

VALSPAR CORP  
Form 10-Q  
June 08, 2005

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

**FORM 10-Q**

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the Three Months  
Ended April 29, 2005

Commission File  
Number: 1-3011

**THE VALSPAR CORPORATION**

State of Incorporation:  
Delaware

IRS Employer ID No.:  
36-2443580

Principal Executive Offices:

1101 Third Street South  
Minneapolis, MN 55415

Telephone Number: 612/332-7371

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. x Yes o No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). x Yes o No

As of June 1, 2005, The Valspar Corporation had 50,991,213 shares of common stock outstanding, excluding 9,230,099 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 29, 2005

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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>April 29,</u> <u>2005</u>	<u>April 30,</u> <u>2004</u>	<u>October 29,</u> <u>2004</u>
	(Unaudited)	(Unaudited)	(Note)
<b>ASSETS</b>			
CURRENT ASSETS:			
Cash and cash equivalents	\$ 51,035	\$ 41,560	\$ 54,143
Accounts receivable less allowance (4/29/05 - \$15,227; 4/30/04 - \$16,167; 10/29/04 - \$13,278)	475,692	445,175	411,635
Inventories:			
Manufactured products	147,029	137,197	131,312
Raw materials, supplies and work-in-process	90,039	79,180	79,242
	<u>237,068</u>	<u>216,377</u>	<u>210,554</u>
Deferred income taxes	32,574	27,738	34,898

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	April 29, 2005	April 30, 2004	October 29, 2004
Prepaid expenses and other	81,347	80,350	91,085
<b>TOTAL CURRENT ASSETS</b>	<b>877,716</b>	<b>811,200</b>	<b>802,315</b>
GOODWILL	1,002,035	1,004,177	996,562
INTANGIBLES, NET	319,294	284,898	320,733
OTHER ASSETS, NET	69,781	83,337	63,082
LONG-TERM DEFERRED INCOME TAX	25,864	25,500	23,135
PROPERTY, PLANT AND EQUIPMENT	826,798	772,747	800,706
Less accumulated depreciation	(397,786)	(350,709)	(372,275)
	429,012	422,038	428,431
	<b>\$ 2,723,702</b>	<b>\$ 2,631,150</b>	<b>\$ 2,634,258</b>

NOTE: The Balance Sheet at October 29, 2004 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)

LIABILITIES AND STOCKHOLDERS EQUITY	April 29, 2005	April 30, 2004	October 29, 2004
	(Unaudited)	(Unaudited)	(Note)
<b>CURRENT LIABILITIES:</b>			
Notes payable to banks	\$ 242,579	\$ 108,985	\$ 168,181
Current Portion of long-term debt	87,005	240	27
Trade accounts payable	264,839	234,810	234,446
Income taxes payable	52,045	51,560	45,254
Accrued liabilities	226,403	230,980	270,303
<b>TOTAL CURRENT LIABILITIES</b>	<b>872,871</b>	<b>626,575</b>	<b>718,211</b>
LONG-TERM DEBT	465,201	710,449	549,073
DEFERRED INCOME TAXES	199,866	187,853	203,608
DEFERRED LIABILITIES	166,818	167,582	163,003
<b>STOCKHOLDERS EQUITY:</b>			
Common Stock (Par Value - \$.50; Authorized - 250,000,000 shares;			

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LIABILITIES AND STOCKHOLDERS EQUITY	April 29, 2005	April 30, 2004	October 29, 2004
Shares issued (including shares in treasury - 60,221,512)	30,110	30,110	30,110
Additional paid-in capital	280,659	261,204	269,599
Retained earnings	833,616	735,662	803,156
Other	15,341	9,995	(60)
	<u>1,159,726</u>	<u>1,036,971</u>	<u>1,102,805</u>
Less cost of Common Stock in treasury (4/29/05 - 9,288,160 shares; 4/30/04 - 8,922,459 shares; 10/29/04 - 8,916,833 shares)	<u>140,780</u>	<u>98,280</u>	<u>102,442</u>
	<u>1,018,946</u>	<u>938,691</u>	<u>1,000,363</u>
	<u>\$ 2,723,702</u>	<u>\$ 2,631,150</u>	<u>\$ 2,634,258</u>

