VALSPAR CORP
Form 10-Q
September 05, 2007

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended July 27, 2007

or

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

For the transition period from _________ to ________

Commission File Number: 1-3011

THE VALSPAR CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**36-2443580**
(State or other jurisdiction of incorporation or organization)	(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)

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. x Yes o 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 x Accelerated filer o Non-accelerated filer o

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

As of August 30, 2007, The Valspar Corporation had 100,558,460 shares of common stock outstanding, excluding 17,884,164 shares held in treasury. The Company had no other classes of stock outstanding.

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THE VALSPAR CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (DOLLARS IN THOUSANDS)

	July 27, 2007 (Unaudited)	July 28, 2006 (Unaudited)	October 27, 2006 (Note)
ASSETS			
CURRENT ASSETS:			
Cash and cash equivalents	$ 83,954	$ 60,583	$ 88,238
Accounts receivable less allowances (7/27/07 $10,633; 7/28/06 $12,898; 10/27/06 $13,145)	568,877	534,475	475,736
Inventories:			
Manufactured products	187,005	167,022	172,561
Raw materials, supplies and work-in-process	120,478	86,849	109,256
	307,483	253,871	281,817
Deferred income taxes	31,508	40,144	32,422
Prepaid expenses and other	100,370	84,973	90,104

	July 27, 2007	July 28, 2006	October 27, 2006
TOTAL CURRENT ASSETS	1,092,192	974,046	968,317
GOODWILL	1,298,077	1,328,958	1,336,098
INTANGIBLES, NET	536,317	360,241	361,957
OTHER ASSETS	73,659	63,588	63,470
LONG-TERM DEFERRED INCOME TAXES	2,195	3,129	2,088
PROPERTY, PLANT AND EQUIPMENT	971,313	833,122	877,391
Less accumulated depreciation	(478,111)	(420,027)	(417,786)
	493,202	413,095	459,605
	$ 3,495,642	$ 3,143,057	$ 3,191,535

NOTE: The Balance Sheet at October 27, 2006 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	July 27, 2007 (Unaudited)	July 28, 2006 (Unaudited)	October 27, 2006 (Note)
CURRENT LIABILITIES:			
Notes payable	$ 347,407	$ 37,310	$ 139,136
Current portion of long-term debt	100,028	350,026	350,027
Trade accounts payable	398,930	337,747	368,159
Income taxes	35,399	55,128	38,455
Accrued liabilities	253,235	274,123	301,100
TOTAL CURRENT LIABILITIES	1,134,999	1,054,334	1,196,877
LONG-TERM DEBT	603,351	550,124	350,267
DEFERRED INCOME TAXES	241,767	203,934	199,816

	July 27, 2007	July 28, 2006	October 27, 2006
DEFERRED LIABILITIES	158,880	153,045	185,789
MANDATORILY REDEEMABLE STOCK	33,924		18,723
STOCKHOLDERS EQUITY:			
Common Stock (Par Value $.50; Authorized 250,000,000 shares; Shares issued, including shares in treasury 118,442,624)	59,220	60,220	60,220
Additional paid-in capital	303,155	311,548	326,011
Retained earnings	1,075,762	969,693	1,007,225
Other	66,694	19,183	24,084
	1,504,831	1,360,644	1,417,540
Less cost of Common Stock in treasury (7/27/07 17,944,651 shares; 7/28/06 18,843,267 shares; 10/27/06 18,538,360 shares)	182,110	179,024	177,477
	1,322,721	1,181,620	1,240,063
	$ 3,495,642	$ 3,143,057	$ 3,191,535

NOTE: The Balance Sheet at October 27, 2006 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	NINE MONTHS ENDED

