Jan 27, 2020

Graco Inc. (GGG)

$51.98 (As of 01/24/20)

Price Target (6-12 Months): **$55.00**

Long Term: 6-12 Months	**Zacks Recommendation:**	**Neutral**
	(Since: 12/24/19)	
	Prior Recommendation: Underperform	
Short Term: 1-3 Months	**Zacks Rank:** (1-5)	**2-Buy**
	Zacks Style Scores:	VGM:C
	Value: D | Growth: C | Momentum: C	

Summary

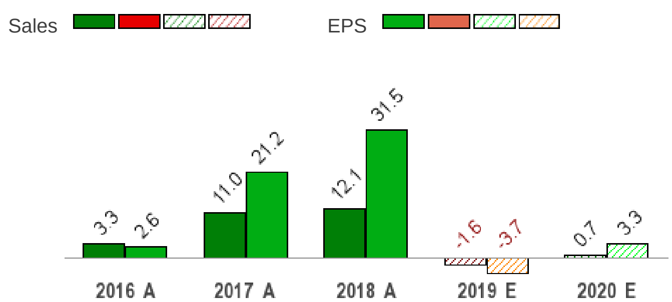
Over the past three months, Graco's shares have outperformed the industry. The company intends to deploy about $100-$105 million for building projects to boost distribution and production capacity in 2019 (results are awaited). In the long term, it anticipates gaining from exposure in new markets, product development, global expansion, buyouts and end-user conversion. Its focus on rewarding shareholders handsomely will work in its favor. However, the company expects challenging macro conditions to continue hampering its financials. It now anticipates organic sales to be flat in 2019, down from low single-digit growth mentioned earlier. Sales in the Asia Pacific are predicted to decrease in double digits versus the previously mentioned low single-digit decline. Rising cost of sales and unfavorable volume can also hurt its gross margin.

Price, Consensus & Surprise

Data Overview

52 Week High-Low	**$53.91 - $41.36**
20 Day Average Volume (sh)	**502,590**
Market Cap	**$8.7 B**
YTD Price Change	**-0.0%**
Beta	**0.98**
Dividend / Div Yld	**$0.70 / 1.3%**
Industry	**Manufacturing - General Industrial**
Zacks Industry Rank	**Bottom 22% (200 out of 255)**
Last EPS Surprise	**-11.8%**
Last Sales Surprise	**-4.9%**
EPS F1 Est- 4 week change	**0.0%**
Expected Report Date	**01/27/2020**
Earnings ESP	**0.0%**
P/E TTM	**28.1**
P/E F1	**27.8**
PEG F1	**2.4**
P/S TTM	**5.3**

Sales and EPS Growth Rates (Y/Y %)



Sales Estimates (millions of $)

	Q1	Q2	Q3	Q4	Annual*
2020	396 E	420 E	400 E	392 E	1,638 E
2019	405 A	428 A	401 A	392 E	1,626 E
2018	406 A	425 A	416 A	406 A	1,653 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2020	$0.45 E	$0.51 E	$0.48 E	$0.42 E	$1.87 E
2019	$0.47 A	$0.50 A	$0.45 A	$0.39 E	$1.81 E
2018	$0.48 A	$0.48 A	$0.50 A	$0.43 A	$1.88 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 01/24/2020. The reports text is as of 01/27/2020.

Overview

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

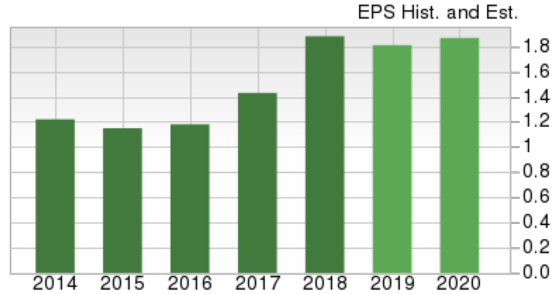
The products offered by the company are produced in China and the United States, and supplied in Belgium, Japan, China, Korea, Australia and Minnesota through the company's authorized distribution centers.

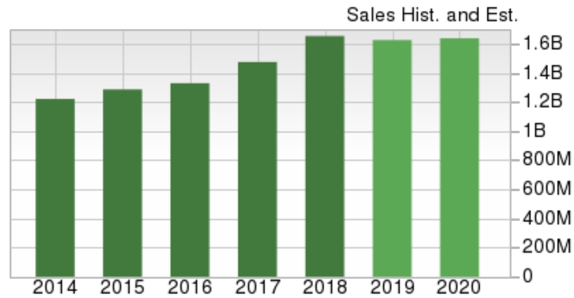
Graco reports its results in terms of three operating segments:

- **Industrial** (43.7% of total revenues in the third quarter of 2019): 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** (21%): 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** (35.3%): 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:

Investments in capacity expansion and innovation as well as solid shareholder-friendly policies are likely to benefit Graco in the quarters ahead.

