VALSPAR CORP
Form 10-K
January 10, 2007
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended October 27, 2006

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 of incorporation)	(I.R.S. Employer Identification No.)
1101 Third Street South	
Minneapolis, Minnesota	**55415**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code (612) 332-7371

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on which Registered**
Common Stock, $.50 Par Value	New York Stock Exchange
Common Stock Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. x Yes o No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. o Yes x No

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 the filing requirements for the past 90 days.
x Yes o No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

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 Rule12b-2 of the Act).
o Yes x No

The aggregate market value of the voting stock held by persons other than officers, directors and more than 5% stockholders of the registrant as of April 28, 2006 was $2.3 billion based on the closing sales price of $28.30 per share as reported on the New York Stock Exchange. As of December 29, 2006, 102,168,636 shares of Common Stock, $.50 par value per share (net of 18,273,988 shares in treasury), were outstanding.

DOCUMENTS INCORPORATED IN PART BY REFERENCE

The Valspar Corporation Notice of 2007 Annual Meeting of Stockholders and Proxy Statement to be filed with the Securities and Exchange Commission within 120 days after the end of fiscal year ended October 27, 2006 (to the extent described herein) is incorporated by reference into Part III hereof.

The Valspar Corporation
Form 10-K

Table of Contents

Table of Contents

PART I

ITEM 1 BUSINESS

OVERVIEW

The Valspar Corporation is a leading global coatings and paints manufacturer and distributor, based on revenues and trade publication rankings. We manufacture and distribute a broad portfolio of coatings, paints and related products. We operate our business in two reportable segments: Coatings and Paints. Our net sales in 2006 from our Coatings and Paints segments were $1,683.5 billion and $985.7 million, respectively. Our total net sales in 2006 were $2,978.1 billion.

Our Coatings segment includes a broad range of decorative and protective coatings for metal, wood, plastic and glass, primarily for sale to OEM customers. Products within our Coatings segment include fillers, primers, varnishes, inks, sprays, stains and other coatings used by customers in a wide range of manufacturing industries, including building products, appliances, automotive parts, furniture, transportation, agricultural and construction equipment, metal packaging and metal fabrication. We utilize a wide variety of coatings technologies to meet our customers coatings requirements, including electrodeposition, powder, solvent-borne, water-borne and UV light-cured coatings. This segment includes our packaging product line and our three industrial product lines: general industrial, coil and wood.

Our packaging product line includes coatings for the interior and exterior of metal packaging containers, principally food containers and beverage cans. We also produce coatings for aerosol and paint cans, bottle crowns for glass, plastic packaging and bottle closures. We believe we are the world s largest supplier of metal packaging coatings. Consolidation and globalization of our customers has been apparent in this product line, and we have responded by offering a wide variety of packaging coatings products throughout the world.

Our general industrial product line offers customers in a wide variety of industries with a single source for powder, liquid and electrodeposition coatings technologies. We have expanded our infrastructure to support our customers in Europe, Latin America and Asia with general industrial products. We recently opened a new powder coatings facility in Shanghai, and through the H.B. Fuller acquisition, we added a new powder coatings facility in the United Kingdom.

Our coil coatings are applied to metal coils that are used to manufacture appliances, pre-engineered buildings and building components and other metal building and architectural products. We believe we are the largest supplier of coil coatings in North America. With our broad technology portfolio, we are poised for growth in Asia and South America. Our recently announced joint venture with Tekno S.A. in Brazil strengthens our position in South America.

Our wood product line within the Coatings segment includes decorative and protective coatings for wood furniture, building products, cabinets and floors. Following the acquisition of an 80% interest in Huarun Paints in 2006, we believe we became the world s largest supplier of wood coatings. Portions of the wood furniture industry have moved to Asia, and we have color design, manufacturing and technical service capabilities in the region to support this business.

Our architectural product line comprises the largest part of our Paints segment. We offer a broad portfolio of interior and exterior paints, stains, primers, varnishes, high performance floor paints and specialty decorative products. We sell these products primarily into the do-it-yourself market through home centers, mass merchants, hardware wholesalers and independent dealers. We develop customized merchandising and marketing support programs for our architectural paints customers, enabling them to differentiate their paint departments through point-of-purchase materials, labeling and product and color selection assistance. We offer our own branded products and exclusive private label brands for customers. At key customers such as

Table of Contents

Lowe s, we also offer additional marketing and customer support by providing Valspar personnel to train paint department employees and to answer coatings questions in stores. In 2007, we are beginning a major initiative to build consumer awareness of the Valspar paint brand through advertising and marketing. At Lowe s, our largest customer, we plan to offer an innovative in-store experience that simplifies the paint shopping process for consumers. We will also continue with a strong field sales support organization and offer a newly designed consumer website at www.valspar.com.

Within the Paints segment, we also offer automotive refinish paints that are sold through automotive refinish distributors and body shops and aerosol spray paints that are sold through automotive distributors and automotive supply retailers. Our Valspar Refinish, De Beer and House of Kolor brands are offered in many countries around the world.

In addition to the main product lines within our two segments, we make and sell specialty polymers, colorants and gelcoats, and we sell furniture protection plans. The specialty polymers and colorants are manufactured for internal use and for external sale to other coatings and building products manufacturers. We believe our ability to develop proprietary polymers for use in our coatings and paints (especially our architectural paints) provides us with advantages over competitors who do not produce these products themselves. Our gelcoats and related products are sold to boat manufacturers, shower and tub manufacturers and others.

The Valspar Corporation is a Delaware corporation and was founded in 1806. Our principal executive offices are located at 1101 Third Street South, Minneapolis, Minnesota 55415, and our telephone number at that address is 612-332-7371. Our corporate website address is www.valsparglobal.com. The information on our website is not part of this filing.

ACQUISITIONS

Much of our growth has occurred during the last decade. During this time we have expanded our business into international markets. A significant portion of our business growth has been accomplished through acquisitions. Since 1995, we have made more than 20 acquisitions, including purchases of equity in joint ventures.

In fiscal 2004, we completed two acquisitions. In January 2004, we 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 $50 million at time of acquisition. In August 2004, we acquired selected assets of the Forest Products business of Associated Chemists, Inc., a manufacturer and distributor of wood coatings and chemicals for the pulp and paper industry based in Portland, Oregon. Revenue of the Forest Products business for calendar year 2003 was approximately $28 million.

In June 2005, we completed the acquisition of Samuel Cabot Incorporated, a privately owned manufacturer of premium quality exterior and interior stains and finishes. Cabot, based in Newburyport, Massachusetts, had sales of approximately $58 million in the year ended September 30, 2004, and had been family-owned since 1877. In 2006, we introduced premium Cabot branded products into Lowe s, our largest customer.

In July 2006, we completed the acquisition of an 80% interest in Huarun Paints Holdings Company Limited, one of China s largest independent coatings companies, from Champion Regal Limited, a Hong Kong based investment company, and certain other shareholders. Founded in 1991, Huarun Paints had grown to become one of China s leading domestic suppliers of wood and furniture coatings and a rapidly growing supplier of architectural coatings, with sales of approximately $200 million in 2006.

In December 2006, after the end of our 2006 fiscal year, we completed the acquisition of H.B. Fuller Company s powder coatings business. This business, which had net sales of

approximately $75 million in 2005, serves customers in more than 20 countries from manufacturing facilities in the United States and the United Kingdom.

PRODUCTS

Coatings Segment

The Coatings segment includes a broad range of decorative and protective coatings for metal, wood, plastic and glass, primarily for sale to OEM customers in North America, South America, Europe and Asia. Products within our Coatings segment include fillers, primers, varnishes, inks, sprays, stains and other coatings used by customers in a wide range of manufacturing industries, including building products, appliances, automotive parts, furniture, transportation, agricultural and construction equipment, metal packaging and metal fabrication.

We use a wide variety of coatings technologies to meet our customers coatings requirements, including electrodeposition, powder, solvent-borne, water-borne and UV light-cured coatings. This broad technology capability allows us to customize our Coatings segment products to our customers specifications and to provide one stop integrated solutions. For example, we believe that we are one of only a small number of coatings manufacturers that currently have the technological and manufacturing capabilities to be a single source coatings supplier to appliance makers.

The packaging product line within our Coatings segment includes coatings for both interior and exterior use in metal packaging containers, principally food containers and beverage cans for global customers. We also produce coatings for aerosol and paint cans, bottle crowns for glass, plastic packaging and bottle closures. We believe we are the world s largest supplier of metal packaging coatings, producing coatings for the entire can. Consolidation and globalization of our customers has been apparent in this product line, and we have responded to these trends by offering a wide variety of packaging coatings products throughout the world.

Within our general industrial product line, we offer a single source for powder, liquid and electrodeposition coatings technologies to customers in a wide variety of industries, including transportation, automotive parts and agricultural and construction equipment. We continue to follow our customers with manufacturing and technical service as they move into Europe, Latin America and Asia.

Our coil coatings are applied to appliances, pre-engineered buildings and building components and other metal building and architectural products. We believe we are the leading coil coatings manufacturer in North America, with particular strength in coil coatings for metal buildings and appliances. With our broad technology portfolio, we have a product for nearly every type of coil coatings application requirement.

Our wood product line supplies decorative and protective coatings for wood furniture, building products, cabinets and floors. We offer color design, manufacturing and technical service for customers throughout North America and Asia. Our investment in Huarun Paints provides us with additional sales and distribution opportunities in the fast-growing Chinese wood coatings market.

Paints Segment

Our architectural paints products comprise the largest portion of our Paints segment. We offer a broad portfolio of interior and exterior paints, stains, primers, varnishes, high performance floor paints and specialty decorative products, such as enamels, aerosols and faux finishes, used primarily in the do-it-yourself market. The primary distribution channels for these products are home centers, mass merchants, hardware wholesalers and independent dealers. Due to the weather requirements of house painting, sales of our architectural products are seasonal, with

Table of Contents

the lowest levels occurring in the first quarter of our fiscal year when weather conditions in much of North America are ill-suited for exterior painting.

We develop highly customized merchandising and marketing support programs for our architectural paints customers, enabling them to differentiate their paint departments from their competitors through point-of-purchase materials, labeling and product and color selection assistance. Through such programs, we offer branded product lines under the names Valspar®, Cabot®, Plasti-Kote®, McCloskey® and Goof Off®. We also manufacture for our customers exclusive brands such as American Tradition®, Signature Colors®, Severe Weather®, Enterprise® and Decorative

Effects®, in addition to a variety of other private label brands. At key customers such as Lowe s, we also offer additional marketing and customer support by providing Valspar personnel to train paint department employees and to answer coatings questions in stores. We have been recognized as the paint supplier of the year eight times for Lowe s and twice for Wal-Mart.

Within the Paints segment, we also manufacture and distribute automotive refinish paints under the brand names Valspar®, De Beer® and House of Kolor®. We also supply aerosol spray paints for automotive distributors and large automotive supply retailers under the brand names Plasti-Kote®, Tempo® and Mr. Spray®. Major customers for these products include large automotive supply retailers.

All Other

In addition to our main product lines, we make and sell specialty polymers, gelcoats and colorants, and we sell furniture protection plans. We manufacture specialty polymers and colorants for internal use and for external sale to other coatings and building products manufacturers. We believe our ability to develop proprietary polymers for use in our paints and coatings (especially our architectural paints) provides us with advantages over some of our competitors who do not produce these products themselves. Our gelcoats and related products are sold to boat manufacturers, shower and tub manufacturers and others.

COMPETITION

All aspects of the coatings and paints business are highly competitive. We face strong competitors in all areas of our business, some of which are larger and better capitalized than us.

Competition in our Coatings segment is based on technical capabilities for specific product formulation, the ability to meet customer delivery requirements, technical assistance to the customer in product application, price and new technology offerings. In addition, the markets for industrial coatings are becoming increasingly global, and customers are looking for global coatings solutions. We believe we can provide global coatings solutions to our customers due to our position as one of the world s largest industrial coatings manufacturers and our commitment to developing innovative technologies.

