May 14, 2020

Graco Inc. (GGG)

$43.62 (As of 05/13/20)

Price Target (6-12 Months): **$46.00**

Long Term: 6-12 Months	**Zacks Recommendation:** (Since: 12/24/19) Prior Recommendation: Underperform	**Neutral**
Short Term: 1-3 Months	**Zacks Rank:** (1-5)	**4-Sell**
	Zacks Style Scores:	VGM:F
	Value: F | Growth: D | Momentum: B	

Summary

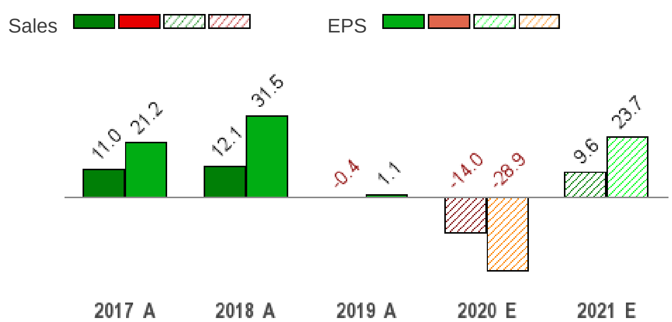
Graco anticipates gaining from the exposure in new markets, global expansion, buyouts and end-user conversion in the long term. Also, its focus on capacity expansion and product innovation might be beneficial in the quarters ahead. In 2020, the company plans to invest $70 million to roll out machinery and equipment. Rewarding shareholders and keeping adequate liquidity will likely aid too. In first-quarter 2020, Graco's earnings and sales lagged estimates by 13.6% and 5.6%, respectively. It noted that the coronavirus outbreak is taking a toll on incoming orders and 2020 revenue projections have been suspended. Also, investments are expected to pressure margins in the second quarter, and forex woes are predicted to hurt 2020 sales and earnings by 1% and 3%, respectively. In the past three months, the company's shares have declined.

Price, Consensus & Surprise

Data Overview

52 Week High-Low	**$56.99 - $38.43**
20 Day Average Volume (sh)	**824,596**
Market Cap	**$7.3 B**
YTD Price Change	**-16.1%**
Beta	**0.57**
Dividend / Div Yld	**$0.70 / 1.6%**
Industry	**Manufacturing - General Industrial**
Zacks Industry Rank	**Bottom 13% (220 out of 253)**
Last EPS Surprise	**-13.6%**
Last Sales Surprise	**-5.6%**
EPS F1 Est- 4 week change	**-19.6%**
Expected Report Date	**07/22/2020**
Earnings ESP	**0.0%**
P/E TTM	**24.1**
P/E F1	**32.3**
PEG F1	**2.8**
P/S TTM	**4.5**

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2021	386 E	392 E	395 E	406 E	1,552 E
2020	374 A	319 E	342 E	382 E	1,416 E
2019	405 A	428 A	401 A	412 A	1,646 A

EPS Estimates

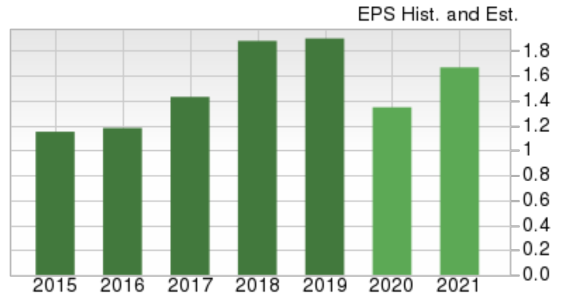
	Q1	Q2	Q3	Q4	Annual*
2021	$0.46 E	$0.45 E	$0.47 E	$0.47 E	$1.67 E
2020	$0.38 A	$0.25 E	$0.33 E	$0.38 E	$1.35 E
2019	$0.47 A	$0.50 A	$0.45 A	$0.48 A	$1.90 A

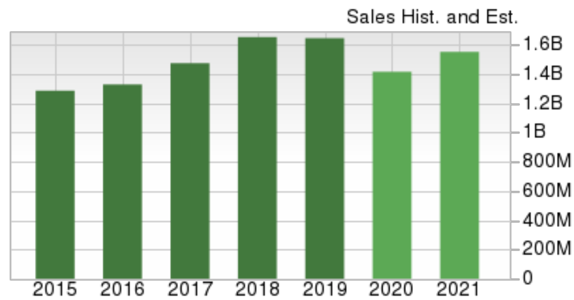
*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 05/13/2020. The reports text is as of 05/14/2020.