- Graco invests in product innovation and capacity expansion. It plans to invest $35 million to roll out machinery and equipment in 2019. Also, the company intends to deploy about $100-$105 million for building projects to boost distribution and production capacity. In October 2019, it launched Sealed 4-Ball Plus Lower pumps. These circulation pumps can deliver fluids at the lowest cycle rates. In January 2020, the company launched Compact Dyna-Star automatic lubrication system as well as GLC X automatic lubrication controller and Auto Lube app. In the long term, the company anticipates gaining from exposure in new markets, product development, global expansion, buyouts and end-user conversion. It targets achieving growth of 10% for revenues (CAGR) and 12% for earnings (CAGR) in the long run.

- Graco tries to provide higher remuneration to shareholders on increased cash generation. The company repurchased common shares worth $5.1 million and paid out dividends worth $79.8 million in the first three quarters of 2019. It is worth mentioning here that in December 2018, the company authorized a buyback program of 18 million shares. In addition, the quarterly dividend rate was hiked 9.4% to 17.5 cents in December 2019.

- Over the past three months, Graco's shares have gained 11.8%, outperforming the industry’s growth of 6.3%. Also, analysts have increasingly grown bullish on the company over the past 60 days. Consequently, the Zacks Consensus Estimate for earnings has moved 0.5% north to $1.87 for 2020 on the back of one upward estimate revision versus no downward. Moreover, the Zacks Consensus Estimate for earnings has remained unchanged at $1.81 for 2019 over the same time frame.

Reasons To Sell:

Weak organic sales, material cost inflation and unfavorable movements in foreign currencies remain the major causes of concern for Graco.

- In the third quarter of 2019, Graco's earnings and sales lagged estimates by 11.76% and 4.9%, respectively. On a year-over-year basis, its earnings declined 10% on forex woes, weakness in the Asia Pacific and low margins. For 2019, the company is wary about challenging macro conditions and hence predicts organic sales (at constant currency rates) to be flat compared with low-single-digit growth mentioned earlier. Sales in the Asia Pacific are predicted to decline in double-digits as compared with previously mentioned low-single-digit decline. For the Americas, organic sales are predicted to be flat to grow in a low-single digit.

- Rising cost of sales has been a major cause of concern for the company. In 2018, the metric moved up 13.4% while year-over-year rise of 1.8% was recorded in the first three quarters of 2019. A marginal fall of 0.7% in cost of sales was recorded in the third quarter. Gross margin in the quarter declined 140 basis points due to unfavorable product and channel mix, forex woes (explained below), and adverse factory volume. Also, costs of raw materials were high in the quarter while favorable pricing was a relief. Rising costs (due to tariffs and hike in raw-material costs), if unchecked, will continue to adversely impact its near-term margins. The company predicts that unfavorable factory volume will impact fourth-quarter gross margin by 75-80 bps.

- Geographical diversification is reflective of a flourishing business of Graco. However, the diversity exposed the company to headwinds, arising from geopolitical issues and unfavorable movements in foreign currencies. In the third quarter of 2019, forex woes adversely impacted sales growth by 2%. The company expects forex woes to reduce sales by 2% (versus 1.5% stated earlier) and earnings by 4% (versus 3% mentioned previously) in 2019.

Last Earnings Report

Graco Misses Q3 Earnings Estimates, Lowers '19 View

Quarter Ending	09/2019
Report Date	Oct 23, 2019
Sales Surprise	-4.93%
EPS Surprise	-11.76%
Quarterly EPS	0.45
Annual EPS (TTM)	1.85

Graco delivered weak results for the third quarter of 2019. Its earnings and sales lagged estimates by 11.76% and 4.9%, respectively. This was the third consecutive quarter of weak results.

Adjusted earnings in the quarter under review were 45 cents per share, lagging the Zacks Consensus Estimate of 51 cents. The company's quarterly earnings declined 10% year over year due to weakness in the Asia Pacific, forex woes and low margins. However, lower tax expenses and roughly 0.7% fall in share count were a relief.

Revenues Decline on Weak Asia Pacific Performance

In the reported quarter, Graco's net sales were $400.6 million, suggesting a 3.7% decline from the year-ago quarter. Weak volume and price, and forex woes adversely impacted results by 3% and 2%, respectively. However, acquisitions boosted sales by 1%.

The company's net sales lagged the Zacks Consensus Estimate of $421.3 million.

On a geographical basis, quarterly sales generated from the Americas grew 3%. Sales in EMEA were flat year over year (or grew 4% at a constant-currency rate) while sales from the Asia Pacific declined 26% (or were down 24% 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 $175 million, representing 43.7% of net revenues in the quarter under review. On a year-over-year basis, the segment's revenues declined 10.6% mainly due to 2% adverse impact of unfavorable movements in foreign currencies, and 9% negative impact of volume and price.