Competition in our Paints segment is based on factors such as price, product quality, distribution and consumer brand recognition. In this segment, we offer highly customized merchandising and marketing support programs to our customers. We also support brand awareness through advertising and by offering high quality products.

RAW MATERIALS

We obtain raw materials from a number of suppliers. The raw materials are derived from petrochemicals, minerals and metals. Historically, all of these materials have been generally available on the open market, with pricing and availability subject to fluctuation. The chemical industry economic cycle for the past 2 3 years has reflected a strong demand globally with high capacity utilization. In some cases we have experienced or are experiencing tight supply and demand dynamics, resulting in continuing price increases for certain types of raw materials, although

---

price increases moderated in 2006. Raw material demand and price increases are being managed to minimize the impact on our operations. In general, higher crude oil and natural gas prices and higher supplier capacity utilization result in higher prices for our raw materials. Because our raw material costs average approximately 80% of our cost of goods sold, the efficient use of raw materials is a critical cost component of the products we manufacture.

PATENTS

Our policy is to seek patent protection for our products and manufacturing processes when appropriate. We also license some patented technology from other sources. Our business is not materially dependent upon licenses or similar rights or on any single patent or group of related patents. Although we believe our patent rights are valuable, our knowledge and trade secret information regarding our manufacturing processes and materials have also been important in maintaining our competitive position. As a condition of employment, we require domestic employees to sign a confidentiality agreement relating to proprietary information.

While we make efforts to protect our trade secret information, others may independently develop or otherwise acquire substantially equivalent proprietary information or techniques or gain access to our proprietary technology or disclose this technology. Any of these factors could adversely impact the value of our proprietary trade secret information and harm our business.

SEASONALITY AND WORKING CAPITAL ITEMS

Our sales volume is traditionally lowest during the first quarter of the fiscal year (November, December and January), and highest in the third quarter of the fiscal year (May, June and July), primarily due to weather and the buying cycle in the paints segment. When sales are generally lowest, we build inventory, the financing for which is provided primarily by internally generated funds and short-term and long-term credit lines discussed in Note 5 of the Notes to Consolidated Financial Statements on pages 35 and 36.

SIGNIFICANT CUSTOMERS

In 2006, our sales to Lowe s Companies, Inc. exceeded 10% of net sales, and our ten largest customers accounted for approximately 35% of net sales. Our sales to Lowe s Companies, Inc. are in the Paints segment. In 2006, our five largest customers in the Paints segment accounted for approximately 66% of our net sales in the segment.

BACKLOG AND GOVERNMENT CONTRACTS

We have no significant backlog of orders and generally are able to fill orders on a current basis. No material portion of our business is subject to renegotiation of profits or termination of contracts or subcontracts at the election of the government.

RESEARCH AND DEVELOPMENT

Many of the products we offer today have resulted from continuous improvements of our proprietary technologies. Many of these improvements have been brought to market in the last five years. We have adopted a best practices approach to technology development by combining our technology efforts with those of the businesses we have acquired. This has resulted in several successful new product developments. For example, in our packaging product line, we are focusing on universal coatings for two-piece food cans. In industrial coatings, we have developed new electrodeposition technology. We have continued to expand our line of polymers, and we now have a full portfolio of both water-based and conventional polymers for architectural, industrial and packaging products.

Research and development costs for fiscal 2006 were $82,608,000, representing a 4.2% increase over fiscal 2005 ($79,286,000). Fiscal 2005 costs increased 4.5% over those of fiscal 2004 ($75,880,000). Our primary emphasis has been on developing and refining emerging technologies in our Coatings segment.

5

Table of Contents

ENVIRONMENTAL COMPLIANCE

We undertake to comply with applicable regulations relating to protection of the environment and workers safety. Capital expenditures for this purpose were not material in fiscal 2006, and capital expenditures for fiscal 2007 to comply with existing laws and regulations are also not expected to be material.

EMPLOYEES

We employ approximately 9,556 persons, approximately 695 of whom are subject to collective bargaining agreements. We believe that our relationship with our unionized employees is good.

FOREIGN OPERATIONS AND EXPORT SALES

Our foreign operations are conducted primarily through majority-owned subsidiaries and, to a lesser extent, joint ventures. Sales from foreign operations continue to increase. In 1996, we acquired the European, U.S. and Australian metal decorating inks and packaging coatings business of Coates Coatings to provide our packaging coatings customers with global support. In 1999, we acquired the global packaging coatings business of the Dexter Corporation, along with its industrial coatings business in France. This acquisition added several manufacturing facilities throughout Europe and in Singapore. In December 2000, we completed our acquisition of Lilly Industries, which had manufacturing operations in Canada, Mexico, Europe and Asia. In 2004, we acquired the Dutch company, De Beer Lakfabrieken, B.V. In July 2006, we acquired an 80% interest in Huarun Paints, with manufacturing and distribution in China. In December 2006, we acquired the powder coatings business of H.B. Fuller Company, with a manufacturing facility in the United Kingdom. We now have manufacturing operations in Australia, Brazil, Canada, China, France, Germany, Ireland, Malaysia, Mexico, the Netherlands, Singapore, Switzerland and the United Kingdom. We also have joint ventures in China, Hong Kong, Japan and South Africa and sales offices in other countries.

Our various acquisitions and joint ventures over the past several years have increased revenues from foreign subsidiaries and operations, which comprised approximately 30% of the Company s total revenues in fiscal 2006. During fiscal 2006, export sales from the United States represented approximately 3.5% of our business.

ITEM 1A RISK FACTORS

You should consider the following risk factors, in addition to the other information presented or incorporated by reference into this Annual Report on Form 10-K, in evaluating us, our business and your investment in us.

Fluctuations in the supply and prices of raw materials could negatively impact our financial results.

We purchase the raw and intermediate materials needed to manufacture our products from a number of suppliers. The majority of our raw materials are petroleum-based derivatives and minerals and metals. Under normal market conditions, these materials are generally available on the open market. From time to time, however, the prices and availability of these raw materials may fluctuate significantly, which could impair our ability to procure necessary materials, or increase the cost of manufacturing our products. During the past 2 3 years, raw material costs have increased significantly, reducing our profit margins. If raw material costs continue to increase, and we are unable to pass along, or are delayed in passing along, those increases to our customers, we will experience further reductions to our profit margins.

Table of Contents

Many of our customers are in cyclical industries, which may affect the demand for our products.

Many of our customers, especially for our industrial products, are in businesses and industries that are cyclical in nature and sensitive to changes in general economic conditions. As a result, the demand for our products by these customers depends, in part, upon general economic conditions. Downward economic cycles affecting the industries of our customers will reduce sales of our products. If general economic conditions deteriorate, we may suffer reductions in our sales and profitability.

The industries in which we operate are highly competitive and some of our competitors may be larger and may have greater financial resources than we do.

All aspects of the coatings and paints business are highly competitive. We face strong competitors in all areas of our business. Any increase in competition may cause us to lose market share or compel us to reduce prices to remain competitive, which could result in reduced margins for our products. Competitive pressures may not only impair our margins but may also impact our revenues and our growth. A number of our competitors are larger than us and may have greater financial resources than we do. Increased competition with these companies could curtail price increases or could require price reductions or increased spending on marketing and sales, any of which could adversely affect our results of operations.

Industry sources estimate that the top ten largest coatings manufacturers represent more than half of the world s coatings sales. Our larger competitors may have more resources to finance acquisitions or internal growth in this competitive environment. Also, we buy our raw materials from large suppliers, primarily chemical companies. In many of our product lines, we then sell our finished goods to large customers, such as do-it-yourself home centers, large equipment manufacturers and can makers. Our larger competitors may have more resources or capabilities to conduct business with these large suppliers and large customers. Finally, many of our larger competitors operate businesses other than paints and coatings. These competitors may be better able to compete during industry downturns.

We have a significant amount of indebtedness.

Our total debt, including notes payable, was $839,430,000 at October 27, 2006. Our level of indebtedness may have important consequences. For example, it:

- may require us to dedicate a material portion of our cash flow from operations to make payments on our indebtedness, thereby reducing the availability of our cash flow to fund working capital, capital expenditures, acquisitions or other general corporate purposes;
- could make us less attractive to prospective or existing customers or less attractive to potential acquisition targets; and
- may limit our flexibility to adjust to changing business and market conditions and make us more vulnerable to a downturn in general economic conditions as compared to a competitor that may have lower indebtedness.

7

Table of Contents

Our strategy of growth through mergers and acquisitions may not be successful.

Mergers and acquisitions have historically contributed significantly to the growth of our company. As part of our growth strategy, we intend to continue pursuing acquisitions of complementary businesses or products and joint ventures. If we are successful in completing such acquisitions, we may experience:

- difficulties in assimilating acquired companies and products into our existing business;
- delays in realizing the benefits from the acquired companies or products;
- diversion of our management s time and attention from other business concerns;
- lack of or limited prior experience in any new markets we may enter;
- unforeseen claims and liabilities, including unexpected environmental exposures or product liability;
- unforeseen adjustments, charges and write-offs;
- problems enforcing the indemnification obligations of sellers of businesses or joint venture partners for claims and liabilities;
- unexpected losses of customers of, or suppliers to, the acquired business;
- difficulty in conforming the acquired business standards, processes, procedures and controls with our operations;
- variability in financial information arising from the implementation of purchase price accounting;
- difficulties in retaining key employees of the acquired businesses; and
- challenges arising from the increased scope, geographic diversity and complexity of our operations.

In addition, an acquisition could materially impair our operating results by causing us to incur debt or requiring us to amortize acquisition expenses or the cost of acquired assets. Any of these factors may make it more difficult to repay our debt. We can give no assurance that we will continue to be able to identify, acquire and integrate successful strategic acquisitions in the future or be able to implement successfully our operating and growth strategies within our existing markets or with respect to any future product or geographic diversification efforts.

We derive a substantial portion of our revenues from foreign markets, which subjects us to additional business risks.

We conduct a substantial portion of our business outside of the United States. We and our joint ventures currently have 20 production facilities, research and development facilities, and administrative and sales offices located outside the United States, including facilities and offices located in Canada, Mexico, the United Kingdom, France, Germany, Ireland, The Netherlands, Switzerland, Australia, China, Malaysia, South Africa, Singapore and Brazil. In 2006, revenues from products sold outside the United States accounted for approximately 30% of our net sales.

Table of Contents

We expect sales from international markets to continue to represent a significant portion of our net sales and the net sales of our joint ventures. Accordingly, our business is subject to risks related to the differing legal, political, social and regulatory requirements and economic conditions of many jurisdictions. Risks inherent in international operations include the following:

- agreements may be difficult to enforce and receivables difficult to collect;
- foreign customers may have longer payment cycles;
- foreign countries may impose additional withholding taxes or otherwise tax our foreign income, or adopt other restrictions on foreign trade or investment, including currency exchange controls;
- foreign operations may experience staffing difficulties and labor disputes;
- transportation and other shipping costs may increase;
- foreign governments may nationalize private enterprises;
- unexpected adverse changes in export duties, quotas and tariffs and difficulties in obtaining export licenses;
- intellectual property rights may be more difficult to enforce;
- fluctuations in exchange rates may affect product demand and may adversely affect the profitability in U.S. dollars of products and services we provide in international markets where payment for our products and services is made in the local currency;
- general economic conditions in the countries in which we operate could have an adverse effect on our earnings from operations in those countries;
- our business and profitability in a particular country could be affected by political or economic repercussions on a domestic, country specific or global level from terrorist activities and the response to such activities;
- unexpected adverse changes in foreign laws or regulatory requirements may occur; and
- compliance with a variety of foreign laws and regulations may be burdensome.

We have certain key customers.