	July 27, 2007	July 28, 2006	July 27, 2007	July 28, 2006
Net sales	$ 893,498	$ 797,376	$ 2,396,492	$ 2,193,957
Cost of goods sold	614,976	550,718	1,672,005	1,534,715
Gross profit	278,522	246,658	724,487	659,242
Research and development	24,096	21,202	69,991	61,149
Selling and administrative	149,981	136,534	420,613	378,126
Income from operations	104,445	88,922	233,883	219,967
Interest expense	16,033	10,897	46,962	32,607
Other (income)/expense - net	1,301	1,495	3,345	2,650
Income before income taxes	87,111	76,530	183,576	184,710
Income taxes	28,894	23,895	60,245	61,599
Net income	$ 58,217	$ 52,635	$ 123,331	$ 123,111
Mandatorily redeemable stock accrual (1)	(5,067)		(15,201)	
Net Income Available to Common Shareholders	$ 53,150	$ 52,635	$ 108,130	$ 123,111
Net income per common share - basic	$ 0.53	$ 0.52	$ 1.07	$ 1.22
Net income per common share - diluted	$ 0.52	$ 0.51	$ 1.05	$ 1.20
Average number of common shares outstanding				
- basic	100,008,949	101,437,514	101,147,717	101,095,368
- diluted	101,836,291	103,069,697	102,938,740	102,673,401
Dividends paid per common share	$ 0.13	$ 0.11	$ 0.39	$ 0.33

See Notes to Condensed Consolidated Financial Statements

(1) Mandatorily Redeemable Stock accrual reduced basic and diluted earnings per share by five cents in the third quarter of 2007 and fifteen cents year to date in 2007 as further described in Note 3.

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THE VALSPAR CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(DOLLARS IN THOUSANDS)

	NINE MONTHS ENDED July 27, 2007	NINE MONTHS ENDED July 28, 2006
OPERATING ACTIVITIES:		
Net income	$ 123,331	$ 123,111
Adjustments to reconcile net income to net cash (used in)/provided by operating activities:		
Depreciation	47,362	48,352
Amortization	4,150	3,594
Stock-based compensation	6,881	6,875
(Gain)/loss on asset divestiture	63	2,675
Changes in certain assets and liabilities, net of effects of acquired businesses:		
(Increase)/decrease in accounts and notes receivable	(65,791)	(64,298)
(Increase)/decrease in inventories and other current assets	(17,341)	(26,223)
Increase/(decrease) in trade accounts payable and accrued liabilities	(44,547)	71,615
Increase/(decrease) in income taxes payable	(3,816)	(3,348)
Increase/(decrease) in other deferred liabilities	7,498	(5,985)
Other	3,779	(2,831)
Net Cash (Used In)/Provided By Operating Activities	61,569	153,537
INVESTING ACTIVITIES:		
Purchases of property, plant and equipment	(47,677)	(40,459)
Acquired businesses, net of cash	(114,375)	(290,387)
Cash proceeds on disposal of assets		7,374
Net Cash Used In Investing Activities	(162,052)	(323,472)
FINANCING ACTIVITIES:		
Net proceeds from (payments on) borrowings	201,901	195,895
Proceeds from sale of treasury stock	22,862	26,043
Payments on deferred liability excess cash Huarun	(19,734)	
Excess tax benefit from stock-based compensation	1,811	2,398
Treasury stock purchases	(15,821)	(13,196)
Retirement of common stock	(55,228)	
Dividends paid	(39,592)	(33,467)
Net Cash (Used In)/Provided By Financing Activities	96,199	177,673
Increase/(Decrease) in Cash and Cash Equivalents	(4,284)	7,738
Cash and Cash Equivalents at Beginning of Period	88,238	52,845
Cash and Cash Equivalents at End of Period	$ 83,954	$ 60,583

See Notes to Condensed Consolidated Financial Statements

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007

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 July 27, 2007 are not necessarily indicative of the results that may be expected for the year ending October 26, 2007.

The Condensed Consolidated Balance Sheet at October 27, 2006 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 27, 2006.