NOTE: The Balance Sheet at October 29, 2004 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 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net sales	\$ 705,942	\$ 638,387	\$ 1,263,086	\$ 1,139,978
Cost of goods sold	<u>497,813</u>	<u>432,420</u>	<u>902,147</u>	<u>777,659</u>
Gross profit	208,129	205,967	360,939	362,319
Research and development	20,284	19,264	39,019	36,539
Selling and administrative	<u>119,454</u>	<u>112,848</u>	<u>222,834</u>	<u>211,673</u>
Income from operations	68,391	73,855	99,086	114,107
Interest expense	10,928	10,590	21,460	20,980

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	THREE MONTHS ENDED		SIX MONTHS ENDED	
Other (income)/expense - net	(1,950)	218	(356)	425
Income before income taxes	59,413	63,047	77,982	92,702
Income taxes	20,172	23,958	27,043	35,227
Net income	\$ 39,241	\$ 39,089	\$ 50,939	\$ 57,475
Net income per common share - basic	\$ 0.77	\$ 0.76	\$ 0.99	\$ 1.13
Net income per common share - diluted	\$ 0.75	\$ 0.74	\$ 0.97	\$ 1.09
Average number of common shares outstanding - basic	51,045,348	51,223,114	51,242,719	51,053,938
- diluted	52,103,676	52,882,688	52,448,118	52,749,529
Dividends paid per common share	\$ 0.20	\$ 0.18	\$ 0.40	\$ 0.36

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 29, 2005	April 30, 2004
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 50,939	\$ 57,475
Adjustments to reconcile net income to net cash (used in)/provided by operating activities:		
Depreciation	29,301	26,994
Amortization	2,387	2,251
Asset divestitures	1,786	494
Changes in certain assets and liabilities, net of effects of acquired businesses:		
(Increase)/decrease in accounts and notes receivable	(57,814)	(44,756)
(Increase)/decrease in inventories and other current assets	(18,379)	(14,906)
Increase/(decrease) in accrued liabilities and trade accounts payable	(16,293)	644
Increase/(decrease) in income taxes payable	6,569	2,185
Increase/(decrease) in other deferred liabilities	6,555	9,691
Other	(8,672)	1,975

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	SIX MONTHS ENDED	
	_____	_____
Net Cash (Used In)/Provided By Operating Activities	(3,621)	42,047
<b>INVESTING ACTIVITIES:</b>		
Purchases of property, plant and equipment	(27,416)	(25,126)
Net assets of businesses acquired		(43,685)
	_____	_____
Net Cash Used In Investing Activities	(27,416)	(68,811)
<b>FINANCING ACTIVITIES:</b>		
Net proceeds from borrowings	74,189	30,455
Proceeds from sale of treasury stock	15,343	15,324
Treasury stock purchases	(41,125)	
Dividends paid	(20,478)	(19,044)
	_____	_____
Net Cash Provided by Financing Activities	27,929	26,735
Decrease in Cash and Cash Equivalents	(3,108)	(29)
Cash and Cash Equivalents at Beginning of Period	54,143	41,589
	_____	_____
Cash and Cash Equivalents at End of Period	\$ 51,035	\$ 41,560
	_____	_____

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 29, 2005

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 29, 2005 are not necessarily indicative of the results that may be expected for the year ending October 28, 2005.

The Condensed Consolidated Balance Sheet at October 29, 2004 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 29, 2004.

NOTE 2: ACCOUNTS PAYABLE

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Trade accounts payable includes \$36.2 million at April 29, 2005, \$40.1 million at October 29, 2004 and \$35.2 million at April 30, 2004 of issued checks that had not cleared the Company's bank accounts.

### NOTE 3: ACQUISITIONS AND DIVESTITURES

In August 2004, the Company purchased selected assets of the forest products coatings business of Associated Chemists, Inc. Revenues of the acquired business for the calendar year 2003 were approximately \$28 million. The net assets and operating results have been included in the Company's financial statements from the date of acquisition. The pro forma results of operations for this acquisition have not been presented, as the impact on reported results is not material.

