

VALSPAR CORP  
Form 10-Q  
June 07, 2006  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

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**FORM 10-Q**

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**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended April 28, 2006**

**or**

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 1-3011**

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**THE VALSPAR CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**36-2443580**

(I.R.S. Employer  
Identification No.)

**1101 Third Street South  
Minneapolis, MN 55415**

(Address of principal executive offices, including zip code)

**612/332-7371**

(Registrant's telephone number, including area code)

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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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

As of June 1, 2006, The Valspar Corporation had 101,933,671 shares of common stock outstanding, excluding 18,508,953 shares held in treasury. The Company had no other classes of stock outstanding.

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THE VALSPAR CORPORATION

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for the Quarter Ended April 28, 2006

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

	April 28, 2006 (Unaudited)	April 29, 2005 (Unaudited)	October 28, 2005 (Note)
<b><u>ASSETS</u></b>			
CURRENT ASSETS:			
Cash and cash equivalents	\$ 58,359	\$ 51,035	\$ 52,845
Accounts receivable less allowance (4/28/06 \$13,905; 4/29/05 \$15,227; 10/28/05 \$16,857)	516,032	475,692	462,396
Inventories:			
Manufactured products	159,472	147,029	142,458
Raw materials, supplies and work-in-process	92,160	90,039	88,182
	251,632	237,068	230,640
Deferred income taxes	39,009	32,574	39,075
Prepaid expenses and other	71,009	81,347	80,248
<b>TOTAL CURRENT ASSETS</b>	<b>936,041</b>	<b>877,716</b>	<b>865,204</b>
GOODWILL	1,064,856	1,002,035	1,064,931

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	April 28, 2006	April 29, 2005	October 28, 2005
INTANGIBLES, NET	313,315	319,294	315,537
OTHER ASSETS, NET	58,124	69,781	60,214
LONG-TERM DEFERRED INCOME TAX	27,347	25,864	27,455
PROPERTY, PLANT AND EQUIPMENT	867,648	826,798	844,220
Less accumulated depreciation	(450,133)	(397,786)	(416,398)
	417,515	429,012	427,822
	\$ 2,817,198	\$ 2,723,702	\$ 2,761,163

NOTE: The Balance Sheet at October 28, 2005 has been derived from the audited consolidated financial statements at that date.

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS CONTINUED  
(DOLLARS IN THOUSANDS)

	April 28, 2006 (Unaudited)	April 29, 2005 (Unaudited)	October 28, 2005 (Note)
<u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>			
CURRENT LIABILITIES:			
Notes payable to banks	\$ 12,728	\$ 242,579	\$ 29,257
Current portion of long-term debt	26	87,005	24
Trade accounts payable	302,139	264,839	260,070
Income taxes	50,429	52,045	58,120
Accrued liabilities	253,488	226,403	278,160
TOTAL CURRENT LIABILITIES	618,810	872,871	625,631
LONG-TERM DEBT	698,148	465,201	706,415
DEFERRED INCOME TAXES	207,290	199,866	209,341
DEFERRED LIABILITIES	153,553	166,818	158,684
STOCKHOLDERS' EQUITY:			
Common Stock (Par Value \$.50; Authorized 500,000,000 shares; Shares issued, including shares in treasury 120,442,624)	60,220	30,110	60,220

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	April 28, 2006	April 29, 2005	October 28, 2005
Additional paid-in capital	307,769	280,659	289,158
Retained earnings	928,228	833,616	880,006
Other	10,240	15,341	11,695
	1,306,457	1,159,726	1,241,079
Less cost of Common Stock in treasury (4/28/06 18,477,191 shares; 4/29/05 18,576,320 shares; 10/28/05 20,010,616 shares)	167,060	140,780	179,987
	1,139,397	1,018,946	1,061,092
	\$ 2,817,198	\$ 2,723,702	\$ 2,761,163

NOTE: The Balance Sheet at October 28, 2005 has been derived from the audited consolidated financial statements at that date.