NOTE 2: ACCOUNTS PAYABLE

Trade accounts payable includes $35.1 million at July 27, 2007, $36.7 million at October 27, 2006 and $35.8 million at July 28, 2006 of issued checks that had not cleared the Company s bank accounts.

NOTE 3: ACQUISITIONS AND DIVESTITURES

In December 2006, the Company acquired the powder coatings business of H.B. Fuller Company. H.B. Fuller s powder coatings business, which had net sales of approximately $75 million in 2005, serves customers in 26 countries from manufacturing facilities in the United States and the United Kingdom. This transaction was accounted for as a purchase. Accordingly, 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.

In July 2006, the Company acquired approximately 80% of the share capital of Huarun Paints Holdings Company Limited (Huarun Paints), one of China s largest independent coatings companies, from Champion Regal Limited, a Hong Kong based investment company, and certain other shareholders. Huarun Paints is one of China s leading domestic suppliers of wood and furniture coatings, and a rapidly growing supplier of architectural coatings. Huarun Paints sells its products primarily through an extensive network of distributors and retail paint stores throughout China. Huarun Paints revenue for fiscal year 2005 was approximately $180 million. The cash purchase price was approximately $290.4 million. Certain of the shares not purchased by the Company at the closing are subject to various put and call rights. The combination of put and call rights makes certain of the minority shares of Huarun Paints mandatorily redeemable, and therefore subject to classification outside of shareholders equity in Mandatorily Redeemable Stock. The balance in Mandatorily Redeemable Stock was $33.9 million at July 27, 2007 and $18.7 million at October 27, 2006.

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 CONTINUED

The Mandatorily Redeemable Stock will be accrued to redemption value at each balance sheet date. The accrual, if material, as well as any dividends, will be shown as an adjustment below net income to arrive at the net income available to common shareholders. The Company accrued $5.1 million and $15.2 million, respectively, for the three and nine month periods ended July 27, 2007. This accrual reduced basic and diluted income available to common shareholders by 5 cents and 15 cents, respectively, for the three and nine month periods ended July 27, 2007. The net income per share available to common shareholders was $0.52 and $1.05, respectively, for the three and nine month periods ended July 27, 2007. The accruals for the redemption value will be subsequently reversed to net income available to common shareholders and acquisition accounting applied upon exercise of the put or call option and acquisition of the underlying shares.

Certain other shares were awarded as part of a Long Term Incentive Plan (LTIP) by Huarun prior to the acquisition closing. The shares covered by the LTIP award are treated as liability awards under SFAS 123R as they are subject to a formula for repurchase at various purchase prices based upon Huarun s EBIT growth rate between January 1, 2006 and July 31, 2010 or July 31, 2011. The LTIP shares will not be considered issued and outstanding until they vest.

The terms of the acquisition also require the Company to pay to Champion Regal and certain other shareholders an amount equal to the excess cash, as defined in the purchase agreement, held by Huarun as of the closing date. The liability shall be paid as soon as practical before the third anniversary of the closing date, including interest at 6%. The excess cash of $34.4 million was recorded as a deferred liability under purchase accounting. In 2007, the Company paid $4.2 million plus accrued interest in the third quarter and $19.7 million plus accrued interest year to date to reduce this deferred liability.

The net assets and operating results have been included in the Company s financial statements from the date of acquisition. Goodwill has been allocated to the Paints (60%) and Coatings (40%) segments. 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 and nine months ended July 27, 2007 and July 28, 2006, Comprehensive Income, a component of Stockholders Equity, was as follows:

(Dollars in thousands)	Three Months Ended		Nine Months Ended	
	July 27, 2007	July 28, 2006	July 27, 2007	July 28, 2006
Net Income	$58,217	$52,635	$123,331	$123,111
Other Comprehensive Income, net of tax:				
Foreign currency translation gain (loss)	24,378	9,555	42,572	7,119
Deferred gain (loss) on hedging activities	(401)	(687)	(32)	267
Minimum pension liability adjustment net of tax	30	75	70	125
Total Comprehensive Income	$82,224	$61,578	$165,941	$130,622