Our relationships with certain key customers are important to us. From 2004 through 2006, sales to our largest customer, Lowe s Companies, Inc., have ranged from 16.7% to 17.6% of our total net sales. In 2006, our ten largest customers accounted for approximately 35% of our total net sales. Although we sell various types of products through various channels of distribution, we believe that the loss of a substantial portion of our sales to Lowe s Companies, Inc. could have a material adverse impact on us.

Table of Contents

Environmental laws and regulations could subject us to significant future liabilities.

We are subject to numerous environmental laws and regulations that impose various environmental controls on us, including among other things, the discharge of pollutants into the air and water, the handling, use, treatment, storage and clean-up of solid and hazardous wastes, the investigation and remediation of soil and groundwater affected by hazardous substances, or otherwise relating to environmental protection and various health and safety matters. These laws and regulations govern actions that may have adverse environmental effects and also require compliance with certain practices when handling and disposing of hazardous wastes. These laws and regulations also impose strict, retroactive and joint and several liability for the costs of, and damages resulting from, cleaning up current sites, past spills, disposals and other releases of hazardous substances and violations of these laws and regulations can also result in fines and penalties. We are currently undertaking remedial activities at a number of our facilities and properties, and have received notices under the Comprehensive Environmental Response, Compensation and Liability Act, or CERCLA, or analogous state laws of liability or potential liability in connection with the disposal of material from our operations or former operations.

ITEM 1B UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 PROPERTIES

We own our principal offices encompassing 225,000 square feet in Minneapolis, Minnesota. Manufacturing operations in North America are conducted at thirty-four locations, primarily in California, Illinois, Indiana, North Carolina, Pennsylvania and Texas, with two plants in Canada and one in Mexico. The combined square footage of the thirty-two owned and two leased plants in North America is approximately 4,788,000 (4,395,000 square feet owned and 393,000 square feet leased). Manufacturing operations in Europe are conducted at eight owned locations, with plants in the United Kingdom, France, Germany, Ireland, the Netherlands and Switzerland with a combined square footage of approximately 834,000. In Asia Pacific, we own five manufacturing facilities in China and one each in Australia, Malaysia and South Africa. In addition, one plant is leased in Singapore and two in China. In South America, we own one manufacturing facility in Brazil. The combined square footage of the nine owned and three leased facilities in Asia Pacific and South America is approximately 1,903,000 (1,777,000 square feet owned and 126,000 square feet leased).

Set forth below is a breakdown of principal facilities square footage by business segment:

Business Segment	**Approximate Square Footage**
Paints	2,323,000
Coatings	4,079,000
All Other	1,123,000

Management believes our manufacturing properties are well maintained, in good operating condition and adequate for the purposes for which they are being used. Operating capacity varies by product line, but additional production capacity is available for most product lines by increasing the number of days and/or shifts worked.

Table of Contents

ITEM 3 LEGAL PROCEEDINGS

Environmental Matters

We are involved in various claims relating to environmental matters at a number of current and former plant sites. We engage or participate in remedial and other environmental compliance activities at certain of these sites. At other sites, we have been named as a potentially responsible party (PRP) under federal and state environmental laws for site remediation. Management reviews each individual site, considering the number of parties involved, the level of our potential liability or contribution relative to the other parties, the nature and magnitude of the hazardous wastes involved, the method and extent of remediation, the potential insurance coverage, the estimated legal and consulting expense with respect to each site and the time period over which any costs would likely be incurred. Based on the above analysis, management estimates the clean-up costs and related claims for each site. The estimates are based in part on discussion with other PRPs, governmental agencies and engineering firms.

We accrue appropriate reserves for potential environmental liabilities, which are reviewed and adjusted as additional information becomes available. While uncertainties exist with respect to the amounts and timing of our ultimate environmental liabilities, management believes there is not a reasonable possibility that such liabilities, individually or in the aggregate, will have a material adverse effect on our financial condition or results of operations.

Other Legal Matters

We are involved in a variety of legal claims and proceedings relating to personal injury, product liability, warranties, customer contracts, employment, trade practices, environmental and other legal matters that arise in the normal course of business. These claims and proceedings include cases where we are one of a number of defendants in proceedings alleging that the plaintiffs suffered injuries or contracted diseases from exposure to chemicals or other ingredients used in the production of some of our products or waste disposal. We believe these claims and proceedings are not out of the ordinary course for a business of the type and size in which we are engaged. While we are unable to predict the ultimate outcome of these claims and proceedings, management believes there is not a reasonable possibility that the costs and liabilities of such matters will have a material adverse effect on our financial condition or results of operations.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There was no matter submitted during the fourth quarter of fiscal year 2006 to a vote of security holders.

Table of Contents

EXECUTIVE OFFICERS OF THE REGISTRANT

The names and ages of all of our executive officers, all of whom are approved by the Board of Directors for re-election in February of each year, and the positions held by them are as listed below. There are no family relationships between any of the officers or between any officer and director.

Name	**Age**	**Position**
William L.	58	President and Chief Executive Officer since February 2005

Name	**Age**	**Position**
Mansfield		
Paul C. Reyelts	60	Executive Vice President since February 2005 and Chief Financial Officer since November 1998
Steven L. Erdahl	54	Executive Vice President since April 2004
Rolf Engh	53	Executive Vice President since July 2005, General Counsel and Secretary since April 1993
Anthony L. Blaine	39	Senior Vice President Human Resources since January 2007
Gary E. Hendrickson	50	Senior Vice President since July 2005
Donald A. Nolan	46	Senior Vice President since July 2005
Lori A. Walker	49	Vice President, Treasurer and Controller since October 2004

The foregoing executive officers have served in the stated capacity for the registrant during the past five years, except for the following:

Prior to February 2005, Mr. Mansfield was Executive Vice President and Chief Operating Officer since April 2004. Prior to April 2004, Mr. Mansfield was Executive Vice President Architectural, Packaging and Specialty Coatings since January 2002. Prior to January 2002, Mr. Mansfield was Senior Vice President Architectural, Automotive and Specialty Coatings since February 2000.

Prior to February 2005, Mr. Reyelts was Senior Vice President, Finance and Chief Financial Officer since November 1998.

Prior to April 2004, Mr. Erdahl was Executive Vice President Industrial and Automotive Coatings since January 2002. Prior to January 2002, Mr. Erdahl was Senior Vice President Packaging and Industrial Coatings since February 2000.

Prior to July 2005, Mr. Engh was Senior Vice President since November 1998.

Prior to January 2007, Mr. Blaine was Vice President Human Resources at MeadWestvaco Corporation since June 2001.

Prior to July 2005, Mr. Hendrickson was Group Vice President Wood Coatings since April 2004. Prior to April 2004, Mr. Hendrickson was Vice President and President Asia Pacific since 2001.

Prior to July 2005, Mr. Nolan was Group Vice President Packaging since April 2004. Prior to April 2004, Mr. Nolan was Vice President Packaging Coatings, Americas since 2001.

Prior to October 2004, Ms. Walker was Vice President and Controller since June 2001.

Table of Contents

PART II

ITEM 5 MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Common Stock is listed on the New York Stock Exchange under the trading symbol VAL. The table below sets forth the quarterly high and low market prices of the Common Stock for fiscal years 2006 and 2005 as quoted on the New York Stock Exchange.

For the Fiscal Year	Market Price (high/low) 2006	2005
First Quarter	27.30 $ 21.54	25.52 $ 23.13
Second Quarter	29.20 $ 25.69	24.62 $ 20.41
Third Quarter	29.62 $ 23.83	24.95 $ 20.63
Fourth Quarter	27.50 $ 23.88	24.89 $ 20.88

The quarterly dividend declared December 6, 2006, which was paid January 12, 2007 to common stockholders of record December 29, 2006, was increased to 13¢ per share. The table below sets forth the quarterly dividend paid for fiscal years 2006 and 2005.

For the Fiscal Year	Per Share Dividends 2006	2005
First Quarter	$ 0.11	$ 0.10
Second Quarter	$ 0.11	$ 0.10
Third Quarter	$ 0.11	$ 0.10
Fourth Quarter	$ 0.11	$ 0.10
	$ 0.44	$ 0.40

The number of record holders of the Company s Common Stock at December 29, 2006 was 1,523.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased(1)	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
7/29/06 8/25/06				3,500,000
8/26/06 9/22/06				3,500,000
9/23/06 10/27/06	85,500	$ 25.51	85,500	4,000,000

(1) 585,500 shares purchased under repurchase authorization of 4,000,000 shares during the period of October 19, 2005 through October 17, 2006 and zero shares purchased under repurchase authorization of 4,000,000 shares for the period of October 18, 2006 through October 16, 2007.

EQUITY COMPENSATION PLANS

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans(1)
Equity Compensation Plans Approved by Security Holders	12,045,507	$ 20.50	7,562,143
Equity Compensation Plans Not Approved by Security Holders	None	None	None
Total	12,045,507	$ 20.50	7,562,143

(1) The number of securities remaining available for future issuance under equity compensation plans consists of shares issuable under the following corporate plans: The Valspar Corporation 1991 Stock Option Plan, The Valspar Corporation Key Employee Annual Bonus Plan, The Valspar Corporation Stock Option Plan for Non-Employee Directors and the 2001 Stock Incentive Plan.

13

Table of Contents

ITEM 6 SELECTED FINANCIAL DATA

The following selected financial data has been derived from the audited Consolidated Financial Statements of the Company and should be read in conjunction with Managements Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this Form 10-K.

	(Dollars in thousands, except per share amounts)	Fiscal Years 2006	2005	2004	2003	2002
Operating Results	Net Sales	$ 2,978,062	$ 2,713,950	$ 2,440,692	$ 2,247,926	$ 2,126,853
	Cost and Expenses					
	Cost of Sales	2,072,157	1,928,352	1,697,176	1,542,144	1,430,184
	Operating Expense	598,468	514,735	473,719	478,279	447,064
		307,437	270,863	269,797	227,503	249,605

		Fiscal Years				
	Income from Operations					
	Other (Income) Expense - Net	3,799	621	(139)	186	2,346
	Interest Expense	46,206	44,522	41,399	45,843	48,711
	Income Before Income Taxes	257,432	225,720	228,537	181,474	198,548
	Net Income	175,252	147,618	142,836	112,514	120,121
	Net Income as a Percent of Sales	5.9%	5.4%	5.9%	5.0%	5.6%
	Return on Average Equity	15.2%	14.3%	15.3%	14.0%	17.3%
	Per Common Share:					
	Net Income - Basic	$ 1.73	$ 1.45	$ 1.39	$ 1.12	$ 1.20
	Net Income - Diluted	1.71	1.42	1.35	1.08	1.17
	Dividends Paid	0.44	0.40	0.36	0.30	0.28
	Stockholders Equity	12.17	10.57	9.75	8.57	7.36
Financial Position	Total Assets	$ 3,188,253	$ 2,732,383	$ 2,634,258	$ 2,496,524	$ 2,419,552
	Working Capital at Year-End	(228,560)	239,573	84,104	207,768	203,057
	Property, Plant and Equipment, Net	459,605	427,822	428,431	414,219	402,475
	Long-Term Debt, Excluding Current Portion	350,267	706,415	549,073	749,199	885,819
	Stockholders Equity	1,240,063	1,061,092	1,000,363	869,317	737,253
Other Statistics	Property, Plant and Equipment Expenditures	$ 75,417	$ 62,731	$ 61,375	$ 51,042	$ 44,698
	Depreciation and Amortization Expense	68,716	68,395	60,537	55,622	51,143
	Research and Development Expense	82,608	79,286	75,880	69,667	65,924
	Total Cash Dividends	$ 44,655	$ 40,658	$ 36,911	$ 30,247	$ 27,962
	Average Diluted Common Shares Outstanding (000 s)	102,726	104,150	105,418	103,848	102,740
	Number of Stockholders	1,532	1,524	1,558	1,614	1,642
	Number of Employees at Year-End	9,556	7,540	7,504	7,013	7,058

	Fiscal Years				
Market Price Range - Common Stock:					
High	$ 29.62	$ 25.52	$ 25.76	$ 24.25	$ 25.08
Low	21.54	20.41	22.34	18.80	16.50

Reference is made to the Notes to Consolidated Financial Statements for a summary of accounting policies and additional information.

