

VALSPAR CORP  
Form 10-Q  
March 08, 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 January 27, 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 March 6, 2006, The Valspar Corporation had 101,656,250 shares of common stock outstanding, excluding 18,786,374 shares held in treasury. The Company had no other classes of stock outstanding.

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for the Quarter Ended January 27, 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)

	<u>January 27, 2006</u>	<u>January 28, 2005</u>	<u>October 28, 2005</u>
	(Unaudited)	(Unaudited)	(Note)
<b>ASSETS</b>			
CURRENT ASSETS:			
Cash and cash equivalents	\$ 51,447	\$ 46,018	\$ 52,845
Accounts receivable less allowance (1/27/06 \$14,649; 1/28/05 \$14,568; 10/28/05 \$16,857)	413,924	425,810	462,396
Inventories:			
Manufactured products	159,632	154,917	142,458
Raw materials, supplies and work-in-process	90,817	93,189	88,182
	<u>250,449</u>	<u>248,106</u>	<u>230,640</u>
Deferred income taxes	37,903	35,427	39,075
Prepaid expenses and other	<u>80,513</u>	<u>91,622</u>	<u>80,248</u>
<b>TOTAL CURRENT ASSETS</b>	<b>834,236</b>	<b>846,983</b>	<b>865,204</b>

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	January 27, 2006	January 28, 2005	October 28, 2005
GOODWILL	1,063,090	1,009,870	1,064,931
INTANGIBLES, NET	314,023	321,576	315,537
OTHER ASSETS, NET	63,338	59,709	60,214
LONG-TERM DEFERRED INCOME TAX	27,361	23,229	27,455
PROPERTY, PLANT AND EQUIPMENT	848,298	821,724	844,220
Less accumulated depreciation	(429,091)	(387,890)	(416,398)
	419,207	433,834	427,822
	\$ 2,721,255	\$ 2,695,201	\$ 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)

	January 27, 2006	January 28, 2005	October 28, 2005
	(Unaudited)	(Unaudited)	(Note)
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES:</b>			
Notes payable to banks	\$ 38,970	\$ 232,695	\$ 29,257
Current Portion of long-term debt	26	88,115	24
Trade accounts payable	259,837	241,131	260,070
Income taxes payable	37,616	38,011	58,120
Accrued liabilities	235,272	224,039	278,160
TOTAL CURRENT LIABILITIES	571,721	823,991	625,631
LONG-TERM DEBT	699,783	465,246	706,415
DEFERRED INCOME TAXES	208,405	202,490	209,341
DEFERRED LIABILITIES	159,945	166,718	158,684

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	<u>January 27, 2006</u>	<u>January 28, 2005</u>	<u>October 28, 2005</u>
<b>STOCKHOLDERS EQUITY:</b>			
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
Additional paid-in capital	298,579	279,222	289,158
Retained earnings	891,493	804,560	880,006
Other	5,360	27,803	11,695
	<u>1,255,653</u>	<u>1,141,695</u>	<u>1,241,079</u>
Less cost of Common Stock in treasury (1/27/06 19,272,539 shares; 1/28/05 17,120,444 shares; 10/28/05 20,010,616 shares)	174,251	104,939	179,987
	<u>1,081,401</u>	<u>1,036,756</u>	<u>1,061,092</u>
	<u>\$ 2,721,255</u>	<u>\$ 2,695,201</u>	<u>\$ 2,761,163</u>

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)

	<b>THREE MONTHS ENDED</b>	
	<u>January 27, 2006</u>	<u>January 28, 2005</u>
Net sales	\$ 629,765	\$ 557,144
Cost of goods sold	449,289	408,418
Gross profit	180,476	148,726
Research and development	19,448	18,734

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	<u>THREE MONTHS ENDED</u>	
Selling and administrative	114,491	99,385
Income from operations	46,537	30,607
Interest expense	10,780	10,532
Other expense	809	1,506
Income before income taxes	34,948	18,569
Income taxes	12,407	6,871
Net income	\$ 22,541	\$ 11,698
Net income per common share basic	\$ 0.22	\$ 0.11
Net income per common share diluted	\$ 0.22	\$ 0.11
Average number of common shares outstanding		
basic	100,441,966	102,880,180
diluted	102,233,523	105,264,870
Dividends paid per common share	\$ 0.110	\$ 0.100