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 CONTINUED

NOTE 5: GOODWILL AND OTHER INTANGIBLE ASSETS

The carrying amount of goodwill as of July 27, 2007 decreased from the end of fiscal 2006 by $38.0 million to $1,298.1 million. The decrease is due to reclassifications of certain assets resulting from completion of a valuation of Huarun Paints and the finalization of the purchase price allocation, partially offset by foreign currency translation and the acquisition of the powder coatings business of H.B. Fuller. As a result of the completion of the Huarun Paints valuation during the third quarter, the Company allocated $177.1 million from Goodwill to Intangibles (Customer Lists $71.4 million, Trademarks $68.2 million and Technology $37.5 million).

Total intangible asset amortization expense for the nine months ended July 27, 2007 was $4.2 million, compared to $3.6 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 July 27, 2007 is expected to be approximately $8.0 million annually.

NOTE 6: SEGMENT INFORMATION

In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131), and based on the nature of the Company s products, technology, manufacturing processes, customers and regulatory environment, the Company aggregates its operating segments into 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 Paints segment aggregates the Company s architectural and automotive product lines. Architectural products include interior and exterior decorative paints, primers, varnishes, high performance floor paints and specialty decorative products, such as enamels, aerosols and faux varnishes for the do-it-yourself and professional markets in North America and Asia. Other Paints products include automotive refinish paints.

The Coatings segment aggregates the Company s 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 metal 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 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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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 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 third quarter results on this basis are as follows:

(Dollars in thousands)	**Three Months Ended**		**Nine Months Ended**	
	July 27, 2007	**July 28, 2006**	**July 27, 2007**	**July 28, 2006**
Net Sales:				
Paints	$ 325,749	$ 282,040	$ 819,213	$ 730,598
Coatings	484,298	431,793	1,349,922	1,234,790

All Other	120,989	115,121	312,273	317,239
Less Intersegment sales	(37,538)	(31,578)	(84,916)	(88,670)
Total Net Sales	$ 893,498	$ 797,376	$ 2,396,492	$ 2,193,957
EBIT				
Paints	$ 36,126	$ 36,062	$ 86,111	$ 74,790
Coatings	58,477	51,775	138,642	144,578
All Other	8,541	(410)	5,785	(2,051)
Total EBIT	$ 103,144	$ 87,427	$ 230,538	$ 217,317
Interest	$ 16,033	$ 10,897	$ 46,962	$ 32,607
Income before Income Taxes	$ 87,111	$ 76,530	$ 183,576	$ 184,710

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 an interest rate swap and treasury locks to manage the interest rate risk associated with its current and expected borrowings. The interest rate swap and treasury lock 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 July 27, 2007, 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.

On April 17, 2007, the Company issued $200 million of unsecured, senior notes that mature on May 1, 2012 with a coupon rate of 5.625%, and $150 million of unsecured, senior notes that mature on May 1, 2017 with a coupon rate of 6.05%. These public offerings were made pursuant to a registration statement filed with the U.S. Securities and Exchange Commission. The net proceeds of $347.2 million were used to settle the $350 million bond that matured on May 1, 2007.

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NOTE 8: GUARANTEES AND CONTRACTUAL OBLIGATIONS

The Company accounts for and discloses guarantees and contractual obligations in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The interpretation requires disclosure in periodic financial statements of certain guarantee arrangements. The interpretation also clarifies situations where a guarantor is required to recognize the fair value of certain guarantees in the financial statements. The Company does not have any guarantees that require recognition at fair value under the interpretation.