Per share data has been adjusted to reflect a 2 for 1 stock split effective in September 2005. The number of stockholders is based on record holders at year-end.

Table of Contents

ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The following discussion of financial condition and results of operations should be read in the context of this overview.

General Economic and Industry-Wide Factors

General economic conditions continued to improve in 2006. The Company s sales increased compared to the prior year, primarily due to higher selling prices to customers and acquisitions. However, the Company continued to experience increases in the cost of raw materials, compared to the prior year period. This continues a trend of raw material cost increases that began in the second half of fiscal 2004. Despite this factor, the Company s gross margin increased from 2005 levels. The increase resulted from price increases to offset increases in raw material costs, as well as manufacturing efficiencies.

Internal Business Performance

Despite the challenges posed by rising raw material prices and supply shortages, the Company had strong results across all of its businesses. Reported net income for the full year increased 18.7% to $175,252,000 in 2006 from $147,618,000 in 2005 and earnings per diluted share increased 20.4% to $1.71 in 2006 from $1.42 in 2005.

The Company reduced the ratio of total debt to capital to 40.4% at the end of 2006, compared to 40.9% at the end of 2005 and 41.8% in 2004. Beginning in 2005 and continuing in 2006, the Company focused its efforts on mitigating the impact of raw material increases and supply shortages by implementing price increases across all the product lines and by continuing its efforts to improve productivity and expand the supply base globally. The Company s strong balance sheet will allow it to participate in future acquisition opportunities.

The Company s overall raw material costs have increased by more than 20% over the past twenty-four months, and the

Company continued to increase prices across most product lines in an effort to recover raw material cost increases. The discrete impact of price increases on net sales is not apparent, as product mix changes from period to period, partly in response to price increases and partly in response to factors unrelated to price increases. The primary categories of raw materials purchased by the Company are pigments, resins, solvents and additives. The Company expects average raw material costs to be flat in 2007 compared to 2006.

In July 2006, the Company acquired an 80% interest in Huarun Paints Holding Company Limited. With manufacturing and distribution of wood, furniture and architectural coatings throughout China, Huarun Paints had sales of approximately $200 million in 2006. In December 2006, the Company acquired H.B. Fuller s powder coatings business, with operations in the United States and the United Kingdom.

In 2005, the Company announced a plan to rationalize its manufacturing capacity in order to increase productivity and improve service to customers. During 2005, we discontinued manufacturing at seven sites. As a result, certain assets have been written off or sold and severance costs have been recognized. The impact to 2005 results was immaterial. The Company completed additional plant closures and downsizings in 2006, which resulted in net after-tax charges to earnings of approximately $4,000,000.

OPERATIONS 2006 VS. 2005

Net sales for the Company increased 9.7% to $2,978,062,000 in 2006 from $2,713,950,000 in 2005. Sales growth was 6.9% after excluding the favorable impact of foreign currency of 0.1% and acquisitions of 2.7%.

Net sales of the Paints segment increased 13.4% to $985,698,000 in 2006 from $869,347,000 in 2005. Excluding the favorable impact of the Huarun and Cabot acquisitions, net sales growth in the Paints segment was 6.9%. Revenue growth in the Paints segment was primarily driven by favorable price/mix, and higher volumes in the architectural product line.

Net sales of the Coatings segment increased 7.0% to $1,683,482,000 in 2006 from $1,573,067,000 in 2005. Excluding the favorable impact of the Huarun acquisition and foreign currency, net sales growth in the Coatings segment was 5.6%. Revenue growth in the Coatings segment was primarily driven by higher selling prices to customers and growth in industrial coatings.

The 2006 gross profit margin increased to 30.4% from 28.9% as a result of increases in selling prices and manufacturing efficiencies, partially offset by higher raw material costs.

Operating expenses (research and development, selling, administrative and amortization) increased 16.3% to $598,468,000 (20.1% of net sales) in 2006 compared to $514,735,000 (19.0% of net sales) in 2005. The dollar increase in operating expenses was driven by Cabot advertising and promotion, incremental Cabot and Huarun Paints expenses, stock based compensation and incentive compensation. The Company expects operating expenses to increase in 2007 in connection with increased advertising and promotion expense.

Earnings before interest and taxes (EBIT) of the Paints segment increased 20.1% from the prior year to $107,756,000. EBIT as a percent of net sales of the Paints segment increased to 10.9% in 2006 compared to 10.3% in 2005. The increase in EBIT as a percent of net sales was largely attributable to higher selling prices and manufacturing efficiencies, partially offset by raw material cost increases. Foreign currency fluctuation had no material effect on

EBIT of the Paints segment.

EBIT of the Coatings segment increased 13.7% from the prior year to $206,309,000. EBIT as a percent of net sales of the Coatings segment increased to 12.3% in 2006 compared to 11.5% in 2005. The increase in EBIT as a percent of net sales was primarily due to higher selling prices and growth in our coil product line. Foreign currency fluctuation had no material effect on EBIT of the Coatings segment.

EBIT of the Company increased 12.4% from prior year to $303,638,000. EBIT as a percent of net sales increased to 10.2% in 2006 compared to 10.0% in 2005. The increase in EBIT as a percent of net sales was primarily driven by higher selling prices and manufacturing efficiencies.

Other expense increased to $3,799,000 in 2006 from $621,000 in 2005, which included the favorable settlement of a lawsuit in 2005.

Interest expense increased to $46,206,000 in 2006 from $44,522,000 in 2005, primarily due to increased average interest rates, offset by a slight decrease in average debt outstanding.

The effective tax rate decreased from 34.6% to 31.9% due to tax adjustments related to prior tax periods, the approval of favorable tax credits and statutory rate reductions in foreign jurisdictions.

Net income for the full year was $175,252,000 or $1.71 per diluted share. On a year-over-year basis, diluted earnings per share increased 20.4% from 2005.

OPERATIONS 2005 VS. 2004

Net sales for the Company increased 11.2% to $2,713,950,000 in 2005 from $2,440,692,000 in 2004. Sales growth was 7.7% after excluding the favorable impact of foreign currency of 1.4% and acquisitions of 2.1%.

Table of Contents

Net sales of the Paints segment increased 8.4% to $869,347,000 in 2005 from $802,114,000 in 2004. Excluding the favorable impact of the Samuel Cabot acquisition, net sales growth in the Paints segment was 3.4%. Revenue growth in the Paints segment was primarily driven by favorable price/mix, partially offset by lower volumes in the architectural product line.

Net sales of the Coatings segment increased 11.4% to $1,573,067,000 in 2005 from $1,412,569,000 in 2004. Excluding the favorable impact of foreign currency, net sales growth in the Coatings segment was 8.4%. Higher selling prices to customers and stronger demand in international markets contributed to the increase.

The 2005 gross profit margin decreased to 28.9% from 30.5% as a result of continued increases in raw material costs during fiscal year 2005, partially offset by price increases. Strategic initiatives and operational changes implemented in our furniture protection plan business in 2004 and continued in 2005 resulted in lower claims experience. These changes had a favorable 0.3% impact on gross margins as a percentage of net sales in 2005, or $8,000,000. Included in the 2004 results was a $6,898,000 benefit for a reduction in estimated future claims expense in the furniture protection plan business.

Operating expenses (research and development, selling, administrative and amortization) increased 8.7% to $514,735,000 (19.0% of net sales) in 2005 compared to $473,719,000 (19.4% of net sales) in 2004. The dollar increase in operating expenses was driven by acquisitions and increased merchandising expense resulting from sales growth.

EBIT of the Paints segment decreased 24.3% from the prior year to $89,691,000. EBIT as a percent of net sales of the Paints segment decreased to 10.3% in 2005 compared to 14.8% in 2004. The decline in EBIT as a percent of net sales was largely attributable to higher raw material costs, partially offset by price increases. Foreign currency fluctuation had no material effect on EBIT of the Paints segment.

EBIT of the Coatings segment increased 6.4% from the prior year to $181,375,000. EBIT as a percent of net sales of the Coatings segment decreased to 11.5% in 2005 compared to 12.1% in 2004. The decline in EBIT as a percent of net sales was due to higher raw material costs, partially offset by price increases. Excluding the favorable impact of foreign currency, EBIT in the Coatings segment increased approximately 3.0% from the prior year.

EBIT of the Company was flat compared to the prior year at $270,242,000. EBIT as a percent of net sales decreased to 10.0% in 2005 compared to 11.1% in 2004. The decline in EBIT as a percent of net sales was due to declines in the Paints and Coatings segments, offset primarily by improvements in our furniture protection plan product line and, to a limited extent, by double digit growth in our resin/colorant and gelcoat product lines. Our furniture protection plan, resin/colorant and gelcoat product lines comprise all of the product lines included in All Other.

Other expense increased to $621,000 in 2005 from other income of $139,000 in 2004.

Interest expense increased to $44,522,000 in 2005 from $41,399,000 in 2004, primarily due to increased average interest rates.

The effective tax rate decreased from 37.5% to 34.6% as a result of favorable tax adjustments related to prior years and improvement in the geographic mix of earnings.

Net income for the full year was $147,618,000 or $1.42 per diluted share. On a year-over-year basis, diluted earnings per share increased 5.2% from 2004.

Table of Contents

FINANCIAL CONDITION

Cash provided by operating activities was $284,540,000 in 2006 compared with $231,129,000 in 2005 and $245,465,000 in 2004. In 2006, the cash provided by operating activities and current cash balances were used to fund $290,386,000 in acquisitions, $75,417,000 in capital expenditures, $44,655,000 in dividend payments and $15,377,000 in share repurchases.

Inventories and Other current assets increased $49,990,000, primarily due to increased inventories in the architectural product line to support continued business growth. Trade accounts payable and accrued liabilities increased by $94,380,000 as a result of negotiating extended payment terms and timing of disbursements. Income taxes payable decreased by $18,290,000 as a result of statutory tax rate reductions in foreign jurisdictions. Accounts and notes receivable decreased by $12,172,000, primarily due to timing of customer payments.

Capital expenditures for property, plant and equipment were $75,417,000 in 2006, compared with $62,731,000 in 2005. The Company anticipates capital spending in Fiscal 2007 to be approximately $80,000,000.

The ratio of total debt to capital decreased to 40.4% at the end of 2006 compared to 40.9% in 2005. Average debt outstanding during 2006 was $778,988,000 at a weighted average interest rate of 5.93% versus $805,763,000 at 5.53% last year. Interest expense for 2006 was $46,206,000 compared to $44,522,000 in 2005.

Under various agreements, the Company is obligated to make future cash payments in fixed amounts. These include payments under the multi-currency credit facilities, commercial paper program, senior notes, industrial development bonds, employee benefit plans, capital leases and non-cancelable operating leases with initial or remaining terms in excess of one year. Interest charges are variable and assumed at today s rates.

The following table summarizes the Company s fixed cash obligations as of October 27, 2006 for the fiscal years ending in October:

CONTRACTUAL CASH OBLIGATIONS

(Dollars in thousands)	2007	2008	2009	2010	2011	2012 and thereafter	Total
Notes & Interest to Banks	$ 31,412	$ 3,553	$ 3,553	$ 88,201	$	$ 2,617	$ 129,336
Commercial Paper	131,539						131,539
Senior Notes & Interest	375,900	108,296	7,650	7,650	7,650	178,688	685,834
Industrial Development Bonds & Interest	462	462	462	462	462	14,207	16,517
Medical Retiree/SERP/Pension	1,019	1,032	1,063	1,123	1,288	39,851	45,376
Capital Leases & Interest	30	30	13				73
Operating Lease	15,324	12,613	9,617	6,158	3,807	4,502	52,021
Total Contractual Cash Obligations	$ 555,686	$ 125,986	$ 22,358	$ 103,594	$ 13,207	$ 239,865	$ 1,060,696

Table of Contents

On October 18, 2006, the Company entered into an agreement to purchase the powder coatings business of H.B. Fuller Company. On December 1, 2006, the Company completed the acquisition for a cash purchase price of $105,250,000.