In January 2004, the Company acquired De Beer Lakfabrieken B.V., a manufacturer and distributor of automotive refinish coatings based in The Netherlands. De Beer's revenue for calendar year 2003 was approximately 39 million EUR (approximately \$50 million at time of acquisition). The net assets and operating results have been included in the Company's financial statements from the date of acquisition. The pro forma results of operations for this acquisition have not been presented, as the impact on reported results is not material.

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
APRIL 29, 2005 CONTINUED

### NOTE 4: COMPREHENSIVE INCOME

For the three and six months ended April 29, 2005 and April 30, 2004, Comprehensive Income, a component of Stockholders' Equity, was as follows:

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net Income	\$ 39,241	\$ 39,089	\$ 50,939	\$ 57,475
Other Comprehensive Income, net of tax:				
Foreign currency translation gain (loss)	(13,195)	3,714	13,554	8,499
Deferred gain (loss) on hedging activities	692	3,274	1,744	6,904
<b>Total Comprehensive Income</b>	<b>\$ 26,738</b>	<b>\$ 46,077</b>	<b>\$ 66,237</b>	<b>\$ 72,878</b>

### NOTE 5: GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill for the quarter ended April 29, 2005 increased from the end of fiscal 2004 by \$5.5 million to \$1,002.0 million. The increase is attributable to foreign currency translation.

Total intangible amortization expense for the six months ended April 29, 2005 was \$2.4 million, compared to \$2.3 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 29, 2005 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 performance of operating segments and allocates resources based on profit or loss from operations before interest expense and taxes (EBIT).

THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 29, 2005 CONTINUED

The Paints segment includes the products from the Architectural, Automotive and Specialty (AAS) product line. AAS products include interior and exterior decorative paints, primers, varnishes and specialty decorative products, such as enamels, aerosols and faux finishes for the do-it-yourself and professional markets in North America. 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 that are used internally and sold to other coatings 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 results for the three and six months ended April 29, 2005 and April 30, 2004 on this basis are as follows:

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
<b>Net Sales:</b>				
Paints	\$ 233,779	\$ 223,796	\$ 392,387	\$ 368,731
Coatings	399,019	356,217	739,201	668,681
All Other	103,987	82,488	185,855	144,681
Less Intersegment sales	(30,843)	(24,114)	(54,357)	(42,115)
<b>Total Net Sales</b>	<b>\$ 705,942</b>	<b>\$ 638,387</b>	<b>\$ 1,263,086</b>	<b>\$ 1,139,978</b>
<b>EBIT</b>				
Paints	\$ 24,683	\$ 36,310	\$ 33,023	\$ 50,008
Coatings	43,598	43,863	68,801	80,451
All Other	2,060	(6,536)	(2,382)	(16,777)
<b>Total EBIT</b>	<b>\$ 70,341</b>	<b>\$ 73,637</b>	<b>\$ 99,442</b>	<b>\$ 113,682</b>
Interest	\$ 10,928	\$ 10,590	\$ 21,460	\$ 20,980
<b>Income before Income Taxes</b>	<b>\$ 59,413</b>	<b>\$ 63,047</b>	<b>\$ 77,982</b>	<b>\$ 92,702</b>



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 transactions.

The Company also holds interest rate swaps used to manage the interest rate risk associated with its borrowings. The interest rate swap contracts 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 29, 2005, the Company had \$100 million notional amount interest rate swap contracts designated as cash flow hedges to pay fixed rates of interest and receive variable rates of interest based on LIBOR. This contract began during fiscal 2004 and will mature during fiscal 2008. The Company also 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 swaps and hedged debt match, there is an assumption of no ineffectiveness for these hedges.

Subsequent to quarter end, the Company entered into \$250 million of treasury locks to hedge, or lock-in, interest rates on anticipated long-term debt the Company plans to issue during the last half of fiscal year 2005 and during fiscal year 2007. The treasury locks are derivative instruments as defined by SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and as the critical terms of the treasury locks and hedged debt match, there is an assumption of no ineffectiveness for these hedges. Once the treasury locks are terminated, any realized gain or loss will be reclassified ratably to our statements of income as a component of interest expense over the term of debt.

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 29, 2005 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 of these recorded amounts and adjusts as necessary.