The Process segment's sales of $84.1 million were down 0.6% from the year-ago quarter. It accounted for roughly 21% of net revenues in the reported quarter. Volume and price had adverse impact of 2% in the quarter, while forex woes had 1% negative impact. However, acquisitions contributed 2% to sales growth.

The Contractor segment generated revenues of $141.4 million, accounting for roughly 35.3% of net revenues in the reported quarter. Sales grew 4.4% year over year on positive impacts of 5% from volume and price, offset by forex woes of 1%.

Margins Decline Y/Y

In the reported quarter, Graco's cost of sales dipped 0.7% year over year to $193.2 million. It represented 48.2% of the quarter's net sales versus 46.8% in the year-ago quarter. Gross profit declined 6.4% year over year to $207.4 million while margin was down by 140 basis points (bps) to 51.8%. The fall in margin was triggered by unfavorable product and channel mix, forex woes, and adverse factory volume. As noted, high costs of raw materials were offset by favorable pricing.

Operating expenses (including product development; selling, marketing and distribution; and general and administrative expenses) declined 2.5% year over year to roughly $104 million. It represented 26% of net sales in the reported quarter versus 25.7% in the year-ago quarter.

Operating profit dipped 9.9% year over year to $103.4 million, with a year-over-year decline of 180 bps in the margin to 25.8%. Interest expenses in the reported quarter rose 1% year over year to $3.6 million. Adjusted tax rate in the quarter was 20%, down from 20.6% in the year-ago quarter.

Balance Sheet & Cash Flow

Exiting the third quarter, Graco had cash and cash equivalents of $177.3 million, down 2% from $180.9 million recorded in the last reported quarter. Long-term debt was up 7.3% sequentially to $192.1 million.

In the first three quarters of 2019, the company generated net cash of $299.5 million from operating activities, roughly 17.8% above the year-ago period. Capital spent on the addition of property, plant and equipment totaled $102.5 million versus $39.6 million in the year-ago period.

The company distributed dividends worth $79.8 million and repurchased shares for $5.1 million in the first nine months of 2019. During the third quarter, it repurchased 60 thousand shares.

Outlook

Graco continues to work on growth strategies, while believes that challenging macro conditions will influence its results in 2019. Organic sales (at a constant-currency rate) are predicted to be flat, down from expectation of low-single-digit growth. The company believes that Process and Industrial segments' performances in the Americas will slow down while the Asia Pacific will witness a sharp decline.

Organic sales (at constant-currency rates) are predicted to be flat to grow in a low-single digit, down from previously mentioned mid-single-digit growth for the Americas. For EMEA, organic sales will likely grow in a mid-single digit (view unchanged). Organic sales for the Asia Pacific are expected to decline in double-digits as compared with previously mentioned low-single-digit decline.

The company predicts capital expenditure (excluding mortar and brick) of $35 million for 2019, down from $40 million mentioned earlier. Also, spending on building projects to boost distribution and production capacity will likely be $100-$105 million versus $110-$115 million stated previously.

Corporate expenses (unallocated) are estimated to be $30 million versus $31 million mentioned earlier. Also, forex woes are predicted to adversely influence sales by 2% (1.5% stated earlier) and earnings by 4% (3% mentioned previously). Effective tax rate is predicted to be 20-21% for the year and the fourth quarter.

The company expects unfavorable factory volume to affect fourth-quarter gross margin to the tune of 75-80 bps.

Recent News

On **Jan 16, 2020**, Graco unveiled Compact Dyna-Star automatic lubrication system. As noted, this product helps in catering to the lubrication requirements of heavy-duty earth-moving machines.

On **Jan 14, 2020**, Graco unveiled the GLC X automatic lubrication controller and Auto Lube app. Given its strong differentiating capabilities for several lubrication metrics, the GLC X controller helps in simplifying automatic lubrication tasks.

On **Dec 6, 2019**, Graco's board of directors approved the payout of a quarterly cash dividend of 17.5 cents per share to shareholders on record as of Jan 21, 2020. The dividend will be paid out on Feb 5, 2020. Notably, the quarterly dividend rate was hiked 9.4%.

Valuation

Graco shares are up 23.9% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Industrial Products sector are up 28.5% and 16.2% over the past year.

The S&P 500 index has moved up 23.9% in the past year.