During 2006, the Company established a $350,000,000 U.S. Commercial Paper program of which $131,539,000 was outstanding as of October 27, 2006.

At October 27, 2006, the Company had unused lines of credit available from banks of $781,230,000. Effective July 2006, the Company entered into a 364-day $350,000,000 credit facility expiring in July 2007. This is in addition to the existing $500,000,000 credit facility entered into in October 2005 and expiring in October 2010.

Common stock dividends of $44,655,000 in 2006 represented a 9.8% increase over 2005. The annual dividend in 2006 was increased to $0.44 per share from $0.40 per share in 2005.

The Company has continuing authorization to purchase shares of its common stock at management s discretion for general corporate purposes. Shares repurchased in 2006 were 585,500 shares totaling $15,377,000. The Company repurchased 3,531,200 shares totaling $82,116,200 in 2005. The Company repurchased 242,000 shares totaling $5,550,000 in 2004.

The Company is involved in various claims relating to environmental and waste disposal matters at a number of current and former plant sites. The Company engages or participates in remedial and other environmental compliance activities at certain of these sites. At other sites, the Company has been named as a potentially responsible party (PRP) under federal and state environmental laws for the remediation of hazardous waste. The Company s management reviews each individual site, considering the number of parties involved, the level of potential liability or contribution of the Company relative to the other parties, the nature and magnitude of the wastes involved, the method and extent of remediation, the potential insurance coverage, the estimated legal and consulting expense with respect to each site, and the time period over which any costs would likely be incurred. Based on the above analysis, management estimates the remediation or other clean-up costs and related claims for each site. The estimates are based in part on discussions with other PRPs, governmental agencies and engineering firms.

The Company accrues appropriate reserves for potential environmental liabilities, which are continually reviewed and adjusted as additional information becomes available. While uncertainties exist with respect to the amounts and timing of the Company s ultimate environmental liabilities, management believes there is not a reasonable possibility that such liabilities, individually and in the aggregate, will have a material adverse effect on the Company s financial condition or results of operations.

The Company is involved in a variety of legal claims and proceedings relating to personal injury, product liability, warranties, customer contracts, employment, trade practices, environmental and other legal matters that arise in the normal course of business. These claims and proceedings include cases where the Company is one of a number of defendants in proceedings alleging that the plaintiffs suffered injuries or contracted diseases from exposure to chemicals or other ingredients used in the production of some of the Company s products or waste disposal. The Company believes these claims and proceedings are not out of the ordinary course for a business of the type and size in which it is engaged. While the Company is unable to predict the ultimate outcome of these claims and proceedings, management believes there is not a reasonable possibility that the costs and liabilities of such matters will have a material adverse effect on the Company s financial condition or results of operations.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company s discussion and analysis of its financial condition and results of operations are based upon the Company s consolidated financial statements, which have been prepared in

accordance with generally accepted accounting principles in the United States (GAAP). The preparation of these financial statements requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of any contingent assets and liabilities at the date of the financial statements. The Company regularly reviews its estimates and assumptions, which are based on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The Company believes the following critical accounting policies are affected by significant judgments and estimates used in the preparation of its consolidated financial statements and that the judgments and estimates are reasonable:

Revenue Recognition

Other than extended furniture protection plans, revenue from sales is recognized at the time of product delivery, passage of title, a sales agreement is in place, pricing is fixed or determinable and collection is reasonably assured. Discounts provided to customers at the point of sale are recognized as a reduction in revenue as the products are sold. The Company sells extended furniture protection plans for which revenue is deferred and recognized over the life of the contract. Historical claims data is used to forecast claim 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. An actuarial study is used to forecast the stream of claim payments over the contract period, and revenue is recognized based on this stream.

The most important factors considered by the Company in reviewing its furniture protection plan business and estimating future claims expense are the number of claims submitted (frequency) and the dollar amount per claim (severity). Comparing 2003 to 2002, claim frequency increased by approximately 66%, while claim severity remained relatively stable, for furniture protection plans sold in 2003 and prior years. The Company then recorded a pre-tax charge of $24,500,000 in 2003. During 2004, following a comprehensive review of this business, the Company implemented a number of strategic initiatives and operational changes, including changes in the terms of the plans and changes in the Company s claims administration policies. Comparing 2004 to 2003, the strategic initiatives and operational changes led to claim frequency and claim severity decreases of approximately 23% and 40%, respectively, for furniture protection plans sold in 2003 and prior years. As a result, the Company reduced the accrual by $6,898,000 in 2004. Comparing 2005 to 2004, claim frequency decreased approximately 30%, while claim severity remained relatively stable, for furniture protection plans sold in 2003 and prior years. In 2005, the Company also began to analyze when an open claim is inactive and unlikely to require any payment. As a result of the decrease in claim frequency and the analysis of open claims, the Company reduced the accrual by an additional $8,000,000 in 2005. In 2006, the Company did not experience a significant change in the frequency or severity of claims for plans sold in 2003 or prior years. If claim frequency or severity for plans sold in 2003 and prior years changes further in 2007, or if the determination of when an open claim is considered inactive and unlikely to require any payment changes in 2007, the Company will consider whether it would be appropriate to adjust the accrual in 2007.

Supplier and Customer Rebates

The Company records supplier and customer rebates as a reduction of cost of goods sold or a reduction to revenue, respectively, as they are earned, in accordance with the underlying agreement. The customer rebate estimate is developed based on historical experience plus current activity for the customer s purchases. Customer rebates that increase based on different levels of sales volume are recognized immediately when the current activity plus expected volume

Table of Contents

triggers a higher earned rebate. The supplier rebate estimate is developed based on historical experience plus current activity for the Company s purchases. Supplier rebates that increase based on different levels of purchases are recognized when there is certainty that the current level of purchases will trigger a higher rebate earned.

Valuation of Goodwill and Indefinite-Lived Intangible Assets

Goodwill represents the excess of cost over the fair value of identifiable net assets of businesses acquired. Other intangible assets consist of customer lists and relationships, purchased technology and patents and trademarks.

Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), requires that goodwill for each reporting unit be reviewed for impairment at least annually. The Company has five reporting units at October 27, 2006 (see Note 14). The Company tests goodwill for impairment using the two-step process prescribed by SFAS 142. In the first step, the Company compares the fair value of each reporting unit, as computed primarily by present value cash flow calculations, to its book carrying value, including goodwill. If the fair value exceeds the carrying value, no further work is required and no impairment loss is recognized. If the carrying value exceeds the fair value, the goodwill of the reporting unit is potentially impaired and the Company would then complete step 2 in order to measure the impairment loss. In step 2, the Company would calculate the implied fair value of goodwill by deducting the fair value of all tangible and intangible net assets (including unrecognized intangible assets) of the reporting unit from the fair value of the reporting unit (as determined in step 1). If the implied fair value of goodwill is less than the carrying value of goodwill, the Company would recognize an impairment loss equal to the difference.

Management also reviews other intangible assets with finite lives for impairment at least annually to determine if any adverse conditions exist that would indicate impairment. If the carrying value of the finite-lived intangible assets exceeds the undiscounted cash flows resulting from the use and disposition of the asset, the carrying value is written down to fair value in the period identified. Indefinite-lived intangible assets are reviewed at least annually for impairment by calculating the fair value of the assets and comparing with their carrying value. In assessing fair value, management generally utilizes present value cash flow calculations using a cash flow approach.

During the fourth quarters of 2006 and 2005, management completed its annual goodwill and intangible asset impairment reviews with no impairments to the carrying values identified.

The discount rate and sales growth assumptions are the two material assumptions utilized in the Company s calculations of the present value cash flows used to estimate the fair value of the reporting units when performing the annual goodwill impairment test and in testing indefinite-lived intangible assets for impairment. The Company utilizes a cash flow approach in estimating the fair value of the reporting units, where the discount reflects a weighted average cost of capital rate. The cash flow model used to derive fair value is most sensitive to the discount rate and sales growth assumptions used. The estimated fair value of the reporting units and indefinite-lived intangible assets have historically exceeded the carrying value of such reporting units or indefinite-lived intangible assets by a substantial amount. The Company performs a sensitivity analysis on the discount rate and revenue growth assumptions. Either the discount rate could increase by 20% of the discount rate utilized or the sales growth assumption could decline to a zero growth environment and the Company s reporting units and indefinite-lived intangible assets would continue to have fair value in excess of carrying value.

Pension Obligations

The Company sponsors several defined benefit plans for certain hourly, salaried and foreign employees. The Company accounts for its defined benefit pension plans in accordance with

21

Table of Contents

GAAP, which requires the amount recognized in financial statements be determined on an actuarial basis. To accomplish this, extensive use is made of assumptions about inflation, investment returns, mortality, turnover, and discount rates. A change in these assumptions could cause actual results to differ from those reported. A reduction of 50 basis points in the long-term rate of return and a reduction of 50 basis points in the discount rate would have increased the Company s pension expense $2,261,000 in 2006.

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.

OFF-BALANCE SHEET ARRANGEMENTS

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.

ITEM 7A 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 October 27, 2006, approximately 40% of the Company s total debt consisted of floating rate debt. If interest rates were to increase 10% from the rates in effect on October 27, 2006, assuming no change in debt balances, the additional interest expense would not have a material effect on the Company s results of operations or financial position.

22

Table of Contents

ITEM 8   FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Board of Directors and Stockholders
The Valspar Corporation

The Valspar Corporation s (the Company) management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). The Company s internal control system is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.

Under the supervision and with the participation of management, including its principal executive officer and principal financial officer, the Company s management assessed the design and operating effectiveness of internal control over financial reporting as of October 27, 2006 based on the framework set forth in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Based on this assessment, management concluded that the Company s internal control over financial reporting was effective as of October 27, 2006. Ernst & Young LLP, an independent registered public accounting firm, has issued an attestation report on management s assessment of the Company s internal control over financial reporting as of October 27, 2006. That report is included herein.

William L. Mansfield
President and Chief Executive Officer

Paul C. Reyelts
Executive Vice President and Chief Financial Officer

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON CONSOLIDATED FINANCIAL STATEMENTS

The Board of Directors and Shareholders
The Valspar Corporation

We have audited the accompanying consolidated balance sheets of The Valspar Corporation and subsidiaries as of October 27, 2006, and October 28, 2005 and the related consolidated statements of income, changes in equity, and consolidated statements of cash flows for each of the three years in the period ended October 27, 2006. Our audits also included the financial statement schedule listed in Item 15(a). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of The Valspar Corporation and subsidiaries at October 27, 2006, and October 28, 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended October 27, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of The Valspar Corporation s internal control over financial reporting as of October 27, 2006, based on criteria established in *Internal Control Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated January 9, 2007, expressed an unqualified opinion thereon.

As discussed in Note 9, Stock-Based Compensation, to the consolidated financial statements, effective October 29, 2005, the Company adopted SFAS 123 (revised 2004), Share-Based Payment , using the modified prospective method.