The Company sells extended furniture protection plans and offers warranties for certain of its products. Revenue related to furniture protection plans is deferred and recognized over the contract life. Historical claims data is used to forecast claims payments over the contract period and revenue is recognized based on the forecasted claims payments. Actual claims costs are reflected in earnings in the period incurred. Anticipated losses on programs in progress are charged to earnings when identified. For product warranties, the Company estimates the costs that may be incurred under these warranties based on historical claims 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. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are estimable. Extended furniture protection plans entered into by the Company have fixed prices. To the extent the actual costs to complete contracts are higher than the amounts estimated as of the date of the financial statements, gross margin would be negatively affected in future quarters when the Company revises its estimates. The Company s practice is to revise estimates as soon as such changes in estimates become known.

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

	Nine Months Ended	
	July 27, 2007	**July 28, 2006**
Beginning balance, previous October	$87,287	$95,687
Change in accrual from previous fiscal year	(990)	(1,723)
Additional net deferred revenue/accrual made during the period	13,922	15,121
Payments made during the period	(12,467)	(14,676)
Ending balance	$87,752	$94,409

NOTE 9: STOCK BASED COMPENSATION

The Company s stock-based employee compensation plans are comprised primarily of fixed stock options, but also include restricted stock. Under the Company s Stock Option Plans, options for the purchase of 26,000,000 shares of common stock may be granted to officers, employees and non-employee directors. Options generally have a contractual term of 10 years, vest ratably over three years or five years for employees and vest immediately upon grant for non-employee directors. Restricted shares vest after three or five 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.

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 CONTINUED

Effective October 29, 2005, the Company adopted SFAS 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, and the Company has elected to recognize the fair value of the awards ratably over the vesting period. 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.

Compensation expense for the first nine months ended July 27, 2007 was $6.9 million ($4.4 million after tax) compared to $6.9 million ($4.4 million after tax) for same period last year.

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)	**Three Months Ended**		**Nine Months Ended**	
	July 27, 2007	**July 28 2006**	**July 27, 2007**	**July 28, 2006**
Service cost	$874	$800	$2,586	$2,926
Interest cost	3,152	2,867	9,412	8,680
Expected return on plan assets	(3,748)	(3,483)	(11,207)	(10,403)
Amortization of transition asset	(31)	(30)	(93)	(91)
Amortization of prior service cost	168	154	504	513
Recognized actuarial (gain)/loss	878	1,002	2,624	3,330
Net periodic benefit cost	$1,293	$1,310	$3,826	$4,955

NOTE 11: RECLASSIFICATION

Certain amounts in the 2006 financial statements have been reclassified to conform with the 2007 presentation.

NOTE 12: RECENTLY ISSUED ACCOUNTING STANDARDS

FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) in June 2006. This interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be adopted by the Company effective for the first quarter of fiscal year 2008. The Company is currently evaluating the impact of this interpretation on its financial statements.

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 CONTINUED

In June 2006, FASB ratified Emerging Issues Task Force (EITF) No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)* (EITF 06-3). The scope of EITF 06-3 includes any tax assessed by a governmental authority that is imposed concurrent with a revenue-producing transaction between a seller and a customer. The Company shows these taxes net. That is, they are excluded from both revenue and cost of goods sold. This guidance is effective for the first interim reporting period beginning after December 15, 2006. The Company adopted this policy for the second quarter of fiscal year 2007.

FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157) in September 2006. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements. However, for some entities, the application of this statement will change current practice. The Company is currently evaluating the impact of SFAS 157 on its financial statements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. For the Company, this statement is effective for the fiscal year beginning 2009.

FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans* (SFAS 158) in September 2006. This statement requires an employer to: (1) recognize in its statement of financial position an asset for a plan s over-funded status or a liability for the plan s under-funded status, (2) measure the plans assets and obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions) and (3) recognize as a component of other comprehensive income, the changes in the funded status of the plan that arise during the year but are not recognized as components of net periodic benefit cost pursuant to other relevant accounting standards. SFAS 158 also requires an employer to disclose in the notes to the financial statements additional information on how delayed recognition of certain changes in the funded status of a defined benefit postretirement plan affects net periodic benefit cost for the next fiscal year. Adoption of SFAS 158 is required for public companies by the end of the fiscal year ending after December 15, 2006, which would be the fiscal year ending October 26, 2007 for the Company. Measurement of the plans assets and obligations that determine its funded status as of the end of the employer s fiscal year is required to be adopted for fiscal years ending after December 15, 2008, which would be the fiscal year ending October 30, 2009 for the Company. The Company is currently evaluating the impact of this statement on its financial statements.