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)

	<u>THREE MONTHS ENDED</u>	
	January 27, 2006	January 28, 2005

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	THREE MONTHS ENDED	
	2019	2018
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 22,541	\$ 11,698
Adjustments to reconcile net income to net cash (used in)/provided by operating activities:		
Depreciation	15,572	14,546
Amortization	1,201	1,193
(Gain)/loss on asset divestiture	(1,534)	385
Changes in certain assets and liabilities, net of effects of acquired businesses:		
(Increase)/decrease in accounts and notes receivable	46,645	(3,257)
(Increase)/decrease in inventories and other current assets	(22,568)	(37,409)
Increase/(decrease) in trade accounts payable and accrued liabilities	(38,911)	(46,612)
Increase/(decrease) in income taxes payable	(20,401)	(7,606)
Increase/(decrease) in other deferred liabilities	1,819	6,385
Other	(2,978)	4,182
	<u>1,386</u>	<u>(56,495)</u>
<b>INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(9,558)	(13,032)
Cash proceeds on disposal of assets	2,578	
	<u>(6,980)</u>	<u>(13,032)</u>
<b>FINANCING ACTIVITIES:</b>		
Net proceeds from borrowings	4,106	62,592
Proceeds from sale of treasury stock	11,188	13,311
Treasury stock purchases		(4,206)
Dividends paid	(11,098)	(10,295)
	<u>4,196</u>	<u>61,402</u>
Net Cash Provided by Investing Activities	(6,980)	(13,032)
Net Cash Provided by Financing Activities	4,196	61,402
Decrease in Cash and Cash Equivalents	(1,398)	(8,125)
Cash and Cash Equivalents at Beginning of Period	52,845	54,143
Cash and Cash Equivalents at End of Period	<u>\$ 51,447</u>	<u>\$ 46,018</u>

See Notes to Condensed Consolidated Financial Statements

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### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) JANUARY 27, 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 January 27, 2006 are not necessarily indicative of the results that may be expected for the year ending October 27, 2006.

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 \$26.9 million at January 27, 2006, \$36.8 million at October 28, 2005 and \$35.5 million at January 28, 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 three months ended January 27, 2006 and January 28, 2005, Comprehensive Income, a component of Stockholders Equity, was as follows:

(Dollars in thousands)	Three Months Ended	
	January 27, 2006	January 28, 2005
Net Income	\$ 22,541	\$ 11,698
Other Comprehensive Income, net of tax:		
Foreign currency translation gain(loss)	(5,269)	26,749
Deferred gain (loss) on hedging activities	(1,043)	1,052
Total Comprehensive Income	\$ 16,229	\$ 39,499

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
JANUARY 27, 2006 CONTINUED

### NOTE 5: GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill for the quarter ended January 27, 2006 decreased from the end of fiscal 2005 by \$1.8 million to \$1,063.1 million. The decrease is attributable to foreign currency translation.

Total intangible asset amortization expense for the three months ended January 27, 2006 was \$1.2 million, compared to \$1.2 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 January 27, 2006 is expected to be approximately \$4.8 million annually.

### NOTE 6: SEGMENT INFORMATION

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 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.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
JANUARY 27, 2006 CONTINUED

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 first quarter results on this basis are as follows:

(Dollars in thousands)	Three Months Ended	
	January 27, 2006	January 28, 2005
Net Sales:		
Paints	\$ 187,658	\$ 158,608
Coatings	381,044	340,182

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(Dollars in thousands)	Three Months Ended	
All Other	87,917	81,868
Less Intersegment sales	(26,854)	(23,514)
Total Net Sales	\$ 629,765	\$ 557,144
<b>EBIT</b>		
Paints	\$ 8,152	\$ 8,340
Coatings	44,007	25,203
All Other	(6,431)	(4,442)
Total EBIT	\$ 45,728	\$ 29,101
Interest	\$ 10,780	\$ 10,532
Income before Income Taxes	\$ 34,948	\$ 18,569

**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 January 27, 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 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.

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 JANUARY 27, 2006 CONTINUED

**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

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of these recorded amounts and adjusts as necessary.