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)  
(DOLLARS IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	THREE MONTHS ENDED		SIX MONTHS ENDED	
	April 28, 2006	April 29, 2005	April 28, 2006	April 29, 2005
Net sales	\$ 766,816	\$ 705,942	\$ 1,396,581	\$ 1,263,086
Cost of goods sold	534,708	502,847	983,997	911,265
Gross profit	232,108	203,095	412,584	351,821
Research and development	20,500	20,284	39,948	39,018
Selling and administrative	127,100	114,445	241,591	213,830
Income from operations	84,508	68,366	131,045	98,973
Interest expense	10,930	10,928	21,710	21,460

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	THREE MONTHS ENDED		SIX MONTHS ENDED	
	346	(1,975)	1,155	(469)
Other (income)/expense net				
Income before income taxes	73,232	59,413	108,180	77,982
Income taxes	25,297	20,172	37,704	27,043
Net income	\$ 47,935	\$ 39,241	\$ 70,476	\$ 50,939
Net income per common share basic	\$ 0.47	\$ 0.38	\$ 0.70	\$ 0.50
Net income per common share diluted	\$ 0.46	\$ 0.38	\$ 0.69	\$ 0.49
Average number of common shares outstanding				
- basic	101,344,587	102,090,696	100,924,295	102,485,438
- diluted	103,116,052	104,207,352	102,487,907	104,896,236
Dividends paid per common share	\$ 0.11	\$ 0.10	\$ 0.22	\$ 0.20

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(DOLLARS IN THOUSANDS)

	SIX MONTHS ENDED	
	April 28, 2006	April 29, 2005
OPERATING ACTIVITIES:		
Net income	\$ 70,476	\$ 50,939
Adjustments to reconcile net income to net cash (used in)/provided by operating activities:		
Depreciation	33,793	29,301
Amortization	2,396	2,387
Stock-based compensation	4,443	
(Gain)/loss on asset divestiture	(255)	1,786
Changes in certain assets and liabilities, net of effects of acquired businesses:		
(Increase)/decrease in accounts and notes receivable	(52,582)	(57,814)
(Increase)/decrease in inventories and other current assets	(12,930)	(18,379)
Increase/(decrease) in trade accounts payable and accrued		

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	SIX MONTHS ENDED	
liabilities	21,444	(16,293)
Increase/(decrease) in income taxes payable	(7,741)	6,569
Increase/(decrease) in other deferred liabilities	(9,224)	6,555
Other	339	(8,672)
Net Cash (Used In)/Provided By Operating Activities	50,159	(3,621)
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(26,041)	(27,416)
Cash proceeds on disposal of assets	2,587	
Net Cash Used In Investing Activities	(23,454)	(27,416)
FINANCING ACTIVITIES:		
Net proceeds from (payments on) borrowings	(24,620)	74,189
Proceeds from sale of treasury stock	23,469	15,343
Excess tax benefit from stock-based compensation	2,257	
Treasury stock purchases		(41,125)
Dividends paid	(22,297)	(20,478)
Net Cash (Used In)/Provided By Financing Activities	(21,191)	27,929
Increase/(Decrease) in Cash and Cash Equivalents	5,514	(3,108)
Cash and Cash Equivalents at Beginning of Period	52,845	54,143
Cash and Cash Equivalents at End of Period	\$ 58,359	\$ 51,035

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 28, 2006

NOTE 1: BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of The Valspar Corporation ( the Company ) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended April 28, 2006 are not necessarily indicative of the results that may be expected for the year ending October 27, 2006.

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The Condensed Consolidated Balance Sheet at October 28, 2005 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

For further information refer to the consolidated financial statements and footnotes thereto included in The Valspar Corporation's annual report on Form 10-K for the year ended October 28, 2005.

### NOTE 2: ACCOUNTS PAYABLE

Trade accounts payable includes \$36.3 million at April 28, 2006, \$36.8 million at October 28, 2005 and \$36.2 million at April 29, 2005 of issued checks that had not cleared the Company's bank accounts.