Minneapolis, Minnesota
January 9, 2007

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Shareholders
The Valspar Corporation

We have audited management s assessment, included in the accompanying Report of Management on Internal Control over Financial Reporting, that The Valspar Corporation maintained effective internal control over financial reporting as of October 27, 2006, based on criteria established in *Internal Control Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Valspar Corporation s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that The Valspar Corporation maintained effective internal control over financial reporting as of October 27, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, The Valspar Corporation maintained, in all material respects, effective internal control over financial reporting as of October 27, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of The Valspar Corporation and subsidiaries as of October 27, 2006, and October 28, 2005, and the related consolidated statements of income, statement of changes in equity and consolidated statements of cash flows for each of the three years in the period ended October 27, 2006, of The Valspar Corporation and our report dated January 9, 2007, expressed an unqualified opinion thereon.

Minneapolis, Minnesota
January 9, 2007

Table of Contents

CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share amounts)

		October 27, 2006	October 28, 2005
ASSETS			
Current Assets	Cash and cash equivalents	$ 88,238	$ 52,845
	Accounts and notes receivable, less allowances for doubtful accounts (2006 - $13,145; 2005 - $16,857)	475,736	462,396
	Inventories	281,817	230,640
	Deferred income taxes	31,228	37,750
	Prepaid expenses and other current assets	90,104	80,248
	Total Current Assets	967,123	863,879
Goodwill		1,336,098	1,064,931
Intangibles, net		361,957	315,537
Other Assets		63,470	60,214
Property, Plant and Equipment	Land	33,323	35,149
	Buildings	296,243	270,056
	Machinery and equipment	547,825	539,015
		877,391	844,220
	Less accumulated depreciation	417,786	416,398
	Net Property, Plant and Equipment	459,605	427,822
	Total Assets	$ 3,188,253	$ 2,732,383
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities	Notes payable	$ 139,136	$ 29,257
	Trade accounts payable	368,159	260,070
	Income taxes	38,455	58,120
	Accrued liabilities	299,906	276,835
	Current portion of long-term debt	350,027	24
	Total Current Liabilities	1,195,683	624,306
Long-Term Debt, net of current portion		350,267	706,415
Deferred Income Taxes		197,728	181,886
Deferred Liabilities		185,789	158,684
	Total Liabilities	1,929,467	1,671,291
Mandatorily Redeemable Stock		18,723	
Stockholders Equity	Common stock (par value $0.50 per share; shares authorized 250,000,000; shares issued, including shares in treasury 120,442,624)	60,220	60,220
	Additional paid-in capital	326,011	289,158
	Retained earnings	1,007,225	880,006
	Other	24,084	11,695

	October 27, 2006	October 28, 2005
	1,417,540	1,241,079
Less cost of common stock in treasury (2006 18,538,360 shares) (2005 20,010,616 shares)	177,477	179,987
Total Stockholders Equity	1,240,063	1,061,092
Total Liabilities and Stockholders Equity	$ 3,188,253	$ 2,732,383

See Notes to Consolidated Financial Statements

26

Table of Contents

CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except per share amounts)

For the Year Ended	October 27, 2006 (52 weeks)	October 28, 2005 (52 weeks)	October 29, 2004 (52 weeks)
Net Sales	$ 2,978,062	$ 2,713,950	$ 2,440,692
Cost and Expenses			
Cost of Sales	2,072,157	1,928,352	1,697,176
Research and Development	82,608	79,286	75,880
Selling and Administrative	510,894	430,683	393,360
Amortization Expense	4,966	4,766	4,479
Income from Operations	307,437	270,863	269,797
Other Expense (Income), net	3,799	621	(139)
Interest Expense	46,206	44,522	41,399
Income before Income Taxes	257,432	225,720	228,537
Income Taxes	82,180	78,102	85,701
Net Income	$ 175,252	$ 147,618	$ 142,836
Net Income Per Common Share Basic	$ 1.73	$ 1.45	$ 1.39
Net Income Per Common Share Diluted	$ 1.71	$ 1.42	$ 1.35

See Notes to Consolidated Financial Statements

Table of Contents

STATEMENT OF CHANGES IN EQUITY
(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance, October 31, 2003	$ 30,110	$ 250,400	$ 697,231	$ (102,689)	$ (5,735)	$ 869,317
Net Income			142,836			142,836
Foreign Currency Translation					9,612	9,612
Minimum Pension Liability Adjustment, net of tax of $2,386					(3,977)	(3,977)
Net Unrealized Loss on Financial Instruments, net of tax of $278					(464)	(464)
Comprehensive Income						$ 148,007
Restricted Stock Granted for 104,894 Shares		2,008		568		2,576
Common Stock Options Exercised of 1,385,756 Shares		17,191		5,229		22,420
Purchase of Shares of Common Stock for Treasury of 242,000 Shares				(5,550)		(5,550)
Cash Dividends on Common Stock - $0.36 per Share			(36,911)			(36,911)
Other					504	504
Balance October 29, 2004	$ 30,110	$ 269,599	$ 803,156	$ (102,442)	$ (60)	$ 1,000,363
Net Income			147,618			147,618
Foreign Currency Translation					9,898	9,898
Minimum Pension Liability Adjustment, net of tax of $888					(1,580)	(1,580)
					3,235	3,235

	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Net Unrealized Gain on Financial Instruments, net of tax of $1,820						
Comprehensive Income						$ 159,171
Restricted Stock Granted for 140,102 Shares		2,467		890		3,357
Common Stock Options Exercised of 1,450,503 Shares		17,092		3,681		20,773
Purchase of Shares of Common Stock for Treasury of 3,531,200 Shares				(82,116)		(82,116)
Cash Dividends on Common Stock - $0.40 per Share			(40,658)			(40,658)
Stock Split	30,110		(30,110)			
Other					202	202
Balance, October 28, 2005	$ 60,220	$ 289,158	$ 880,006	$ (179,987)	$ 11,695	$ 1,061,092
Net Income			175,252			175,252
Foreign Currency Translation					4,508	4,508
Minimum Pension Liability Adjustment, net of tax of $4,968					9,097	9,097
Net Unrealized Loss on Financial Instruments, net of tax of $761					(1,242)	(1,242)
Comprehensive Income						187,615
Restricted Stock Granted for 201,900 Shares		3,425		1,829		5,254
Common Stock Options Exercised of 1,911,729 Shares		21,997		16,058		38,055
Purchase of Shares of Common Stock for Treasury of 585,500 Shares				(15,377)		(15,377)
			(44,655)			(44,655)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Cash Dividends on Common Stock - $0.44 per Share						
Stock Option Expense FAS 123R		11,273				11,273
Mandatorily Redeemable Stock Accretion			(3,378)			(3,378)
Other		158			26	184
Balance, October 27, 2006	$ 60,220	$ 326,011	$ 1,007,225	$ (177,477)	$ 24,084	$ 1,240,063

See Notes to Consolidated Financial Statements

Table of Contents

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

For the Year Ended		October 27, 2006 (52 weeks)	October 28, 2005 (52 weeks)	October 29, 2004 (52 weeks)
Operating Activities	Net Income	$ 175,252	$ 147,618	$ 142,836
	Adjustments to Reconcile Net Income to Net Cash Provided by (used in) Operating Activities:			
	Depreciation	63,750	63,629	56,058
	Amortization	4,966	4,766	4,479
	Deferred Income Taxes	1,798	3,928	12,237
	Loss on Sales or Abandonment of Property, Plant and Equipment	3,068	6,544	5,862
	Changes in Certain Assets and Liabilities, Net of Effects of Acquired Businesses:			
	Decrease (Increase) in Accounts and Notes Receivable	12,172	(33,804)	(6,624)
	Decrease (Increase) in Inventories and Other Assets	(49,990)	(4,393)	(16,054)
	Increase (Decrease) in Trade Accounts Payable and Accrued Liabilities	94,380	23,820	39,692
	Increase (Decrease) in Income Taxes Payable	(18,290)	24,413	1,492

For the Year Ended		October 27, 2006 (52 weeks)	October 28, 2005 (52 weeks)	October 29, 2004 (52 weeks)
	Increase (Decrease) in Other Deferred Liabilities	(1,088)	1,105	(4,571)
	Stock Option Expense	11,273		
	Other	(12,751)	(6,497)	10,058
	Net Cash Provided by (Used in) Operating Activities	284,540	231,129	245,465
Investing Activities	Purchases of Property, Plant and Equipment	(75,417)	(62,731)	(61,375)
	Acquired Businesses, (net of cash)	(290,386)	(78,691)	(72,585)
	Cash proceeds on Disposal of Assets	8,738		
	Net Cash Provided by (Used in) Investing Activities	(357,065)	(141,422)	(133,960)
Financing Activities	Net Proceeds from (Payments on) Borrowings	98,006	10,224	(75,871)
	Proceeds from Sales of Treasury Stock	32,685	21,545	19,381
	Purchase of Shares of Common Stock for Treasury	(15,377)	(82,116)	(5,550)
	Excess Tax Benefit from Stock-Based Compensation	2,889		
	Deferred Liability-Excess Cash Huarun	34,370		
	Dividends Paid	(44,655)	(40,658)	(36,911)
	Net Cash Provided by (Used in) Financing Activities	107,918	(91,005)	(98,951)
	Increase (Decrease) in Cash and Cash Equivalents	35,393	(1,298)	12,554
Cash and Cash Equivalents at Beginning of Year		52,845	54,143	41,589
Cash and Cash Equivalents at End of Year		$ 88,238	$ 52,845	$ 54,143

See Notes to Consolidated Financial Statements

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
The Valspar Corporation Years Ended October 2006, 2005 and 2004
(Dollars in thousands, except per share amounts)

NOTE 1 SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year: The Valspar Corporation has a 4-4-5 week accounting cycle with the fiscal year ending on the Friday on or immediately preceding October 31. Fiscal years 2006, 2005 and 2004 each include 52 weeks.

Principles of Consolidation: The consolidated financial statements include the accounts of the parent company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Investments in which the Company has a 20 to 50 percent interest and where the Company does not have management control and is not the primary beneficiary are accounted for using the equity method.

Estimates: The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires the Company to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

Revenue Recognition: Other than extended furniture protection plans, revenue from sales is recognized at the time of product delivery, passage of title, a sales agreement is in place, pricing is fixed or determinable and collection is reasonably assured. Discounts provided to customers at the point of sale are recognized as a reduction in revenue as the products are sold. The Company sells extended furniture protection plans for which revenue is deferred and recognized over the life of the contract. Historical claims data is used to forecast claim 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. An actuarial study is used to forecast the stream of claim payments over the contract period, and revenue is recognized based on this stream.

Allowance for Doubtful Accounts: The Company estimates the allowance for doubtful accounts by analyzing accounts receivable by age, specific collection risk and evaluating the historical write-off percentage over the past five year period. Accounts are written off sooner in the event of bankruptcy or other circumstances that make further collection unlikely. When it is deemed probable that a customer account is uncollectible, that balance is written off against the existing allowance.

Cash Equivalents: The Company considers all highly liquid instruments purchased with an original maturity of less than three months to be cash equivalents.

Inventories: Inventories are stated at the lower of cost or market. The Company s domestic inventories are recorded on the last-in, first-out (LIFO) method. The remaining inventories are recorded using the first-in, first-out (FIFO) method.

Property, Plant and Equipment: Property, plant and equipment are recorded at cost. Expenditures that improve or extend the life of the respective assets are capitalized, while maintenance and repairs are expensed as incurred. Provision for depreciation of property is made by charges to operations at rates calculated to amortize the cost of the property over its useful life (twenty years for buildings; three to ten years for machinery and equipment) primarily using the straight-line method.

Table of Contents

Impairment of Long-Lived Tangible and Intangible Assets: The Company evaluates long-lived assets, including intangible assets with finite lives, in compliance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). An impairment loss is recognized whenever events or changes in circumstances indicate the carrying amount of an asset is not recoverable. In applying

SFAS 144, assets are grouped and evaluated at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets. The Company considers historical performance and future estimated results in its evaluation of impairment. If the carrying amount of the asset exceeds expected undiscounted future cash flows, the Company measures the amount of impairment by comparing the carrying amount of the asset to its fair value, generally measured by discounting expected future cash flows.

