2015
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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 September 25, 2015
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 (Zip Code)
(Address of principal executive offices)
(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, 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 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

55,913,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of October 14, 2015.

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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		Thirty-nine Weeks Ended	
	Sep 25, 2015	Sep 26, 2014	Sep 25, 2015	Sep 26, 2014
Net Sales	\$318,986	\$302,614	\$960,928	\$915,125
Cost of products sold	148,790	136,800	447,980	413,149
Gross Profit	170,196	165,814	512,948	501,976
Product development	14,783	13,785	44,980	40,349
Selling, marketing and distribution	48,374	47,466	149,924	143,311
General and administrative	30,112	25,656	91,995	78,856
Operating Earnings	76,927	78,907	226,049	239,460
Interest expense	4,025	4,566	13,453	13,830
Held separate investment (income), net	(2,388	) (8,520	) (190,744	) (22,757
Other expense (income), net	1,389	310	1,661	355
Earnings Before Income Taxes	73,901	82,551	401,679	248,032
Income taxes	23,210	23,000	109,510	71,500
Net Earnings	\$50,691	\$59,551	\$292,169	\$176,532
Per Common Share				
Basic net earnings	\$0.88	\$0.99	\$5.02	\$2.92
Diluted net earnings	\$0.86	\$0.97	\$4.90	\$2.85
Cash dividends declared	\$0.30	\$0.28	\$0.90	\$0.83

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 25, 2015	Sep 26, 2014	Sep 25, 2015	Sep 26, 2014
Net Earnings	\$50,691	\$59,551	\$292,169	\$176,532
Other comprehensive income (loss)				
Cumulative translation adjustment	(13,572	) (12,888	) (4,179	) (14,882
Pension and postretirement medical liability adjustment	2,537	1,463	6,894	3,876
Income taxes				
Pension and postretirement medical liability adjustment	(837	) (490	) (2,478	) (1,354
Other comprehensive income (loss)	(11,872	) (11,915	) 237	(12,360
Comprehensive Income	\$38,819	\$47,636	\$292,406	\$164,172

See notes to consolidated financial statements.

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

	Sep 25, 2015	Dec 26, 2014
ASSETS		
Current Assets		
Cash and cash equivalents	\$51,913	\$23,656
Accounts receivable, less allowances of \$10,200 and \$8,100	229,504	214,944
Inventories	197,215	159,797
Deferred income taxes	21,451	19,969
Investment in businesses held separate	—	421,767
Other current assets	19,797	19,374
Total current assets	519,880	859,507
Property, Plant and Equipment		
Cost	452,370	433,751
Accumulated depreciation	(280,145	) (272,521)
Property, plant and equipment, net	172,225	161,230
Goodwill	397,322	292,574
Other Intangible Assets, net	233,858	176,278
Deferred Income Taxes	39,435	28,982
Other Assets	24,679	26,207
Total Assets	\$1,387,399	\$1,544,778
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable to banks	\$9,243	\$5,016
Trade accounts payable	50,231	39,306
Salaries and incentives	43,612	40,775
Dividends payable	17,100	17,790
Other current liabilities	84,161	71,593
Total current liabilities	204,347	174,480
Long-term Debt		
Retirement Benefits and Deferred Compensation	137,987	136,812
Deferred Income Taxes	22,084	22,454
Other non-current liabilities	11,489	—
Shareholders' Equity		
Common stock	56,238	59,199
Additional paid-in-capital	396,140	384,704
Retained earnings	284,613	252,865
Accumulated other comprehensive income (loss)	(100,499	) (100,736)
Total shareholders' equity	636,492	596,032
Total Liabilities and Shareholders' Equity	\$1,387,399	\$1,544,778
See notes to consolidated financial statements.		

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

	Thirty-nine Weeks Ended	
	Sep 25, 2015	Sep 26, 2014
Cash Flows From Operating Activities		
Net Earnings	\$292,169	\$176,532
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	33,286	27,621
Deferred income taxes	(13,723	) (7,079
Share-based compensation	15,488	13,810
Excess tax benefit related to share-based payment arrangements	(1,200	) (3,700
(Gain) loss on sale of business, net	(149,003) —
Change in		
Accounts receivable	(21,195	) (31,632
Inventories	(28,648	) (12,889
Trade accounts payable	3,124	2,058
Salaries and incentives	(2,759	) (3,323
Retirement benefits and deferred compensation	8,802	3,813
Other accrued liabilities	19,556	7,661
Other	(20,665	) (2,468
Net cash provided by operating activities	135,232	170,404
Cash Flows From Investing Activities		
Property, plant and equipment additions	(28,860	) (25,284
Acquisition of businesses, net of cash acquired	(187,853	) (65,219
Proceeds from sale of assets	610,162	—
Investment in restricted assets	(8,580) —
Investment in businesses held separate	—	530
Other	(43	) (991
Net cash provided by (used in) investing activities	384,826	(90,964
Cash Flows From Financing Activities		
Borrowings (payments) on short-term lines of credit, net	4,265	(3,611
Borrowings on long-term line of credit	595,400	485,230
Payments on long-term line of credit	(835,400	) (384,850
Payments of debt issuance costs	—	(890
Excess tax benefit related to share-based payment arrangements	1,200	3,700
Common stock issued	16,768	21,987
Common stock repurchased	(224,730	) (141,857
Cash dividends paid	(52,658	) (50,007
Net cash provided by (used in) financing activities	(495,155	) (70,298
Effect of exchange rate changes on cash	3,354	(161
Net increase (decrease) in cash and cash equivalents	28,257	8,981
Cash and cash equivalents		
Beginning of year	23,656	19,756
End of period	\$51,913	\$28,737
See notes to consolidated financial statements.		