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

Balance, October 29, 2004	\$ 88,376
Additional net deferred revenue/accrual made during the period	18,599
Payments made during the period	<u>(11,791)</u>
Balance, April 29, 2005	<u>\$ 95,184</u>

NOTE 9: STOCK PLANS

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Under the Company's Stock Option Plans, options for the purchase of up to 10,250,000 shares of common stock may be granted to officers, employees, and non-employee directors. Options are issued at market value at the date of grant and are exercisable in full or in part over a prescribed period of time. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation is reflected in income, as all options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 29, 2005 CONTINUED

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net income, as reported	\$39,241	\$39,089	\$50,939	\$57,475
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 method for all awards, net of related tax effects	1,451	1,561	2,836	3,116
Pro forma net income	\$37,790	\$37,528	\$48,103	\$54,359
Earnings per share:				
Basic - as reported	\$0.77	\$0.76	\$0.99	\$1.13
Basic - pro forma	\$0.74	\$0.73	\$0.94	\$1.06
Diluted - as reported	\$0.75	\$0.74	\$0.97	\$1.09
Diluted - pro forma	\$0.73	\$0.73	\$0.93	\$1.06

**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.

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THE VALSPAR CORPORATION AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
 APRIL 29, 2005 CONTINUED

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The cost of the pension benefits is as follows:

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
<b>Net periodic benefit cost</b>				
Service cost	\$ 688	\$ 526	\$ 1,372	\$ 1,034
Interest cost	2,747	2,593	5,488	5,158
Expected return on plan assets	(3,176)	(3,025)	(6,347)	(6,026)
Amortization of transition asset	(31)	(30)	(61)	(61)
Amortization of prior service cost	198	217	397	433
Recognized actuarial (gain)/loss	865	546	1,728	1,081
<b>Net periodic benefit cost</b>	<b>\$ 1,291</b>	<b>\$ 827</b>	<b>\$ 2,577</b>	<b>\$ 1,619</b>

### NOTE 11: SUBSEQUENT EVENTS

In May 2005, the Company announced that it has agreed to acquire Samuel Cabot Incorporated, a privately owned manufacturer of premium quality exterior and interior stains and finishes based in Newburyport, Massachusetts. Samuel Cabot's revenues for calendar 2004 were approximately \$58 million. The cash merger transaction is expected to close during June 2005, subject to regulatory approval.

### NOTE 12: RECLASSIFICATION

Certain amounts in the 2004 financial statements have been reclassified to conform with the 2005 presentation.

### NOTE 13: NEW PRONOUNCEMENTS

The Financial Accounting Standards Board (FASB) issued FASB Statement No. 123R, Shareholder Based Payment on December 16, 2004. This statement requires companies to measure and recognize compensation cost relating to share-based payment transactions in a company's financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Statement No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Originally, this statement was effective for public companies as of the first interim or annual reporting period beginning after June 15, 2005 or the fourth quarter of fiscal year 2005. On April 14, 2005, the Securities and Exchange Commission adopted a rule that allows companies to implement Statement 123R at the beginning of their next fiscal year, instead of the next reporting period that begins after June 15, 2005. Under such rules, the Company will adopt SFAS 123R in the first quarter of fiscal 2006. At that time, we will begin recognizing compensation expense related to unvested stock-based awards and newly granted awards. The Company is currently evaluating the impact of the adoption of this statement on its financial position and results of operations.

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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 2005, our sales increased compared to the prior year as we raised selling prices to customers. However, we continued to experience increases in the cost of our raw materials, compared to the prior year period, due to issues of availability and unprecedented increases in the price of raw material feedstocks. This continues a trend of raw material cost increases that began in the second half of fiscal 2004. This factor reduced our gross margin in the second quarter from the 2004 levels, although net income for the quarter was flat compared to the prior year period. Our near-term ability to return to historical levels of gross margins depends on our ability to implement further price increases to offset future increases in raw material costs.

**Critical Accounting Policies:** There were no material changes in the Company's critical accounting policies during the quarter and six months ended April 29, 2005.