Management also reviews other intangible assets with finite lives for impairment at least annually to determine if any adverse conditions exist that would indicate impairment. If the carrying value of the finite-lived intangible assets exceeds the undiscounted cash flows resulting from the use and disposition of the asset, the carrying value is written down to fair value in the period identified.

As required by SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), the Company continues to amortize intangibles with finite lives. Included in intangible assets are patents, trademarks, trade names, customer lists and technology.

Goodwill and Indefinite-Lived Intangible Assets: Goodwill represents the excess of cost over the fair value of identifiable net assets of businesses acquired. Other intangible assets consist of customer lists and relationships, purchased technology and patents and trademarks.

SFAS 142 requires that goodwill for each reporting unit be reviewed for impairment at least annually. The Company has five reporting units at October 27, 2006 (see Note 14). The Company tests goodwill for impairment using the two-step process prescribed by SFAS 142. In the first step, the Company compares the fair value of each reporting unit, as computed primarily by present value cash flow calculations, to its book carrying value, including goodwill. If the fair value exceeds the carrying value, no further work is required and no impairment loss is recognized. If the carrying value exceeds the fair value, the goodwill of the reporting unit is potentially impaired and the Company would then complete step 2 in order to measure the impairment loss. In step 2, the Company would calculate the implied fair value of goodwill by deducting the fair value of all tangible and intangible net assets (including unrecognized intangible assets) of the reporting unit from the fair value of the reporting unit (as determined in step 1). If the implied fair value of goodwill is less than the carrying value of goodwill, the Company would recognize an impairment loss equal to the difference.

Indefinite-lived intangible assets are reviewed at least annually for impairment by calculating the fair value of the assets and comparing with their carrying value. In assessing fair value, management generally utilizes present value cash flow calculations using a cash flow approach.

During the fourth quarters of 2006 and 2005, management completed its annual goodwill and indefinite-lived intangible asset impairment reviews with no impairments to the carrying values identified.

Stock-Based Compensation: The Company s stock-based employee compensation plans are comprised primarily of fixed stock options, but also include restricted stock. Options generally have a contractual term of 10 years, vest ratably over three years or five years for employees and immediately upon grant for non-employee directors. Restricted shares vest after three or five years.

Table of Contents

Effective October 29, 2005, the Company adopted SFAS No. 123R, *Share-Based Payment* (SFAS 123R), which requires the use of the fair value method for accounting for all stock-based compensation. Please see Note 9 for additional information.

Contingent Liabilities: The Company is involved in various claims relating to environmental and waste disposal matters at a number of current and former plant sites. The Company engages or participates in remedial and other environmental compliance activities at certain of these sites. At other sites, the Company has been named as a potentially responsible party (PRP) under federal and state environmental laws for the remediation of hazardous waste. The Company s management reviews each individual site, considering the number of parties involved, the level of potential liability or contribution of the Company relative to the other parties, the nature and magnitude of the wastes involved, the method and extent of remediation, the potential insurance coverage, the estimated legal and consulting expense with respect to each site, and the time period over which any costs would likely be incurred. Based on the above analysis, management estimates the remediation or other clean-up costs and related claims for each site. The estimates are based in part on discussions with other PRPs, governmental agencies and engineering firms.

The Company accrues appropriate reserves for potential environmental liabilities, which are continually reviewed and adjusted as additional information becomes available. While uncertainties exist with respect to the amounts and timing of the Company s ultimate environmental liabilities, management believes there is not a reasonable possibility that such liabilities, individually and in the aggregate, will have a material adverse effect on the Company s financial condition or results of operations.

The Company is involved in a variety of legal claims and proceedings relating to personal injury, product liability, warranties, customer contracts, employment, trade practices, environmental and other legal matters that arise in the normal course of business. These claims and proceedings include cases where the Company is one of a number of defendants in proceedings alleging that the plaintiffs suffered injuries or contracted diseases from exposure to chemicals or other ingredients used in the production of some of the Company s products or waste disposal. The Company believes these claims and proceedings are not out of the ordinary course for a business of the type and size in which it is engaged. While the Company is unable to predict the ultimate outcome of these claims and proceedings, management believes there is not a reasonable possibility that the costs and liabilities of such matters will have a material adverse effect on the Company s financial condition or results of operations.

Asset Retirement Obligations: The Financial Accounting Standards Board (FASB) issued SFAS Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), an interpretation of SFAS No. 143, *Accounting for Asset Retirement Obligations* (SFAS 143), in March 2005. FIN 47 states that a conditional asset retirement obligation is a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional upon a future event that may or may not be within control of the entity. FIN 47 is effective for fiscal years ending after December 31, 2005 and was adopted by the Company for its year ending October 27, 2006. The adoption of FIN 47 did not have a material impact on our results of operations for the year ending October 27, 2006 and we do not expect this interpretation to have a material impact on the Company s future results of operations, financial position or liquidity.

Foreign Currency: Foreign currency denominated assets and liabilities are translated into U.S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rates throughout the period. The effect of exchange rate fluctuations on translation of assets and liabilities is recorded as a component of stockholders

---

Table of Contents

equity (accumulated other comprehensive income). Gains and losses from foreign currency transactions are included in other expense (income), net.

Net Income Per Share: The following table reflects the components of common shares outstanding for the three most recent fiscal years in accordance with SFAS 128:

	2006	2005	2004
Weighted-average common shares outstanding basic	101,152,608	101,900,764	102,404,358
Dilutive effect of stock options and unvested restricted stock	1,573,724	2,248,800	3,013,870
Equivalent average common shares outstanding diluted	102,726,332	104,149,564	105,418,228

Under the provisions of SFAS No. 128, *Earnings per Share* (SFAS 128), basic earnings per share are based on the weighted average number of common shares outstanding during each year. In computing diluted earnings per share, the number of common shares outstanding is increased by common stock options with exercise prices lower than the average market prices of common shares during each year and reduced by the number of shares assumed to have been purchased with proceeds from the exercised options. Potential common shares of 291,725, 1,507,691 and 1,590,724 related to the Company s outstanding stock options were excluded from the computation of diluted earnings per share for 2006, 2005 and 2004, respectively, as inclusion of these shares would have been antidilutive.

Financial Instruments: All financial instruments are held for purposes other than trading. See Note 6 to the Consolidated Financial Statements for additional information.

Accumulated Other Comprehensive Income: Period end balances for accumulated other comprehensive income are comprised of the following:

	Year ended October 27, 2006	Year ended October 28, 2005	Year ended October 29, 2004
Foreign currency translation	$ 51,567	$ 47,059	$ 37,161
Minimum pension liability	(29,858)	(38,955)	(37,375)
Net unrealized gain (loss) on financial instruments	2,350	3,592	357
Other	25	(1)	(203)
Accumulated other comprehensive income (loss)	$ 24,084	$ 11,695	$ (60)

Research and Development: Research and development is expensed as incurred.

Reclassification: Certain amounts in the prior years financial statements have been reclassified to conform to the 2006 presentation. Such reclassifications had no effect on net income or stockholders equity as previously reported.

NOTE 2 ACQUISITIONS AND DIVESTITURES

The Company agreed on October 18, 2006 to acquire the powder coatings business of H.B. Fuller Company. H.B. Fuller s powder coatings business, which had net sales of approximately $75,000 in 2005, serves customers in 26 countries from manufacturing facilities in the United States and the United Kingdom. This transaction closed in December 2006 and will be accounted for as a purchase. As the transaction occurred after the Company s 2006 fiscal year, the net assets and operating results will be included in the Company s fiscal year 2007 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 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 $180,000. The cash purchase price was approximately $290,386. 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 $18,723 at October 27, 2006. 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 amount available to common shareholders. The redemption value will be subsequently reversed 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 will be 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, with compensation being recorded from the issuance date through the vesting date using the fair value at the time the awards were granted. The balance in Deferred Liabilities related to Huarun minority interest shares was $13,495 at October 27, 2006.

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 on the books of 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 $34,370 was recorded as a deferred liability under purchase accounting. In November 2006, the Company paid $10,931 plus interest 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. The purchase price allocation is preliminary pending completion of an appraisal, and 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.

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 calendar year 2004 was approximately $58,000. 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 pro forma results of operations for this acquisition have not been presented, as the impact on reported results is not material.

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 $28,000. 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 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 $50,000 at time of acquisition. The 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 pro forma results of operations for this acquisition have not been presented, as the impact on reported results is not material.

NOTE 3 INVENTORIES

The major classes of inventories consist of the following:

	2006	2005
Manufactured products	$ 172,561	$ 142,458
Raw Materials, supplies and work-in-progress	109,256	88,182
	$ 281,817	$ 230,640

Inventories stated at cost determined by the last-in, first-out (LIFO) method aggregate $169,062 at October 27, 2006 and $132,077 at October 28, 2005, approximately $58,140 and $47,495 lower, respectively, than such costs determined under the first-in, first-out (FIFO) method.

NOTE 4 SUPPLEMENTAL DISCLOSURES RELATED TO CURRENT LIABILITIES

Trade accounts payable include $36,733 and $36,813 of issued checks which had not cleared the Company s bank accounts as of October 27, 2006 and October 28, 2005, respectively.

Accrued liabilities include the following:

	2006	2005
Employee compensation	$ 102,130	$ 86,612
Uninsured loss reserves and deferred revenue	69,790	72,172
Customer volume rebates and incentives	54,658	50,449
Contribution to employees retirement trusts	15,804	14,826
Interest	16,274	15,094
Taxes, insurance, professional fees and services	13,529	12,995
Advertising and promotions	9,030	5,583
Other	18,691	19,104

	2006	2005
	$ 299,906	$ 276,835

NOTE 5 DEBT AND CREDIT ARRANGEMENTS

Long-term debt consists of the following:

	2006	2005
Notes to Banks (3.619% - 6.517% at October 27, 2006)	$ 87,725	$ 93,852
Senior Notes (5.10% - 7.75% at October 27, 2006 payable in 2007, 2008, and 2015)	600,000	600,000
Industrial development bonds (3.62% - 3.67% at October 27, 2006 payable in 2014 and 2015)	12,502	12,501
Obligations under capital lease (5.3% at October 27, 2006)	67	86
	700,294	706,439
Less Current maturities	(350,027)	(24)
	$ 350,267	$ 706,415

35

Table of ContentCCEEFF" style="background:#CCEEFF;padding:0in 0in 0in 0in;width:2.5%;">

$

1,170,981

$

1,161,557

Nationstar HECM Loan Trust

2016-3A A 2.013% 8/25/2026**,	
	100,542
	100,622
2016-1A A 2.981% 2/25/2026**,	
	258,468
	258,256
Nomura Resecuritization Trust 2016-1R 3A1 5.00% 9/28/2036**,@	
	186,272
	194,332
RiverView HECM Trust 2007-1 A 1.18% 5/25/2047**,@	
	608,448
	537,722
Sunset Mortgage Loan Co. LLC 2014-NPL1 A 3.228% 8/16/2044**,@@	

		66,240
		66,096
Towd Point Mortgage Trust		
2016-3 A1	2.25% 8/25/2055**,@	
		796,851
		798,818
2015-1 AES	3.00% 10/25/2053**	
		701,631
		717,612
2015-2 2A1	3.75% 11/25/2057**,@	
		480,634
		498,510

VOLT XL LLC 2015-NP14 A1 4.375% 11/27/2045**,@@	
	931,458
	940,400
VOLT XXV LLC 2015-NPL8 A1 3.50% 6/26/2045**,@@	
	577,995
	578,696
VOLT XXVII LLC 2014-NPL7 A1 3.375% 8/27/2057**,@@	
	944,203
	943,993
VOLT XXX LLC 2015-NPL1 A1 3.625% 10/25/2057**,@@	
	591,719
	591,866
VOLT XXXI LLC 2015-NPL2 A1 3.375% 2/25/2055**,@@	
	816,655

	815,704
VOLT XXXIII LLC 2015-NPL5 A1 3.50% 3/25/2055**,@@	
	884,726
	885,136
VOLT XXXV LLC 2015-NPL9 A1 3.50% 6/26/2045**,@@	
	810,277
	810,277
$	9,899,597
TOTAL RESIDENTIAL MORTGAGE-BACKED SECURITIES (Cost $23,770,489)	
$	24,023,770

Asset-Backed Securities 21.1%

Auto 9.1%

AmeriCredit Automobile Receivables Trust 2013-1 D 2.09% 2/8/2019	$ 1,300,000	$ 1,303,774
Capital Auto Receivables Asset Trust		

2016-3 A3 1.54% 8/20/2020	252,000	252,064
2015-2 A3 1.73% 9/20/2019	1,185,000	1,187,646
Credit Acceptance Auto Loan Trust		
2014-1A A 1.55% 10/15/2021**	569,714	569,358

2015-1A A 2.00% 7/15/2022**	1,390,000	1,389,228
2014-1A B 2.29% 4/15/2022**	925,000	921,839
2016-2A A 2.42% 11/15/2023**	250,000	250,772
2014-2A B 2.67% 9/15/2022**	250,000	250,217
2015-2A B 3.04% 8/15/2023**	251,000	

252,201

2016-2A B 3.18% 5/15/2024**

601,000

602,339

Drive Auto Receivables Trust 2015-BA B 2.12% 6/17/2019**

1,030,573

1,031,467

DT Auto Owner Trust

2016-1A A 2.00% 9/16/2019**

645,012

644,904

2016-4A B 2.02% 8/17/2020**,

366,000

365,871

See notes to financial statements.