Overview

Graco Inc. manufactures, designs and sells equipment and systems used to measure, move, control, spray and dispense fluid as well as powder materials. This Minneapolis, MN-based company was founded in 1926.





The products offered by the company are produced in the United States, Italy, the U.K., Belgium, Switzerland, China and Romania. The products are mainly sold through the company's authorized distribution centers.

Graco reports its results in terms of three operating segments:

- **Industrial** (42.5% of total revenues in the first quarter of 2020): The segment includes Applied Fluid Technologies and Industrial Products divisions. The company provides pre-engineered and equipment packages for paints, sealants, coatings, adhesives and other fluids under this segment.

- **Process** (23.1%): The segment includes Oil and Natural Gas, Process and Lubrication divisions. The company provides valves, pumps, accessories, and meters to dispense and move chemicals, wastewater, oil and natural gas, petroleum, lubricants, food and other fluids under this segment.

- **Contractor** (34.4%): The company provides sprayers under this segment. These sprayers are used to paint structures like walls and other product models that can be used by professional painting contractors as well as homeowner.

Reasons To Buy:

▲ Graco invests in product innovation and capacity expansion. It plans to invest $70 million to roll out machinery and equipment in 2020, including $30 million for the expansion of facilities. In January 2020, the company unveiled the GLC X automatic lubrication controller, and Auto Lube app and Compact Dyna-Star automatic lubrication system, while launched Fusion ProConnect (PC) spray gun in February. Also, it unveiled the G-Mini compact lubrication pump and GrindLazer surface preparation products (high-production) — including RC820 H, RC1640 H and RC1625 G — in March. In the long term, the company anticipates gaining from the exposure in new markets, product development, global expansion, buyouts and end-user conversion. It targets achieving revenue growth of 10% (CAGR) and earnings improvement of 12% (CAGR) in the long run.

Investments in capacity expansion and innovation as well as solid shareholder-friendly policies will likely aid Graco, going forward. Also, a healthy liquidity position places the company to honor its financial obligations.

▲ Graco tries to provide higher remuneration to shareholders on increased cash generation. The company's cash flow from operations increased 7.3% year over year in the first quarter of 2020. Dividends totaling $29.3 million were distributed and shares worth $82.2 million were repurchased during the period, suggesting improvements over respective figures of $26.4 million and $2.4 million in the year-ago quarter. It is worth mentioning here that the quarterly dividend rate was hiked 9.4% to 17.5 cents in December 2019.

▲ In the past three years (2017-2019), Graco's long-term debt has decreased 10.1% (CAGR). At the end of first-quarter 2020, the same metric grew 143.5% sequentially to $400 million, while its total-debt-to-total-capital ratio moved from 13.8% to 28.2%. Notably, the company predicts $1 million increase in quarterly interest expense due to $250 million raised in the quarter (through revolving credit facility). Despite this, we believe that a healthy liquidity position equips it to meet its debt-related financial obligations. At first-quarter 2020 end, Graco's cash and cash equivalents increased 106.7% sequentially to $456.7 million, while its cash ratio improved from 0.77 to 1.47. Also, the company's times interest earned stood at 33.1 versus the previous quarter's 32.

Reasons To Sell:

- Over the past three months, Graco's shares have moved down 22.2% versus the industry's decline of 25.9%. In the first quarter of 2020, the company's earnings and sales lagged estimates by 13.6% and 5.6%, respectively. Organic sales in the quarter decreased 8% year over year. Further, sales performance was weak in the Americas, EMEA and Asia regions. For 2020, the company has suspended its revenue projections due to economic uncertainties caused by the coronavirus outbreak. It also noted that the pandemic has resulted in 30% reduction in incoming order rates since mid-March. Also, in the past 30 days, the Zacks Consensus Estimate for the company's earnings per share have been decreased by 17.2% for 2020 and 10.2% for 2021.