### NOTE 3: ACQUISITIONS AND DIVESTITURES

In June 2005, the Company acquired Samuel Cabot Incorporated, a privately owned manufacturer of premium quality exterior and interior stains and finishes based in Newburyport, Massachusetts. Samuel Cabot's revenue for fiscal year 2004 was approximately \$58 million. The net assets and operating results have been included in the Company's financial statements from the date of acquisition. The purchase price allocation is preliminary. The pro forma results of operations for this acquisition have not been presented, as the impact on reported results is not material.

### NOTE 4: COMPREHENSIVE INCOME

For the six months ended April 28, 2006 and April 29, 2005, Comprehensive Income, a component of Stockholders' Equity, was as follows:

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### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) APRIL 28, 2006 CONTINUED

(Dollars in thousands)

	Three Months Ended		Six Months Ended	
	April 28, 2006	April 29, 2005	April 28, 2006	April 29, 2005
Net Income	\$ 47,935	\$ 39,241	\$ 70,476	\$ 50,939
Other Comprehensive Income, net of tax:				
Foreign currency translation gain (loss)	2,833	(13,195)	(2,436)	13,554
Deferred gain (loss) on hedging activities	1,997	692	954	1,744
Minimum pension liability adjustment net of tax	50		50	
Total Comprehensive Income	\$ 52,815	\$ 26,738	\$ 69,044	\$ 66,237

### NOTE 5: GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill for the quarter ended April 28, 2006 decreased from the end of fiscal 2005 by \$0.1 million to \$1,064.9 million. The decrease is attributable to foreign currency translation.

Total intangible asset amortization expense for the six months ended April 28, 2006 was \$2.4 million, equal to \$2.4 million for the same period last year. Estimated amortization expense for each of the five succeeding fiscal years based on the intangible assets as of April 28, 2006 is expected to be approximately \$4.8 million annually.

### NOTE 6: SEGMENT INFORMATION



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In accordance with Statement of Financial Accounting Standards No. 131 (SFAS 131), Disclosures about Segments of an Enterprise and Related Information, and based on the nature of the Company's products, technology, manufacturing processes, customers, and regulatory environment, the Company has determined that it operates its business in two reportable segments: Paints and Coatings.

SFAS 131 requires an enterprise to report segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources. The Company evaluates the performances of operating segments and allocates resources based on profit or loss from operations before interest expense and taxes (EBIT).

The Paints segment includes the products from the Architectural, Automotive and Specialty (AAS) product line. AAS products include interior and exterior decorative paints, stains, primers, varnishes and specialty decorative products, such as enamels, aerosols, and faux finishes, used primarily in the do-it-yourself market. Other Paints products include automotive refinish paints and high performance floor paints.

The Coatings segment includes the products from the Industrial and Packaging product lines. Industrial products include a broad range of decorative and protective coatings for metal, wood, plastic and glass. Packaging products include both interior and exterior coatings used in rigid packaging containers, principally food containers and beverage cans. The products of this segment are sold throughout the world. The Company's remaining activities are included in All Other. These activities include specialty polymers and colorants for internal use and for external coatings and building

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#### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) APRIL 28, 2006 CONTINUED

product manufacturers, as well as composites (gelcoats and related products) and furniture protection plans. Also, included within All Other are the administrative expenses of the Company's corporate headquarters site. The administrative expenses include interest and amortization expense, certain environmental-related expenses and other expenses not directly allocated to any other operating segment.

In the following table, sales between segments are recorded at selling prices that are below market prices, generally intended to recover internal costs. Segment EBIT includes income realized on inter-segment sales. Comparative second quarter results on this basis are as follows:

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	April 28, 2006	April 29, 2005	April 28, 2006	April 29, 2005
<b>Net Sales:</b>				
Paints	\$ 260,900	\$ 233,779	\$ 448,558	\$ 392,387
Coatings	421,953	399,019	802,997	739,201
All Other	114,201	103,987	202,118	185,855
Less Intersegment sales	(30,238)	(30,843)	(57,092)	(54,357)
<b>Total Net Sales</b>	<b>\$ 766,816</b>	<b>\$ 705,942</b>	<b>\$ 1,396,581</b>	<b>\$ 1,263,086</b>
<b>EBIT</b>				
Paints	\$ 32,387	\$ 24,683	\$ 40,539	\$ 33,023
Coatings	54,476	43,598	98,483	68,801
All Other	(2,701)	2,060	(9,132)	(2,382)
<b>Total EBIT</b>	<b>\$ 84,162</b>	<b>\$ 70,341</b>	<b>\$ 129,890</b>	<b>\$ 99,442</b>
Interest	\$ 10,930	\$ 10,928	\$ 21,710	\$ 21,460
<b>Income before Income Taxes</b>	<b>\$ 73,232</b>	<b>\$ 59,413</b>	<b>\$ 108,180</b>	<b>\$ 77,982</b>

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(Dollars in thousands)

Three Months Ended

Six Months Ended

## NOTE 7: FINANCIAL INSTRUMENTS

The Company's involvement with derivative financial instruments is limited principally to managing well-defined interest rate and foreign currency exchange risks. Forward foreign currency exchange contracts are used primarily to hedge the impact of currency fluctuations on certain inter-company and third party transactions.

The Company also holds interest rate swaps and treasury locks to manage the interest rate risk associated with its current and expected borrowings. The interest rate swap and treasury lock contract are reflected at fair value in the condensed consolidated balance sheets. Amounts to be paid or received under the contracts are accrued as interest rates change and are recognized over the life of the contracts as an adjustment to interest expense. Credit risk is only applicable to gains on derivatives.

At April 28, 2006, the Company had a \$100 million notional amount interest rate swap contract designated as a fair value hedge to pay floating rates of interest based on LIBOR, maturing during

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## THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) APRIL 28, 2006 CONTINUED

fiscal 2008. As the critical terms of the interest rate swap and hedged debt match, there is an assumption of no ineffectiveness for these hedges. The Company also had a \$100 million notional amount of treasury locks to hedge, or lock in, interest rates on a probable long-term debt issuance the Company plans to issue during fiscal year 2007.

## NOTE 8: GUARANTEES AND CONTRACTUAL OBLIGATIONS

The Company sells extended furniture protection plans and offers warranties for certain of its products. For the furniture protection plans, revenue is deferred over the contract period, generally five years, and is recognized based on the ratio of costs incurred to estimated total costs at program completion. For product warranties, the Company estimates the costs that may be incurred under these warranties based on historical claim data and records a liability in the amount of such costs at the time revenue is recognized. The Company periodically assesses the adequacy of these recorded amounts and adjusts as necessary.

Changes in the recorded amounts during the period are as follows (dollars in thousands):

	Six Months Ended	
	April 28, 2006	April 29, 2005
Beginning balance, October	\$ 95,687	\$ 88,376
Change in accrual from previous fiscal year	(911)	(1,800)
Additional net deferred revenue/accrual made during the period	9,451	20,399
Payments made during the period	(9,609)	(11,791)
Ending balance	\$ 94,618	\$ 95,184

## NOTE 9: STOCK BASED COMPENSATION

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The Company has stock-based employee compensation plans comprised primarily of fixed stock options. Prior to fiscal year 2006, the Company accounted for stock-based compensation programs using the intrinsic value method under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25) and related Interpretations and applied Statement of FAS No. 123, Accounting for Stock-Based Compensation (FAS No. 123), as amended by FAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure (FAS No. 148), for disclosure purposes only. The FAS No. 123 disclosures include pro forma net income and earnings per share as if the fair value-based method of accounting had been used. Under the provisions of APB No. 25, no stock-based employee compensation cost is reflected in net income for stock options, as all options granted under those plans had an exercise price equal to the market value of the underlying stock on the date of grant.