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GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

The consolidated balance sheet of Graco Inc. and Subsidiaries (the “Company”) as of September 25, 2015 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 25, 2015 and September 26, 2014, and cash flows for the thirty-nine weeks ended September 25, 2015 and September 26, 2014 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 September 25, 2015, 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 2014 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.

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 25, 2015	Sep 26, 2014	Sep 25, 2015	Sep 26, 2014
Net earnings available to common shareholders	\$50,691	\$59,551	\$292,169	\$176,532
Weighted average shares outstanding for basic earnings per share	57,325	59,928	58,180	60,401
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,339	1,614	1,410	1,602
Weighted average shares outstanding for diluted earnings per share	58,664	61,542	59,590	62,003
Basic earnings per share	\$0.88	\$0.99	\$5.02	\$2.92
Diluted earnings per share	\$0.86	\$0.97	\$4.90	\$2.85

Stock options to purchase 1,391,000 and 617,000 shares were not included in the September 25, 2015 and September 26, 2014 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

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On May 11, 2015, the Company entered into an accelerated share repurchase arrangement (“ASR”) with a financial institution. In exchange for an up-front payment of \$60 million, the financial institution delivered 742,880 shares of Company common stock with a fair value of \$54 million. The total number of shares ultimately delivered under the ASR was determined at the end of the purchase period based on the volume weighted-average price of the Company’s common stock during that period. The purchase period ended in the third quarter and the Company received an additional 94,515 shares to complete the ASR at an average realized price of \$71.65 per share.

The Company accounted for the up-front payment as a reduction of shareholders’ equity in the period made. Shares received under the ASR were retired and reflected as a reduction of outstanding shares on the date delivered for purposes of calculating earnings per share. The forward contract aspect of the ASR met all of the applicable criteria for equity classification, and therefore, was accounted for as a derivative indexed to the Company’s equity.

³ Options on common shares granted and outstanding, as well as the weighted average exercise price, are shown below (in thousands, except exercise prices):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 26, 2014	4,975	\$44.72	3,318	\$34.86
Granted	543	74.19		
Exercised	(171	) 34.57		
Canceled	(17	) 72.14		
Outstanding, September 25, 2015	5,330	\$47.96	3,739	\$38.55

The Company recognized year-to-date share-based compensation of \$15.5 million in 2015 and \$13.8 million in 2014. As of September 25, 2015, there was \$13.6 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.8 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:

	Thirty-nine Weeks Ended		
	Sep 25, 2015	Sep 26, 2014	
Expected life in years	6.5	6.5	
Interest rate	1.7	% 2.0	%
Volatility	35.0	% 36.1	%
Dividend yield	1.6	% 1.5	%
Weighted average fair value per share	\$23.18	\$24.83	

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Under the Company's Employee Stock Purchase Plan, the Company issued 166,000 shares in 2015 and 193,000 shares in 2014. 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:

	Thirty-nine Weeks Ended		
	Sep 25, 2015	Sep 26, 2014	
Expected life in years	1.0	1.0	
Interest rate	0.2	% 0.1	%
Volatility	18.9	% 21.4	%
Dividend yield	1.6	% 1.4	%
Weighted average fair value per share	\$16.51	\$17.81	

In April 2015, shareholders of the Company approved the Graco Inc. 2015 Stock Incentive Plan. The plan provides for issuance of up to 3.5 million shares of Graco common stock.

Shares authorized for issuance under stock option and purchase plans are shown below (in thousands):

	Total Shares Authorized	Available for Future Issuance as of Sep 25, 2015
Stock Incentive Plan (2015)	3,500	3,452
Employee Stock Purchase Plan (2006)	7,000	4,928
Total	10,500	8,380

Amounts available for future issuance exclude outstanding options. Options outstanding as of September 25, 2015, include options granted under three plans that were replaced by subsequent plans. No shares are available for future grants under those plans.

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	Sep 25, 2015	Sep 26, 2014	Sep 25, 2015	Sep 26, 2014
Pension Benefits				
Service cost	\$2,265	\$1,707	\$6,268	\$5,146
Interest cost	3,741	3,909	11,121	11,985
Expected return on assets	(5,010	) (5,311	) (14,586	) (15,941
Amortization and other	2,291	1,341	7,070	4,029
Net periodic benefit cost	\$3,287	\$1,646	\$9,873	\$5,219
Postretirement Medical				
Service cost	\$107	\$115	\$407	\$365
Interest cost	263	181	716	736
Amortization	(63) (229) (265) (483
Net periodic benefit cost	\$307	\$67	\$858	\$618

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

	Pension and Post-retirement Medical	Cumulative Translation Adjustment	Total	
Thirteen Weeks Ended				
September 26, 2014				
Beginning balance	\$(48,583	) \$1,789	\$(46,794)
Other comprehensive income before reclassifications	—	(12,888	) (12,888)
Amounts reclassified from accumulated other comprehensive income	973	—	973	
Ending balance	\$(47,610	) \$(11,099	) \$(58,709)
Thirteen Weeks Ended				
September 25, 2015				
Beginning balance	\$(73,868	) \$(14,759	) \$(88,627)
Other comprehensive income before reclassifications	—	(13,572	) (13,572)
Amounts reclassified from accumulated other comprehensive income	1,700	—	1,700	