- In the first quarter, Graco's gross margin fell 20 basis points (bps) year over year due to forex woes, unfavorable product and channel mix, and weak factory volume. Pricing, however, came in as a relief. Operating margin in the quarter also decreased 180 bps year over year. We believe that the persistence of the headwinds in the quarters ahead might hurt the company's margin profile. In addition, rise in costs and expenses (corporate expenses are predicted to be $30 million in 2020) might hurt margins. For the second quarter, the company expects spending on new products, capital investments, acquisitions and marketing initiatives to adversely impact margins.

Graco is likely to face the adverse impacts of the coronavirus outbreak. Also, investments on growth strategies and forex woes remain concerning for the company in the quarter ahead.

- Geographical diversification is reflective of a flourishing business of the company. However, the diversity exposed it to headwinds arising from geopolitical issues and unfavorable movements in foreign currencies. In the first quarter of 2020, forex woes adversely impacted sales growth by 1%. For 2020, the company expects forex issues to lower its sales by 1% and earnings per share by 3%.

Last Earnings Report

Graco Lags Q1 Earnings Estimates, Withdraws Sales View

Quarter Ending	03/2020
Report Date	Apr 22, 2020
Sales Surprise	-5.58%
EPS Surprise	-13.64%
Quarterly EPS	0.38
Annual EPS (TTM)	1.81

Graco delivered weaker-than-expected results for the first quarter of 2020. Its earnings and sales missed estimates by 13.6% and 5.6%, respectively.

Adjusted earnings in the quarter under review were 38 cents per share, lagging the Zacks Consensus Estimate of 44 cents. On a year-over-year basis, earnings decreased 19.1% due to weak revenue generation and a fall in margins.

Top-Line Details

In the reported quarter, Graco's net sales were $373.6 million, suggesting a 7.7% decline from the year-ago quarter. Volume and price adversely impacted sales by 8%, while forex woes had an adverse impact of 1%. However, acquisitions contributed 1%.

Also, the company's net sales lagged the Zacks Consensus Estimate of $395.6 million.

On a geographical basis, quarterly sales generated from the Americas fell 3% to $224.8 million. In EMEA, sales were $87.8 million, decreasing 12% year over year (or slipped 10% at a constant-currency rate), while sales from the Asia Pacific were $61 million, declining 17% year over year (or were down 15% at a constant-currency rate).

The company reports revenues under three segments. A brief discussion of the quarterly results is provided below:

The **Industrial** segment's revenues totaled $158.7 million, suggesting a 16.1% decline from the year-ago quarter. Volume and price had an adverse impact of 15% on sales, and forex woes too lowered sales by 1%. The segment's sales accounted for 42.5% of the company's net revenues in the quarter.

The **Process** segment's sales of $86.1 million were down 0.9% from the year-ago quarter. Acquisitions contributed 5% to sales growth, while volume and price had an adverse impact of 6% in the quarter. The segment's sales accounted for 23.1% of net revenues in the reported quarter.

The **Contractor** segment's revenues were flat year over year at $128.8 million. Volume and price had a positive impact of 1% on sales, while forex woes adversely influenced sales by 1%. The segment's sales accounted for 34.4% of net revenues in the reported quarter.

Margin Profile

In the reported quarter, Graco's cost of sales decreased 7.4% year over year to $174.9 million. It represented 46.8% of the quarter's net sales versus 46.6% in the year-ago quarter. Gross profit decreased 8.1% year over year to $198.6 million, while margin was down 20 basis points (bps) to 53.2%. The fall in margin was triggered by unfavorable product and channel mix, forex woes, and weak factory volume, partially offset by favorable pricing.

Operating expenses (including product development; selling, marketing and distribution; and general and administrative expenses) declined 2.4% year over year to $108.8 million. It represented 29.1% of net sales in the reported quarter versus 27.5% in the year-ago quarter.