**Operations:** Consolidated net sales increased 10.6% in the quarter to \$705.9 million from \$638.4 million in the prior year. Excluding the positive effect of foreign currency exchange and acquisitions, net sales increased 8.5% in the quarter, (unit growth of negative 0.5% and price mix of 9.0%). Consolidated net sales increased 10.8% in the six-month period to \$1,263.1 million from \$1,140.0 million in the prior year. Excluding the positive effect of foreign currency exchange and acquisitions, net sales increased 7.3% in the six-month period.

Net sales for the Paints segment increased 4.5% to \$233.8 million in the quarter compared to the prior year. Net sales increased 6.4% to \$392.4 million year to date compared to the same period last year. Before acquisitions and excluding the positive effect of foreign currency exchange,

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core sales growth in Paints was 3.9% and 2.8% in the second quarter and year to date, respectively. Paints sales growth in the quarter was attributable to favorable price mix, partially offset by lower volumes in the architectural business. Net sales for the Coatings segment increased 12.0% to \$399.0 million in the quarter compared to the same period last year. Net sales increased 10.5% to \$739.2 million year to date compared to the prior year. Before acquisitions and excluding the positive effect of foreign currency exchange, core sales growth in Coatings was 8.7% and 6.9% in the second quarter and year to date, respectively. Coatings core sales growth in the quarter was attributable to higher selling prices to customers and stronger demand in international markets. Due to the seasonal nature of the Company's business, sales for the second quarter are not necessarily indicative of sales for the full year.

In the second quarter of 2005, consolidated gross profit increased \$2.2 million from the prior year to \$208.1 million. As a percent of consolidated net sales, consolidated gross profit during the second quarter of 2005 decreased to 29.5% from 32.3%. For the six-month period, consolidated gross profit decreased \$1.4 million to \$360.9 million. As a percent of consolidated net sales, consolidated gross profit during the six-month period of 2005 decreased to 28.6% from 31.8%. The decrease in gross profit in the second quarter was caused by significant increases in raw material costs, partially offset by 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 5.8% to \$139.7 million (19.8% of consolidated net sales) in the second quarter of 2005 from \$132.1 million (20.7% of consolidated net sales) in 2004. For the six-month period, consolidated operating expenses increased 5.5% to \$261.9 million (20.7% of consolidated net sales) from \$248.2 million (21.8% of consolidated net sales) in the prior year. As a percent of consolidated net sales, expenses decreased in the second quarter primarily due to the effect of sales growing faster than expenses.

Second quarter earnings before interest and taxes (EBIT) decreased \$3.3 million or 4.5% from the prior year second quarter. First half EBIT decreased \$14.2 million or 12.5% from the prior year. Foreign currency exchange fluctuation had an immaterial effect on EBIT. EBIT in the Paints segment decreased to \$24.7 million from \$36.3 million in the prior year second quarter. Year to date EBIT in the Paints segment decreased to \$33.0 million from \$50.0 million. As a percent of net sales for the Paints segment, EBIT decreased to 10.6% from 16.2% in the prior year second quarter and to 8.4% from 13.6% from the prior year to date. The decrease was largely attributable to higher raw material costs and manufacturing inefficiencies due to volume declines, partially offset by higher prices to customers. EBIT in the Coatings segment decreased to \$43.6 million from \$43.9 million in the prior year second quarter. Year to date EBIT in the Coatings segment decreased to \$68.8 million from \$80.5 million. As a percent of net sales for the Coatings segment, EBIT decreased to 10.9% from 12.3% in the prior year second quarter and to 9.3% from 12.0% from the prior year to date. The decrease was primarily due to higher raw materials costs, partially offset by higher prices to customers. Due to the seasonal nature 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 increased to \$10.9 million in the second quarter of 2005 from \$10.6 million in the second quarter of 2004. The increase was primarily driven by higher interest rates on borrowings partly offset by lower debt levels and savings associated with the reduction in our revolving bank line of credit from \$1 billion to \$500 million during the first quarter. Year to date interest expense increased to \$21.5 million in 2005 from \$21.0 million in the prior year. The year to date increase in interest expense was driven by higher interest rates, partially offset by lower debt levels.

Other income increased to \$2.0 million in the second quarter from expense of \$0.2 million in the same period last year. The improvement is the result of a favorable lawsuit settlement that occurred during the quarter.