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

	Three Months Ended	
	January 27, 2006	January 28, 2005
Beginning balance, October	\$ 95,687	\$ 88,376
Change in accrual from previous fiscal year	(340)	
Additional net deferred revenue/accrual made during the period	3,996	11,831
Payments made during the period	(4,410)	(5,538)
	\$ 94,933	\$ 94,669
Ending balance	\$ 94,933	\$ 94,669

### NOTE 9: STOCK BASED COMPENSATION

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 awards that had been included in pro-forma expense in prior periods. The impact of adopting SFAS No. 123R for the Company's first 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

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### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) JANUARY 27, 2006 CONTINUED

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 \$9.8 million during fiscal 2006.

During the first quarter of fiscal 2006, the company granted 126,766 restricted stock shares to employees, under its Key Employee Bonus Plan. These shares vest after three years, and have a fair value equal to the \$25.07 market value as of the January 12, 2006 grant date.

Employees who retire from the company after age 60 and officers who retire after age 55 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 (currently three years). 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 first quarter of 2006 and the pro forma compensation cost for the first quarter of 2005 would have been \$1.5 million and \$1.0 million, respectively.

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As of January 28, 2006, there was \$15.0 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 2.1 years.

The following table illustrates the effect on net income and earnings per share for the three months ended January 28, 2005 if the Company had applied the fair-value recognition of FASB statement No. 123, Accounting for Stock-Based Compensation for the three months ended January 28, 2005:

(Dollars in thousands, except per share amounts)	Three Months Ended
	January 28, 2005
Net income, as reported	\$ 11,698
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	(1,385)
Pro forma net income	\$ 10,313
Earnings per share:	
Basic as reported	\$ 0.11
Basic pro forma	\$ 0.10
Diluted as reported	\$ 0.11
Diluted pro forma	\$ 0.10

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#### THE VALSPAR CORPORATION AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) JANUARY 27, 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 diluted earnings per share for fiscal 2005:

	Three Months Ended	
	January 27, 2006	January 28, 2005
Weighted average shares for basic earnings per share	100,441,966	102,880,180
Effect of dilutive securities:		
Dilutive effect of stock-based compensation	1,791,557	839,670
Weighted average shares for diluted (loss) earnings per share	102,233,523	103,719,850

Stock options awards of 4,523,406 and 3,010,744 were excluded from the shares used in the computation of diluted earnings per share for the three months ended January 27, 2006 and January 28, 2005, respectively, since they were anti-dilutive.

#### NOTE 10: PENSION AND OTHER POST RETIREMENT 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):

	Three Months Ended	
	January 27, 2006	January 28, 2005
Service cost	\$ 1,061	\$ 684
Interest cost	2,905	2,741
Expected return on plan assets	(3,459)	(3,171)
Amortization of transition asset	(30)	(30)
Amortization of prior service cost	179	199
Recognized actuarial (gain)/loss	1,163	863
Net periodic benefit cost	\$ 1,819	\$ 1,286

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
JANUARY 27, 2006 CONTINUED

### NOTE 11: RECLASSIFICATION

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

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

**Overview:** In the first quarter of fiscal 2006, sales increased compared to the prior year as a result of growth across all product lines due to improved product mix and price increases. Raw material prices have continued to increase, but the rate of increases has moderated compared to the prior year. In the quarter, higher raw material prices were offset by improved product mix and price increases. Additionally, the Company began to recognize compensation expense for our stock-based compensation programs following adoption of SFAS 123R. 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.

**Critical Accounting Policies:** There were no material changes in the Company's critical accounting policies during the first quarter ended January 27, 2006.

**Operations:** Consolidated net sales increased 13.0% for the quarter to \$629.8 million from \$557.1 million in the prior year. Sales growth was 11.7%, after excluding the negative effect of foreign currency of 0.7% and the positive effect of acquisitions of 2.0%.

Net sales for the Paints segment increased 18.3% to \$187.7 million in the quarter compared to the prior year. The increase in sales was largely attributable to increased sales in the Architectural product line due to strong retail momentum and favorable weather. Before acquisitions and excluding the negative effect of foreign currency exchange, core sales growth in Paints was 12.2%. Net sales of the Coatings segment increased 12.0% to \$381.0 million in the quarter compared to the prior year. Before acquisitions and excluding the negative effect of foreign currency exchange, core sales growth in Coatings was 12.7%. Coatings core sales growth was driven by higher selling prices to customers and growth in industrial coatings. Due to the seasonal nature of portions of the Company's business, sales for the first quarter are not necessarily indicative of sales for subsequent quarter or for the full year.