The stock is currently trading at 27.69x forward 12-month earnings per share, which compares to 21x for the Zacks sub-industry, 18.01x for the Zacks sector and 18.94x 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 23.08x. Our Neutral recommendation indicates that the stock will perform in line with the market. Our price target of $55 reflects 29.07x 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	27.69	21	18.01	18.94
	5-Year High	31.88	22.58	19.91	19.34
	5-Year Low	17.27	15.2	12.6	15.18
	5-Year Median	23.08	18.95	16.54	17.45
EV/EBITDA F12M	Current	18.73	12.81	17.82	12.66
	5-Year High	18.73	12.81	18.22	12.66
	5-Year Low	10.73	8.3	10.69	9.08
	5-Year Median	14.71	10.7	14.03	10.78
EV/Sales F12M	Current	5.29	2.78	3.14	3.26
	5-Year High	5.38	2.78	3.14	3.37
	5-Year Low	2.94	1.67	1.76	2.3
	5-Year Median	4.21	2.31	2.28	2.78

As of 01/24/2020

Industry Analysis Zacks Industry Rank: Bottom 22% (200 out of 255)

Top Peers

Colfax Corporation **(CFX)**	Neutral
The Carlyle Group L.P. **(CG)**	Neutral
Flowserve Corporation **(FLS)**	Neutral
IDEX Corporation **(IEX)**	Neutral
Ingersoll-Rand PLC (Ireland) **(IR)**	Neutral
ITT Inc. **(ITT)**	Neutral
MUELLER WATER PRODUCTS **(MWA)**	Neutral
Nordson Corporation **(NDSN)**	Neutral

Industry Comparison Industry: Manufacturing - General Industrial

Industry Peers

	GGG Neutral	X Industry	S&P 500	CFX Neutral	IEX Neutral	NDSN Neutral
VGM Score	C	-	-	C	D	C
Market Cap	8.67 B	1.97 B	24.13 B	4.37 B	13.09 B	9.87 B
# of Analysts	6	4	13	7	7	5
Dividend Yield	1.35%	0.00%	1.78%	0.00%	1.16%	0.89%
Value Score	D	-	-	C	D	D
Cash/Price	0.02	0.05	0.04	0.03	0.04	0.02
EV/EBITDA	18.36	13.46	14.02	22.27	20.59	18.36
PEG Ratio	2.42	2.11	2.03	2.20	2.86	1.66
Price/Book (P/B)	8.81	2.63	3.30	1.40	6.05	6.22
Price/Cash Flow (P/CF)	23.14	12.55	13.52	10.16	26.49	21.75
P/E (F1)	27.80	18.52	18.92	16.92	28.62	27.38
Price/Sales (P/S)	5.29	1.42	2.65	1.17	5.23	4.50
Earnings Yield	3.60%	5.38%	5.28%	5.90%	3.49%	3.65%
Debt/Equity	0.20	0.56	0.72	1.32	0.39	0.69
Cash Flow ($/share)	2.25	2.51	6.94	3.65	6.50	7.86
Growth Score	C	-	-	C	C	B
Hist. EPS Growth (3-5 yrs)	13.95%	5.37%	10.60%	4.49%	12.58%	NA
Proj. EPS Growth (F1/F0)	3.15%	7.72%	7.59%	10.75%	3.40%	6.37%
Curr. Cash Flow Growth	26.72%	15.81%	13.90%	-19.54%	18.92%	-1.46%
Hist. Cash Flow Growth (3-5 yrs)	8.54%	7.16%	9.00%	4.18%	8.19%	7.90%
Current Ratio	2.69	2.03	1.22	2.32	3.21	2.12
Debt/Capital	16.34%	36.44%	42.99%	56.84%	28.18%	40.69%
Net Margin	20.29%	6.22%	11.35%	-12.40%	17.05%	15.36%
Return on Equity	36.17%	13.11%	17.10%	9.06%	21.28%	22.74%
Sales/Assets	1.04	0.83	0.55	0.41	0.70	0.63
Proj. Sales Growth (F1/F0)	0.73%	1.90%	4.03%	1.82%	1.63%	1.94%
Momentum Score	C	-	-	A	D	C
Daily Price Chg	-1.48%	-0.32%	-1.01%	-0.75%	-0.92%	-0.76%
1 Week Price Chg	1.29%	1.58%	2.29%	3.09%	2.20%	3.60%
4 Week Price Chg	-0.19%	-0.19%	1.02%	1.81%	-0.34%	4.99%
12 Week Price Chg	15.00%	3.75%	6.85%	10.48%	10.68%	9.04%
52 Week Price Chg	24.15%	13.57%	20.39%	53.64%	25.87%	35.35%
20 Day Average Volume	502,590	41,380	1,536,379	962,149	272,454	221,845
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	0.03%	0.02%	0.00%
(F1) EPS Est 12 week change	0.15%	-0.38%	-0.23%	0.71%	-0.87%	-3.89%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%

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	D
Growth Score	C
Momentum Score	C
VGM Score	C

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.

Disclosures

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