NOTE 13: INCOME TAXES

On March 16, 2007, the National People s Congress in China passed the unified enterprise income tax law. The new law will take effect on January 1, 2008. The Chinese State Council will formulate and promulgate detailed implementation rules on the basis of the new law prior to January 1, 2008. It is anticipated that the new tax law will impact the combined tax rates used to value the net deferred tax assets and liabilities of our Chinese subsidiaries. However, due to the lack of detailed implementation rules, it is not possible to accurately determine the impact of the law on our deferred tax accounts at this time. The Company believes that when final guidance is issued, the impact of the law could result in a discrete tax event, which could range from a $10 million income tax benefit to a $3 million income tax expense.

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THE VALSPAR CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JULY 27, 2007 CONTINUED

NOTE 14: SUBSEQUENT EVENTS

In August 2007, the Company announced that it had acquired Teknos Nova Coil TNC Oy, a privately owned manufacturer of high-performance coil coatings based in Helsinki, Finland. TNC s revenues for calendar 2006 were approximately 31 million (approximately $42 million at current exchange rates).

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

Overview: In the third quarter of fiscal 2007, sales increased compared to the prior year as a result of the acquisitions of Huarun Paints Holdings Company Limited (Huarun Paints) in July 2006 and of H.B. Fuller s powder coatings business in December 2006, partially offset by continued weak demand in our architectural and wood coatings product lines. Gross margins improved slightly compared to the prior year due to manufacturing efficiencies and improved product mix, offset by higher raw material costs. Operating expenses decreased as a percent of sales as a result of lower incentive compensation costs offset by the Company s continued investment in building the Valspar brand. The increase in debt from the end of fiscal year 2006 was driven by the acquisition of H.B. Fuller s powder coatings business, share repurchases and working capital needs.

Earnings Per Share: The Company accrued $5.1 million in the third quarter of 2007 and $15.2 million year to date in 2007 for the Mandatorily Redeemable Stock related to the Huarun Paints acquisition (See Note 3 for further details). The accrual reduced basic and diluted income available to common shareholders by 5 cents per share in the third quarter of 2007 and 15 cents per share year to date in 2007. The net income per share available to common shareholders was $0.52 for the period ended July 27, 2007 and $1.05 year to date in 2007.

The table below includes a non-GAAP financial measure Adjusted net income per common share-diluted which excludes a non-cash accrual relating to mandatorily redeemable stock in connection with the Huarun Paints acquisition.

	Three Months Ended		**Nine Months Ended**	
	July 27, 2007	**July 28, 2006**	**July 27, 2007**	**July 28, 2006**
Net income per common share diluted	$ 0.52	$ 0.51	$ 1.05	$ 1.20
Mandatorily redeemable stock accrual	0.05		0.15	
Adjusted net income per common share diluted	$ 0.57	$ 0.51	$ 1.20	$ 1.20

Management discloses this measure because it believes this measure may assist investors in comparing the Company s results of operations in the respective periods without regard to the effect on results in the 2007 periods of the non-cash accrual relating to the Huarun acquisition.

When the Mandatorily Redeemable Stock is redeemed, the accruals for the redemption value will be reversed and acquisition accounting applied.

Critical Accounting Policies: There were no material changes in the Company s critical accounting policies during the third quarter ended July 27, 2007.