The effective tax rate decreased from 38% in the second quarter last year to 34% in the second quarter of 2005. The tax rate decreased from 38% to 35% for the six-month period in 2005. The decline in the quarter and year to date tax rate is primarily related to increased income in lower tax jurisdictions. We expect our effective tax rate from continuing operations to be approximately 36% for the remainder of 2005.

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

Net income in the second quarter of 2005 increased 0.4% to \$39.2 million or \$0.75 per diluted share. For the six-month period, net income decreased 11.4% to \$50.9 million or \$0.97 per diluted share.

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**Financial Condition:** The net cash used by the Company's operations was \$3.6 million for the first six months of 2005, compared with net cash provided by operations of \$42.0 million for the first six months of 2004. For the first six months of 2005, \$89.5 million in proceeds from bank borrowings and sale of treasury stock were used to fund \$27.4 million in capital expenditures, \$20.5 million in dividend payments, and \$41.1 million in treasury stock purchases.

The use of cash for operations was related to increases in accounts receivable and inventories, and a decrease in accrued liabilities and accounts payable. Accounts Receivable increased \$57.8 million as a result of increased sales primarily in the Architectural and Packaging product lines. Inventory increased \$18.4 million due to higher raw material costs and accelerated purchases from suppliers due to availability. The decrease in accrued liabilities and accounts payable was due to timing of disbursements.

Capital expenditures for property, plant and equipment were \$27.4 million in the first six months of 2005, compared with \$25.1 million in the first six months of 2004. The Company expects capital spending in 2005 to be in the range of \$60 to \$65 million.

The ratio of total debt to capital increased to 43.8% at the end of second quarter of 2005 compared to 41.8% at the close of fiscal 2004. The total debt to capital ratio as of April 30, 2004 was 46.6%. 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. The Company has a five-year \$500 million unsecured committed revolving multi-currency credit facility with a syndicate of banks maturing November 2005. The intent of the Company is to replace this facility with a new credit facility on or before November 2005.

There were no material changes in the Company's fixed cash obligations during the six months ended April 29, 2005.

**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.

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

**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 dependence of internal earnings growth on economic conditions and growth in the domestic and international coatings industry; risks related to any future significant acquisitions, including risks of adverse changes in the results of acquired businesses, risks of disruptions in business resulting from the Company's relationships with customers and suppliers; unusual weather conditions that might adversely affect sales; changes in raw materials pricing and availability; delays in passing 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 April 29, 2005, approximately 43% 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 position.

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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 29, 2004.

### ITEM 2(c): ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs
01/29/05 - 02/25/05	800,100	46.11259	800,100	1,073,200
02/26/05 - 03/25/05	0	0	0	1,073,200
03/26/05 - 04/29/05	0	0	0	1,073,200

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

The Annual Meeting of Stockholders was held at the Research Center of the Corporation at 312 South 11<sup>th</sup> Avenue, Minneapolis, Minnesota, on February 23, 2005. The stockholders took the following actions:

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

(i) The stockholders elected three directors to serve 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:

	Votes For	Votes Withheld
Thomas R. McBurney	45,656,641	2,151,168
Richard M. Rompala	46,332,024	1,475,785
Richard L. White	47,366,959	440,850

(ii) The stockholders approved an increase in the shares reserved under the Corporation's Stock Option Plan for Non-Employee Directors. 34,767,379 votes were cast for the resolution; 7,566,267 votes were cast against the resolution; 303,879 votes abstained; and there were 5,170,284 broker non-votes.

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(iii) The stockholders ratified the appointment of Ernst & Young LLP as the Company's independent auditors for fiscal 2005. 45,998,065 votes were cast for the resolution; 1,698,113 votes were cast against the resolution; shares representing 111,631 votes abstained; and there were no broker non-votes.

ITEM 6: EXHIBITS

- 10(a) Amendment No. 1 to Credit Agreements between the Registrant and Barclays Bank PLC dated as of April 27, 2005
- 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: June 8, 2005

By/s/Rolf Engh

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Rolf Engh  
Secretary

Date: June 8, 2005

By/s/Paul C. Reyelts

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Paul C. Reyelts  
Executive Vice President and  
Chief Financial Officer