Operating profit decreased 14.1% year over year to $89.8 million. The results suffered from unfavorable movements in foreign currencies, and weakness in the Industrial and Process segments, partially offset by improvements in the Contractor segment. Operating margin decreased 180 bps year over year to 24%.

Interest expenses in the reported quarter decreased 29.7% year over year to $2.5 million. Effective tax rate in the quarter was 11%, down 3 percentage points from the previous-year quarter.

Balance Sheet & Cash Flow

Exiting the first quarter, Graco had cash and cash equivalents of $456.7 million, suggesting a 106.7% increase from $221 million recorded in the last reported quarter. Long-term debt expanded 143.5% sequentially to $400 million.

In the quarter, the company generated net cash of $54.2 million from operating activities, rising 7.3% from the year-ago quarter. Capital spent on the addition of property, plant and equipment totaled $18.9 million versus $30.4 million in the first quarter of 2019.

The company distributed dividends worth $29.3 million and repurchased 2.1 million shares for $82.2 million during the quarter.

Outlook

In the near term, Graco seems well-equipped — with operations running globally, healthy liquidity position and efficient management team — to handle the challenges related to the coronavirus outbreak.

However, the company did mention that there has been a 30% fall in incoming order rates since mid-March. Given the prevailing economic uncertainties, it suspended revenue projections for 2020. Notably, the company had earlier predicted organic sales (at a constant-currency rate) to grow in low-single digits in the year.

On the contrary, it still predicts capital expenditure of $70 million for the year. This includes $50 million for the expansion of facilities. Corporate expenses (unallocated) are estimated to be $30 million (maintained). Unfavorable movements in foreign currencies are estimated to adversely impact sales by 1% and earnings by 3% in the year.

Effective tax rate for the second quarter and 2020 is predicted to be 20-21%.

Recent News

On **May 6, 2020**, Graco paid a quarterly cash dividend of 17.5 cents per share to shareholders of record as of Apr 20.

On **Mar 9, 2020**, Graco unveiled G-Mini compact lubrication pump. As noted, the product will complement existing lubrication pumps (G1 and G3 Series).

On **Mar 2, 2020**, Graco unveiled GrindLazer surface preparation products (high-production) — including RC820 H, RC1640 H and RC1625 G. As noted, the products will help in removing markings on surfaces with ease.

Valuation

Graco shares are down 16.1% and 10.8% in the year-to-date and the trailing 12-month periods, respectively. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector are down 22.1% and 25.8% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and the sector have decreased 14.4% and 20%, respectively.

The S&P 500 index has moved down 12.5% year to date and 1.4% in the past year.

The stock is currently trading at 29.79x forward 12-month earnings per share, which compares to 22.87x for the Zacks sub-industry, 17.95x for the Zacks sector and 20.44x for the S&P 500 index.

Over the past five years, the stock has traded as high as 31.88x and as low as 17.27x, with a 5-year median of 23.39x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our $46 price target reflects 31.28x forward 12-month earnings per share.

The table below shows summary valuation data for GGG.

Valuation Multiples - GGG

		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	29.79	22.87	17.95	20.44
	5-Year High	31.88	23.5	19.93	20.79
	5-Year Low	17.27	15.6	12.55	15.19
	5-Year Median	23.39	19.46	16.65	17.45
EV/EBITDA F12M	Current	15.36	10.89	16.39	12.29
	5-Year High	18.77	11.34	18.05	12.65
	5-Year Low	10.73	7.64	10.56	9.09
	5-Year Median	15.25	9.71	14.08	10.82
EV/Sales F12M	Current	5.23	2.9	2.31	3.07
	5-Year High	5.53	3.28	3.12	3.51
	5-Year Low	2.94	1.81	1.76	2.3
	5-Year Median	4.42	2.59	2.3	2.82

As of 05/13/2020

Industry Analysis **Zacks Industry Rank:** Bottom 13% (220 out of 253)