Effective October 29, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R), which requires the use of the fair value method for accounting for all stock-based compensation. The statement was adopted using the modified prospective method of application. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized for the remaining vesting periods of

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#### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) APRIL 28, 2006 CONTINUED

awards that had been included in pro-forma expense in prior periods. The impact of adopting SFAS No. 123R on the Company's second quarter of fiscal 2006 was an increase in compensation expense of \$2.2 million (\$1.4 million after tax), a reduction of \$0.01 for basic earnings per share and \$0.01 for diluted earnings per share. The Company expects the adoption of SFAS No. 123R to incrementally increase before-tax compensation expense by approximately \$10.5 million during fiscal 2006.

During the second quarter of fiscal 2006, the Company granted 67,373 restricted stock shares to employees. These shares vest after five years, and have a fair value equal to the \$27.83 market value as of the April 19, 2006 grant date.

As of April 29, 2006, there was \$14.6 million of total unrecognized before-tax compensation costs related to nonvested awards. That cost is expected to be recognized over a weighted-average period of 2.3 years.

Employees who retire from the company after age 60 and officers who retire after age 55 generally become fully vested in their stock options. Under SFAS No. 123 accounting, pro forma compensation cost for stock options was calculated on a straight-line basis over the stated vesting period. Under SFAS No. 123R, compensation cost for awards granted after the adoption date is recognized over the period to the earlier of the retirement eligibility date or the stated vesting date (the non-substantive vesting period approach). If this approach had been used under SFAS No. 123, the before-tax compensation cost for the second quarter and year-to-date in 2006 would have been \$1.5 million and \$3.1 million, respectively and the pro-forma compensation cost for the second quarter and year-to-date in 2005 would have been \$3.3 million and \$4.2 million respectively.

The following table illustrates the effect on net income and earnings per share for the three months and six months ended April 29, 2005 if the Company had applied the fair-value recognition of FASB statement No. 123, Accounting for Stock-Based Compensation:

(Dollars in thousands, except per share amounts)	Three Months Ended April 29, 2005	Six Months Ended April 29, 2005
Net income, as reported	\$ 39,241	\$ 50,939
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of related tax effects	1,451	2,836
Pro forma net income	\$ 37,790	\$ 48,103
Earnings per share:		
Basic as reported	\$ 0.38	\$ 0.50

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(Dollars in thousands, except per share amounts)		Three Months Ended	Six Months Ended
Basic	pro forma	\$ 0.37	\$ 0.47
Diluted	as reported	\$ 0.38	\$ 0.49
Diluted	pro forma	\$ 0.37	\$ 0.47

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 28, 2006 CONTINUED

The following table sets forth a reconciliation of shares used in the computation of basic and diluted earnings per share for fiscal 2006 and pro-forma basic and pro-forma diluted earnings per share for fiscal 2005:

	Six Months Ended	
	April 28, 2006	April 29, 2005
Weighted average shares for basic earnings per share	100,924,295	102,485,438
Effect of dilutive securities:		
Dilutive effect of stock-based compensation	1,563,612	689,076
Weighted average shares for diluted (loss) earnings per share	102,487,907	103,174,514

Stock options awards of 3,139,721 and 1,540,386 were excluded from the shares used in the computation of diluted earnings per share for the six months ended April 28, 2006 and April 29, 2005, respectively, since they were anti-dilutive under the provisions of SFAS No. 123R.

NOTE 10: PENSION AND OTHER POSTRETIREMENT BENEFITS

The company sponsors a number of defined benefit pension plans for certain hourly, salaried and foreign employees. The benefits for these plans are generally based on stated amounts for each year of service. The Company funds the plans in amounts consistent with the limits of allowable tax deductions.

The net periodic benefit cost of the pension benefits is as follows (dollars in thousands):

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	April 28, 2006	April 29, 2005	April 28, 2006	April 29, 2005
Service cost	\$ 1,065	\$ 688	\$ 2,126	\$ 1,372
Interest cost	2,908	2,747	5,813	5,488
Expected return on plan assets	(3,461)	(3,176)	(6,920)	(6,347)
Amortization of transition asset	(31)	(31)	(61)	(61)
Amortization of prior service cost	180	198	359	397
Recognized actuarial (gain)/loss	1,165	865	2,328	1,728
Net periodic benefit cost	\$ 1,826	\$ 1,291	\$ 3,645	\$ 2,577

NOTE 11: RECLASSIFICATION

Certain amounts in the 2005 financial statements have been reclassified to conform with the 2006 presentation.