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

Operations: Consolidated net sales increased 12.1% for the quarter to $893.5 million from $797.4 million in the prior year. Sales growth was 0.4%, after excluding the positive effect of foreign currency of 1.7% and the positive effect of acquisitions of 10.0%. Consolidated net sales increased 9.2% in the nine-month period to $2,396.5 million from $2,194.0 million. Consolidated net sales decreased 1.5%, excluding the positive effect of foreign currency of 1.5% and the positive effect of acquisitions of 9.2%.

Net sales for the Paints segment increased 15.5% to $325.7 million in the quarter compared to the prior year. Net sales increased 12.1% to $819.2 million year to date compared to the same period last year. The increase in sales for the three month and nine month periods ended July 27, 2007 was primarily due to the Huarun Paints acquisition. Excluding the positive effect of acquisitions and foreign currency exchange, core sales growth in Paints was 1.0% in the third quarter and negative 1.9% year to date. Sales in our architectural product line continued to be adversely affected by weakness in the U.S. residential construction and housing markets. Net sales of the Coatings segment increased 12.2% to $484.3 million in the quarter compared to the prior year. Net sales increased 9.3% to $1,349.9 million year to date compared to the same period last year. The increase in sales for the three and nine month periods ended July 27, 2007 was primarily due to the acquisition of Huarun Paints and H.B. Fuller s powder coatings business. Excluding the positive effect of acquisitions and foreign currency exchange, core sales growth in Coatings was 0.4% in the third quarter and negative 1.2% year to date. Coatings core sales were impacted by soft sales in the wood coatings product line related to weakness in the furniture and new construction markets. Due to the seasonal nature of portions of the Company s business, sales for the third quarter are not necessarily indicative of sales for subsequent quarters or for the full year.

In the third quarter of 2007, consolidated gross profit increased $31.9 million from the prior year to $278.5 million. As a percent of consolidated net sales, consolidated gross profit during the third quarter of 2007 increased to 31.2% from 30.9%. For the nine-month period, consolidated gross profit increased $65.2 million to $724.5 million. As a percent of consolidated net sales, gross profit during the nine-month period of 2007 increased to 30.2% from 30.0%. The increase in gross margins this year compared to the prior year was due to manufacturing improvements related to the Company s 2006 manufacturing rationalization cost program and improved mix, offset by higher raw material costs.

Consolidated operating expenses (research and development, selling and administrative) increased 10.4% to $174.1 million (19.5% of consolidated net sales) in the quarter compared to $157.7 million (19.8% of consolidated net sales) in the third quarter of 2006. For the nine-month period, consolidated operating expenses increased 11.7% to $490.6 million (20.5% of consolidated net sales) from $439.3 million (20.0% of consolidated net sales) in the prior year. The dollar increase in operating expenses during the third quarter was primarily driven by our investment in building the Valspar brand and the acquisition of Huarun Paints and H.B. Fuller s powder coatings business, partially offset by lower incentive compensation.

Third quarter earnings before interest and taxes (EBIT) increased $15.7 million or 18.0% from the prior year third quarter. For the nine-month period EBIT increased $13.2 million or 6.1% from the prior year. Foreign currency exchange fluctuation had an immaterial effect on EBIT.

EBIT in the Paints segment for the third quarter was flat compared to last year at $36.1 million. Year to date EBIT in the Paints segment increased to $86.1 million from $74.8 million. As a percent of net sales for the Paints segment, EBIT decreased to 11.1% from 12.8% in the prior year third quarter and increased

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

to 10.5% from 10.2% in the prior year to date. The decrease of EBIT as a percentage of sales in the quarter was attributable to spending related to our brand building initiative. The year to date increase of EBIT as a percentage of sales compared to the prior year was driven by improved product mix and improvements in our automotive refinish product line, partially offset by brand building expenses.

EBIT in the Coatings segment increased to $58.5 million from $51.8 million in the prior year third quarter. Year to date EBIT in the Coatings segment decreased to $138.6 million from $144.6 million. As a percent of net sales for the Coatings segment, EBIT increased to 12.1% from 12.0% in the prior year third quarter and decreased to 10.3% from 11.7% in the prior year to date. The decrease of EBIT as a percentage of sales year to date was primarily due to lower operating profit in our wood coatings product line related to the weakness in the furniture and new construction markets.