Top Peers

Company (Ticker)	Rec	Rank
Colfax Corporation **(CFX)**	Neutral	4
The Carlyle Group LP **(CG)**	Neutral	3
IDEX Corporation **(IEX)**	Neutral	4
Ingersoll Rand Inc **(IR)**	Neutral	3
ITT Inc **(ITT)**	Neutral	4
MUELLER WATER PRODUCTS **(MWA)**	Neutral	3
Nordson Corporation **(NDSN)**	Neutral	3
Flowserve Corporation **(FLS)**	Underperform	5

Industry Comparison Industry: Manufacturing - General Industrial

				Industry Peers		
	GGG	**X Industry**	**S&P 500**	**CFX**	**IEX**	**NDSN**
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	4	4	3
VGM Score	F	-	-	D	C	C
Market Cap	7.27 B	1.02 B	18.76 B	2.80 B	11.07 B	9.26 B
# of Analysts	6	3	14	9	8	6
Dividend Yield	1.60%	0.00%	2.23%	0.00%	1.36%	0.95%
Value Score	F	-	-	D	F	D
Cash/Price	0.06	0.08	0.06	0.11	0.05	0.01
EV/EBITDA	15.41	9.92	11.39	12.51	17.54	17.38
PEG Ratio	2.70	2.84	2.54	3.78	3.07	2.31
Price/Book (P/B)	7.13	1.49	2.56	0.84	4.96	5.66
Price/Cash Flow (P/CF)	19.44	7.98	10.04	5.09	21.37	20.36
P/E (F1)	31.10	19.31	18.48	19.52	30.72	30.01
Price/Sales (P/S)	4.50	1.03	1.91	0.81	4.49	4.23
Earnings Yield	3.09%	4.87%	5.09%	5.12%	3.26%	3.33%
Debt/Equity	0.39	0.48	0.75	0.79	0.45	0.66
Cash Flow ($/share)	2.24	2.24	7.01	4.64	6.87	7.86
Growth Score	D	-	-	B	B	B
Hist. EPS Growth (3-5 yrs)	14.61%	11.57%	10.82%	8.44%	13.62%	NA
Proj. EPS Growth (F1/F0)	-29.12%	-29.02%	-10.51%	-48.02%	-17.61%	-9.14%
Curr. Cash Flow Growth	0.13%	4.08%	5.83%	27.59%	4.80%	-1.46%
Hist. Cash Flow Growth (3-5 yrs)	7.47%	4.95%	8.52%	3.20%	7.29%	7.90%
Current Ratio	3.36	2.19	1.27	1.93	3.51	2.71
Debt/Capital	28.20%	33.00%	44.25%	44.24%	30.94%	39.89%
Net Margin	20.43%	4.33%	10.59%	-13.62%	16.92%	15.54%
Return on Equity	31.40%	10.81%	16.36%	8.89%	19.89%	21.78%
Sales/Assets	0.93	0.74	0.54	0.40	0.65	0.62
Proj. Sales Growth (F1/F0)	-13.99%	-8.96%	-2.55%	-20.79%	-9.48%	-4.26%
Momentum Score	B	-	-	F	B	C
Daily Price Chg	-2.96%	-1.05%	-2.85%	-6.19%	-0.86%	-0.48%
1 Week Price Chg	3.46%	2.58%	3.23%	13.88%	2.25%	5.37%
4 Week Price Chg	-6.21%	2.17%	-0.28%	11.88%	0.96%	13.45%
12 Week Price Chg	-23.29%	-27.73%	-23.80%	-35.16%	-15.41%	-6.67%
52 Week Price Chg	-10.80%	-26.15%	-13.31%	-10.76%	-4.34%	16.03%
20 Day Average Volume	824,596	72,851	2,552,088	1,631,161	487,860	259,756
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	-15.83%	0.00%	0.00%
(F1) EPS Est 4 week change	-19.57%	-7.82%	-6.15%	-17.67%	-4.28%	-3.90%
(F1) EPS Est 12 week change	-32.04%	-32.76%	-16.21%	-44.81%	-16.77%	-15.48%
(Q1) EPS Est Mthly Chg	-31.56%	-27.85%	-12.28%	-76.43%	-6.45%	-2.44%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	F
Growth Score	D
Momentum Score	B
VGM Score	F

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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