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**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview:** In the second quarter of fiscal 2006, sales increased compared to the prior year due to continued growth in our Paints and Coatings segment, with our strongest increases in our architectural, industrial and resin product lines. Gross margins improved compared to the prior year because customer pricing and improved manufacturing performance more than offset increased raw material costs. The Company's ability to return to historical levels of gross margins depends on its ability to implement further price increases to offset continuing increases in raw material costs. Additionally, beginning in the first quarter of fiscal 2006 the Company began to recognize compensation expense for our stock-based compensation programs under the Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). See Note 9 to Condensed Consolidated Financial Statements (Unaudited) contained in this Quarterly Report on Form 10-Q.

**Critical Accounting Policies:** There were no material changes in the Company's critical accounting policies during the second quarter ended April 28, 2006.

**Operations:** Consolidated net sales increased 8.6% for the quarter to \$766.8 million from \$705.9 million in the prior year. Sales growth was 6.9%, after excluding the negative effect of foreign currency of 0.6% and the positive effect of acquisitions of 2.3%. Consolidated net sales increased 10.6% in the six-month period to \$1,396.6 million from \$1,263.1 million. Consolidated net sales increased 9.0%, excluding the negative effect of foreign currency of 0.6% and the positive effect of acquisitions of 2.2%.

Net sales for the Paints segment increased 11.6% to \$260.9 million in the quarter compared to the prior year. Net sales increased 14.3% to \$448.6 million year to date compared to the same period last year. Before acquisitions and excluding the negative effect of foreign currency exchange, core sales growth in Paints was 5.2% and 8.0% in the second quarter and year to date, respectively. Paints core sales growth was largely attributable to increased sales in the architectural product line due to strong retail demand and higher selling prices to customers. Net sales of the Coatings segment increased 5.7% to \$422.0 million in the quarter compared to the prior year. Net sales increased 8.6% to \$803.0 million year to date compared to the same period last year. Excluding the negative effect of foreign currency exchange, core sales growth in Coatings was 6.3% and 9.2% in the second quarter and year to date, respectively. Coatings core sales growth was driven by higher selling prices to customers and growth in industrial coatings, specifically in coil coatings. Due to the seasonal nature of portions of the Company's business, sales for the second quarter are not necessarily indicative of sales for subsequent quarters or for the full year.

In the second quarter of 2006, consolidated gross profit increased \$29.0 million from the prior year to \$232.1 million. As a percent of consolidated net sales, consolidated gross profit during the second quarter of 2006 increased to 30.3% from 28.8%. For the six-month period, consolidated gross profit increased \$60.8 million to \$412.6 million. As a percent of consolidated net sales, gross profit during the six-month period of 2006 increased to 29.5% from 27.9%. The increase in gross margin was largely attributable to increases in selling prices and manufacturing efficiencies.

Consolidated operating expenses (research and development, selling and administrative) increased 9.6% to \$147.6 million (19.2% of consolidated net sales) in the quarter compared to \$134.7 million (19.1% of consolidated net sales) in the second quarter of 2005. For the six-month period, consolidated operating expenses increased 11.3% to \$281.5 million (20.2% of consolidated net sales) from \$252.9 million (20.0% of consolidated net sales) in the prior year. The increase in operating

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**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CONTINUED**

expenses during the second quarter was primarily due to the impact of the Cabot acquisition and the adoption of SFAS 123R for stock-based compensation.