In the first quarter of 2006, consolidated gross profit increased \$31.8 million from the prior year to \$180.5 million. As a percent of consolidated net sales, consolidated gross profit during the first quarter of 2006 increased to 28.7% from 26.7%. The increase in gross margin was largely attributable to increases in selling prices, principally in the Coatings segment, and manufacturing efficiencies, partially offset by raw material price increases.

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

Consolidated operating expenses (research and development, selling and administrative) increased 13.4% to \$133.9 million (21.3% of consolidated net sales) in the quarter compared to \$118.1 million (21.2% of consolidated net sales) in the first quarter of 2005. The increase in operating expenses during the first quarter was due to a broad range of items including the Cabot acquisition and adoption of SFAS 123R for stock-based compensation.

Earnings before interest and taxes (EBIT) increased \$16.6 million or 57.1% from the prior year first quarter. Foreign currency exchange fluctuation had an immaterial effect on EBIT. EBIT in the Paints segment decreased to \$8.2 million from \$8.3 million in the prior year. As a percent of net sales for the Paints segment, EBIT decreased to 4.3% from 5.3%. The decrease was attributable to expenses related to inventory write-downs associated with impacts from the hurricanes in the last half of fiscal 2005, plant rationalization and stock-based compensation. EBIT in the Coatings segment increased to \$44.0 million from \$25.2 million in the quarter compared to last year. As a percent of net sales for the Coatings segment, EBIT increased to 11.5% from 7.4%. The increase was primarily due to higher prices to customers and manufacturing efficiencies, partially offset by raw material costs and stock-based compensation expenses. EBIT in the Other segment decreased to negative \$6.4 million from negative \$4.4 million in the quarter compared to last year. As a percent of net sales for the Other segment, EBIT decreased to negative 10.5% from 7.6%. Included in this decrease is the impact of stock-based compensation expenses. Due to the seasonal nature of portions of the Company's business, EBIT for the first quarter is not necessarily indicative of EBIT for subsequent quarters or for the full year.

Interest expense increased to \$10.8 million in the first quarter of 2006 from \$10.5 million in the first quarter of 2005, primarily due to increased average interest rates.

The effective tax rate decreased from 37.0% to 35.5% as a result of an improvement in the geographic mix of earnings and the phase-in of the domestic manufacturing deduction enacted with the American Jobs Creation Act of 2004.

Net income in the first quarter of 2006 increased 92.7% to \$22.5 million or \$.22 per diluted share.

Financial Condition: The net cash generated by operations was \$1.4 million for the first three months of 2006, compared with net cash used by operations of \$56.5 million for the first three months of 2005. During the same period, \$17.9 million in proceeds from bank borrowings, sale of treasury stock and disposal of assets were used to fund \$11.1 million in dividend payments and \$9.6 million in capital expenditures.

The cash generated from operations was related to a reduction in accounts receivable offset by decreases in accounts payable and accrued liabilities and an increase in inventory. Accounts receivable decreased by \$46.6 million due to timing of customer payments. Accounts payable and accrued liabilities decreased \$38.9 million largely as a result of accrued liability disbursements offset by improved accounts payable management. Inventory increased \$22.6 million, primarily due to higher raw material costs.

Capital expenditures for property, plant and equipment were \$9.6 million in the first three months of 2006, compared with \$13.0 million in the first three months of 2005. The Company anticipates capital spending in 2006 to be approximately \$75 million.

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

The ratio of total debt to capital decreased to 40.6% at the end of first quarter of 2006 compared to 41.0% at the close of fiscal 2005. The total debt to capital ratio as of January 28, 2005 was 43.1%. 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 three months ended January 27, 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.

## 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 January 27, 2006, approximately 32% 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 first quarter would increase the Company's interest expense for the second quarter of 2006 by approximately \$0.3 million.

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## 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 6: EXHIBITS**

Exhibits

- 10(a) The Valspar Corporation 1991 Stock Option Plan, as amended through February 22, 2006
- 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

Date: March 8, 2006

By /s/ Rolf Engh

Rolf Engh  
Secretary

Date: March 8, 2006

By /s/ Paul C. Reyelts

Paul C. Reyelts  
Executive Vice President and  
Chief Financial Officer

SIGNATURES