EBIT for businesses in the All Other category increased to $8.5 million from negative $0.4 million in the prior year third quarter. Year to date EBIT for such businesses increased to $5.8 million from negative $2.1 million. As a percent of net sales for businesses in the All Other category, EBIT increased to 10.2% from negative 0.5% in the prior year third quarter and increased to 2.5% from negative 0.9% in the prior year to date. The increase in the quarter and year to date was primarily due to reductions in variable compensation and improvements in businesses in the All Other category.

Due to the seasonal nature of portions of the Company s business, EBIT for the third quarter is not necessarily indicative of EBIT for subsequent quarters or for the full year.

Interest expense increased to $16.0 million in the third quarter of 2007 from $10.9 million in the third quarter of 2006. Year to date interest expense increased to $47.0 million in 2007 from $32.6 million in the prior year. The increase in interest expense was driven by higher debt levels.

The effective tax rate increased to 33.2% from 31.2% in the third quarter of 2006. The third quarter of 2006 included favorable tax adjustments related to prior tax periods. The year to date tax rate decreased to 32.8% from 33.3% in the prior year primarily due to continued improvement in the geographical mix of earnings combined with declining non-U.S. statutory income tax rates.

Net income in the third quarter of 2007 increased 10.6% to $58.2 million or $0.52 per diluted share. For the nine-month period, net income increased 0.2% to $123.3 million or $1.05 per diluted share. As described under Earnings Per Share above, adjusted net income per common share was $0.57 for the period ended July 27, 2007, compared to $0.51 in the 2006 period, and $1.20 year to date in both 2007 and 2006.

Financial Condition: For the first nine months of 2007, net cash generated by operations was $61.6 million, compared with $153.5 million in net cash generated for the first nine months of 2006. The cash generated from operations resulted from strong net income partially offset by increases in accounts receivable and decreases in accrued liabilities. Accounts receivable increased by $65.8 million due to increases in sales volume and timing of customer payments. Lower accruals for incentive compensation contributed to the decrease in accrued liabilities when compared to the same period in 2006.

During the first nine months of 2007, cash generated from operations, $201.9 million of proceeds from borrowings and $22.9 million from the sale of treasury stock were used to fund seasonal working capital as well as $114.4 million in acquisitions, $55.2 million in retirement of common stock, $47.7 million in

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capital expenditures, $39.6 million in dividend payments, $19.7 million to reduce the deferred liability for excess cash related to the Huarun Paints acquisition (see Note 3 for additional information) and $15.8 million in treasury purchases.

Capital expenditures for property, plant and equipment were $47.7 million in the first nine months of 2007, compared with $40.4 million in the first nine months of 2006. The Company anticipates capital spending in 2007 to be approximately $80 million.

The ratio of total debt to capital increased to 44.3% at the end of third quarter of 2007 compared to 40.4% at the close of fiscal 2006. The total debt to capital ratio as of July 28, 2006 was 44.2%. 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 nine months ended July 27, 2007.

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.

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ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK CONTINUED

The Company is also subject to interest rate risk. At July 27, 2007, approximately 52% 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 third quarter would increase the Company s interest expense for the fourth quarter of 2007 by approximately $0.8 million.

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. Disclosure controls and procedures are defined by Rules 13a-15(e) and 15d-15(e) of the Exchange Act as controls and other procedures that are designed to ensure that information required to be disclosed by us in reports filed with the Securities and Exchange Commission (SEC) under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in reports filed under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

There have been no significant changes 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 27, 2006.

ITEM 6: EXHIBITS

Exhibits

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: September 5, 2007

By /s/ Rolf Engh
Rolf Engh
Secretary

Date: September 5, 2007

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