Second quarter earnings before interest and taxes (EBIT) increased \$13.8 million or 19.6% from the prior year second quarter. First half EBIT increased \$30.5 million or 30.6% from the prior year. Foreign currency exchange fluctuation had an immaterial effect on EBIT. EBIT in the

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Paints segment increased to \$32.4 million from \$24.7 million in the prior year second quarter. Year to date EBIT in the Paints segment increased to \$40.5 million from \$33.0 million. As a percent of net sales for the Paints segment, EBIT increased to 12.4% from 10.6% in the prior year second quarter and to 9.0% from 8.4% from the prior year to date. The increase was attributable to higher prices to customers along with manufacturing efficiencies associated with volume increases. EBIT in the Coatings segment increased to \$54.5 million from \$43.6 million in the prior year second quarter. Year to date EBIT in the Coatings segment increased to \$98.5 million from \$68.8 million. As a percent of net sales for the Coatings segment, EBIT increased to 12.9% from 10.9% in the prior year second quarter and to 12.3% from 9.3% in the prior year to date. The increase was primarily due to higher prices to customers and manufacturing efficiencies. EBIT in the Other segment decreased to negative \$2.7 million from positive \$2.0 million in the prior year second quarter. Year to date EBIT in the Other segment decreased to negative \$9.1 million from negative \$2.4 million. As a percent of net sales for the Other segment, EBIT decreased to negative 3.2% from positive 2.8% in the prior year second quarter and to negative 6.3% from negative 1.8% in the prior year to date. The decrease is primarily due to the impact of a favorable legal settlement on last year's results. Due to the seasonal nature of portions of the Company's business, EBIT for the second quarter is not necessarily indicative of EBIT for subsequent quarters or for the full year.

Interest expense was \$10.9 million in the second quarter of 2006 and in the second quarter of 2005. Year to date interest expense increased to \$21.7 million in 2006 from \$21.5 million in the prior year. Higher average interest rates were offset by lower debt levels.

The effective tax rate increased from 34.0% in the second quarter of 2005 to 34.5% in the second quarter of 2006. The year to date tax rate decreased from 35.5% at the end of the first quarter of 2006 to 34.9% at the end of the second quarter of 2006. The decline in the quarter and year to date tax rate from the first quarter of 2006 was primarily due to the favorable resolution of two state income tax audits. Our expected effective tax rate on income from operations for the balance of fiscal 2006 is 35.5%.

Net income in the second quarter of 2006 increased 22.2% to \$47.9 million or \$0.46 per diluted share. For the six-month period, net income increased 38.4% to \$70.5 million or \$0.69 per diluted share.

**Financial Condition:** The net cash generated by operations was \$50.2 million for the first six months of 2006, compared with net cash used by operations of \$3.6 million for the first six months of 2005. Cash generated by operations and \$23.5 million of proceeds from the sale of treasury stock (exercise of stock options) were used

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## **ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS - CONTINUED**

to fund capital expenditures of \$26.0 million, decrease bank borrowings by \$24.6 million and fund dividend payments of \$22.3 million.

The cash generated from operations resulted from strong net income and an increase in accounts payable and accrued liabilities, partially offset by increases in accounts receivable and inventory. Accounts payable and accrued liabilities increased \$21.4 million. Accounts receivable increased by \$52.6 million due to timing of customer payments and higher selling prices. Inventory increased \$12.9 million primarily due to higher raw material costs.

Capital expenditures for property, plant and equipment were \$26.0 million in the first six months of 2006, compared with \$27.4 million in the first six months of 2005. The Company anticipates capital spending in 2006 to be approximately \$75 million.

The ratio of total debt to capital decreased to 38.4% at the end of second quarter of 2006 compared to 41.0% at the close of fiscal 2005. The total debt to capital ratio as of April 29, 2005 was 43.8%. The Company believes its cash flow from operations, existing lines of credit, access to credit facilities and access to debt and capital markets will be sufficient to meet its current and projected needs for financing.

There were no material changes in the Company's fixed cash obligations during the six months ended April 28, 2006.

**Off-Balance Sheet Financing:** The Company has no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

**Forward Looking Statements:** This discussion contains certain forward-looking statements. These forward-looking statements are based on management's expectations and beliefs concerning future events. Forward-looking statements are necessarily subject to risks, uncertainties and other factors, many of which are outside the control of the Company that could cause actual results to differ materially from such statements. These uncertainties and other factors include, but are not limited to, dependence of internal earnings growth on economic conditions and growth in the domestic and international coatings industry; risks related to any future acquisitions, including risks of adverse changes in the results of acquired businesses and the assumption of unforeseen liabilities; risks of disruptions in business resulting from the integration process and higher interest costs resulting from further borrowing for any such acquisitions; our reliance on the efforts of vendors, government agencies, utilities and other third parties to achieve adequate compliance and avoid disruption of our business; risks of disruptions in business resulting from the Company's relationships with customers and suppliers; unusual weather conditions adversely affecting sales; changes in raw materials pricing and availability; delays in passing along cost increases to customers; changes in governmental regulation, including more stringent environmental, health and safety regulations; the nature, cost and outcome of pending and future litigation and other legal proceedings; the outbreak of war and other significant national and international events; and other risks and uncertainties. The foregoing list is not exhaustive, and the Company disclaims any obligation to subsequently revise any forward-looking statements to reflect events or circumstances after the date of such statements.

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### **ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company's foreign sales and results of operations are subject to the impact of foreign currency fluctuations. The Company has not hedged its exposure to translation gains and losses; however, it has reduced its exposure by borrowing funds in local currencies. A 10% adverse change in foreign currency rates would not have a material effect on the Company's results of operations or financial position.

The Company is also subject to interest rate risk. At April 28, 2006, approximately 30% of the Company's total debt consisted of floating rate debt. From time to time, the Company may enter into interest rate swaps to hedge a portion of either its variable or fixed rate debt. Assuming the current level of borrowings, a 10% increase in interest rates from those in effect at the end of the second quarter would not have a material effect on the Company's results of operations or financial condition.

### **ITEM 4: CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rules 13a-15(e) or 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report. Based on their evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective.

There have been no significant changes (including corrective actions with regard to significant deficiencies or material weaknesses) in our internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation referenced above.

## **PART II. OTHER INFORMATION**

### **ITEM 1: LEGAL PROCEEDINGS**

During the period covered by this report, there were no legal proceedings instituted that are reportable, and there were no material developments in any of the legal proceedings that were previously reported on the Company's Form 10-K for the year ended October 28, 2005.

### **ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

At the Annual Meeting of Stockholders on February 22, 2006, the stockholders took the following actions:

(i) The stockholders elected three directors in Class II for three-year terms. The stockholders present in person or by proxy cast the following numbers of votes in connection with the election of directors, resulting in the election of all nominees:

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	<b>Votes For</b>	<b>Votes Withheld</b>
John S. Bode	87,322,586	989,531
Susan S. Boren	80,302,398	8,009,719
Jeffrey H. Curler	87,319,571	992,546

(ii) The stockholders approved an increase in the shares reserved under the Corporation's 1991 Stock Option Plan. 46,057,721 votes were cast for the resolution; 31,832,154 votes were cast against the resolution; 535,644 votes abstained; and there were 9,886,598 broker non-votes.

(iii) The stockholders ratified the appointment of Ernst & Young LLP as the Company's independent auditors for fiscal 2006. 86,932,590 votes were cast for the resolution; 1,002,598 votes were cast against the resolution; shares representing 376,928 votes abstained; and there were no broker non-votes.

**ITEM 6: EXHIBITS**

## Exhibits

- 10(a) Form of Stock Option Granted to Non-Employee Directors
- 10(b) Form of Restricted Stock Granted to Certain Executive Officers
- 10(c) Form of Stock Option Granted to Certain Executive Officers
- 31.1 Section 302 Certification of the Chief Executive Officer
- 31.2 Section 302 Certification of the Chief Financial Officer
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. §1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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**SIGNATURES**

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

THE VALSPAR CORPORATION



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Date: June 7, 2006

By /s/ Rolf Engh  
Rolf Engh  
Secretary

Date: June 7, 2006

By /s/ Paul C. Reyelts  
Paul C. Reyelts  
Executive Vice President and  
Chief Financial Officer

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