	Principal Amount		Fair Value
2014-2A C 2.46% 1/15/2020**	$ 556,184	$	557,474
Enterprise Fleet Financing LLC			
2015-1 A2 1.30% 9/20/2020**	836,870		834,630
2016-1 A2 1.83% 9/20/2021**	1,300,000		1,299,886
First Investors Auto Owner Trust			
2015-1A A2 1.21% 4/15/2019**	34,597		34,589
2014-1A A3 1.49% 1/15/2020**	595,822		595,441
2013-1A B 1.81% 10/15/2018**	66,554		66,546
2016-2A A2 1.87% 11/15/2021**	148,000		148,128
2016-1A A1 1.92% 5/15/2020**	835,654		837,029
2016-1A A2 2.26% 4/15/2021**	1,096,000		1,101,770
Ford Credit Auto Owner Trust			
2013-D B 1.54% 3/15/2019	1,250,000		1,254,433
2013-C C 1.91% 3/15/2019	456,000		458,918
GM Financial Automobile Leasing Trust 2016-3 C 2.38% 5/20/2020	208,000		208,219
Hyundai Auto Lease Securitization Trust 2014-A B 1.30% 7/16/2018**	1,000,000		1,000,134
Prestige Auto Receivables Trust			
2015-1 A2 1.09% 2/15/2019**	49,559		49,552
2014-1A A3 1.52% 4/15/2020**	173,041		172,950
2015-1 A3 1.53% 2/15/2021**	1,300,000		1,298,215
2016-1A A3 1.99% 6/15/2020**	1,256,000		1,259,658
Santander Drive Auto Receivables Trust			
2015-1 A3 1.27% 2/15/2019	886,279		885,916
2015-4 A3 1.58% 9/16/2019	395,000		395,325
2014-2 B 1.62% 2/15/2019	576,719		577,000
2013-1 C 1.76% 1/15/2019	575,690		575,888
2013-3 C 1.81% 4/15/2019	932,519		933,893
2014-4 B 1.82% 5/15/2019	1,254,568		1,256,490
2015-2 B 1.83% 1/15/2020	1,300,000		1,302,629
2014-2 C 2.33% 11/15/2019	1,300,000		1,307,587
2013-5 D 2.73% 10/15/2019	439,000		445,340
2013-A C 3.12% 10/15/2019**	1,219,156		1,228,691
2012-3 D 3.64% 5/15/2018	1,004,071		1,008,796
Westlake Automobile Receivables Trust			
2015-1A A2 1.17% 3/15/2018**	133,659		133,637
2016-1A B 2.68% 9/15/2021**	1,300,000		1,310,879
		$	31,561,323
Credit Card 1.6%			
Cabela s Credit Card Master Note Trust			
2014-1 A 0.874% 3/16/2020@	$ 1,198,000	$	1,197,508
2012-2A A1 1.45% 6/15/2020**	1,300,000		1,301,414
2012-1A A1 1.63% 2/18/2020**	1,253,000		1,254,136
2016-1 A1 1.78% 6/15/2022	1,343,000		1,353,943
Synchrony Credit Card Master Note Trust 2012-6 A 1.36% 8/17/2020	325,000		325,605
		$	5,432,606
Other 10.4%			
Apidos CLO XI 2012-11A A 2.069% 1/17/2023**,@	$ 629,000	$	629,282
ARI Fleet Lease Trust			
2015-A A2 1.11% 11/15/2018**	768,563		767,483
2016-A A2 1.82% 7/15/2024**	564,000		565,861
Ascentium Equipment Receivables LLC			

See notes to financial statements.

		Principal Amount		Fair Value
2015-1A A3 1.61% 10/13/2020**	$	651,831	$	652,436
2015-2A B 2.62% 12/10/2019**		1,256,000		1,258,768
Ascentium Equipment Receivables Trust 2016-1A A2 1.75% 11/13/2018**		1,367,000		1,370,761
Black Diamond CLO, Ltd. 2013-1A A1 2.129% 2/6/2026**,@		454,000		454,001
CCG Receivables Trust 2015-1 A2 1.46% 11/14/2018**		606,741		605,949
Cent CLO 19, Ltd. 2013-19A A1A 2.082% 10/29/2025**,@		453,000		452,764
Cerberus Onshore II CLO-2 LLC				
2014-1A A 2.528% 10/15/2023**,@		141,424		141,370
2014-1A B 2.975% 10/15/2023**,@		250,000		249,962
Chesapeake Funding II LLC				
2016-2A A1 1.88% 6/15/2028**		772,000		770,749
2016-1A A1 2.11% 3/15/2028**		1,362,000		1,364,339
CIFC Funding 2013-III, Ltd. 2013-3A A1A 2.045% 10/24/2025**,@		411,000		410,582
Conn s Receivables Funding LLC				
2016-A A 4.68% 4/16/2018**		250,719		251,448
2016-A B 8.96% 8/15/2018**		665,000		665,894
Dell Equipment Finance Trust 2016-1 A1 0.85% 7/24/2017**		1,164,782		1,164,226
Enterprise Fleet Financing LLC				
2014-1 A2 0.87% 9/20/2019**		341,293		340,948
2014-2 A2 1.05% 3/20/2020**		717,627		715,678
2013-2 A3 1.51% 3/20/2019**		626,353		626,308
2016-2 A2 1.74% 2/22/2022**		485,000		483,607
Golden Credit Card Trust 2012-4A A 1.39% 7/15/2019**		1,300,000		1,300,910
Grayson CLO, Ltd. 2006-1A A1B 1.117% 11/1/2021**,@		250,000		245,223
GreatAmerica Leasing Receivables Funding LLC Series				
2015-1 A2 1.12% 6/20/2017**		213,932		213,990
2016-1 A2 1.57% 5/21/2018**		1,367,000		1,369,047
2016-1 A3 1.73% 6/20/2019**		1,000,000		999,068
Hertz Fleet Lease Funding LP 2016-1 A2 1.96% 4/10/2030**		1,364,000		1,364,960
Leaf Receivables Funding 10 LLC 2015-1 B 2.42% 1/15/2021**		834,000		838,395
Leaf Receivables Funding 11 LLC 2016-1 A2 1.72% 7/15/2018**,		457,000		457,402
MMAF Equipment Finance LLC 2014-AA A3 0.87% 1/8/2019**		1,040,303		1,037,921
NRZ Advance Receivables Trust Advance Receivables Backed				
2016-T1 AT1 2.751% 6/15/2049**		1,359,000		1,358,998
2015-T4 AT4 3.196% 11/15/2047**		1,360,000		1,373,600
Ocwen Master Advance Receivables Trust 2016-T1 AT1 2.521% 8/17/2048**		1,343,000		1,340,902
Oportun Funding III LLC 2016-B A 3.69% 7/8/2021**		264,000		263,047
Panhandle-Plains Student Finance Corporation 2001-1 A2 2.027% 12/1/2031 ,@		800,000		795,000
PFS Financing Corporation				
2014-AA A 1.124% 2/15/2019**,@		1,500,000		1,498,806
2014-BA A 1.124% 10/15/2019**,@		1,450,000		1,444,329
2016-A A 1.724% 2/18/2020**,@		1,516,000		1,518,083
Synchrony Credit Card Master Note Trust				
2012-3 A 0.974% 3/15/2020@		1,372,000		1,373,721
2015-3 A 1.74% 9/15/2021		1,012,000		1,019,259
Telos CLO, Ltd. 2013-4A A 1.979% 7/17/2024**,@		250,000		249,433
THL Credit Wind River CLO, Ltd. 2013-2A A2A 2.119% 1/18/2026**,@		250,000		250,000
Volvo Financial Equipment LLC Series 2016-1A A2 1.44% 10/15/2018**		1,151,000		1,152,508

See notes to financial statements.

		Principal Amount		Fair Value
Westwood CDO II, Ltd. 2007-2A A2 1.065% 4/25/2022**,@	$	750,000	$	739,538
			$	36,146,556
TOTAL ASSET-BACKED SECURITIES				
(Cost $73,010,875)			$	73,140,485
Corporate Bonds & Notes 0.7%				
Consumer, Cyclical 0.1%				
Continental Airlines 2000-1 Class B Pass Through Trust 8.388% 5/1/2022	$	57,793	$	57,972
Northwest Airlines 1999-2 Class C Pass Through Trust 8.304% 9/1/2010		276,802		143,937
US Airways 1998-1B Pass Through Trust 7.35% 7/30/2019		53,755		54,427
			$	256,336
Energy 0.4%				
Atwood Oceanics, Inc. 6.50% 2/1/2020	$	1,750,000	$	1,369,375
Financial 0.2%				
N671US Trust 7.50% 9/15/2020**,	$	164,434	$	167,723
Berkshire Hathaway Finance Corporation 1.077% 8/15/2019@		336,000		336,470
			$	504,193
Industrial 0.0%				
Air 2 US 10.127% 10/1/2020**,	$	426,921	$	145,153
TOTAL CORPORATE BONDS & NOTES				
(Cost $2,278,662)			$	2,275,057
Corporate Bank Debt 0.8%				
ACCTL 1.00% 5/16/2022**	$	522,000	$	521,953
MBFODDTL 2.00% 3/31/2017 ,**		100,000		1,574
MBFOTL 5.25% 11/20/2021**		739,802		744,049
MBLODDTL 2.00% 3/31/2017 ,**		50,000		1,130
MBLOTL 8.00% 11/20/2021**		395,737		400,723
OTGDDTL 1.00% 8/23/2021 ,**		50,000		953
OTGTL 9.50% 8/23/2021**		530,000		529,496
Xplornet Communications, Inc. Term Loan B 1.00% 9/6/2021**		660,000		664,587
TOTAL CORPORATE BANK DEBT				
(Cost $2,803,170)			$	2,864,465
Municipals 0.2%				
Wayne County				
GO, (TXBL-NTS), 4.25% 12/1/2018	$	414,000	$	414,000
GO, (TXBL), 5.75% 12/1/2017		205,000		205,512
TOTAL MUNICIPALS				
(Cost $620,119)			$	619,512
U.S. Treasuries 1.4%				
U.S. Treasury Notes				
1.00% 12/15/2017	$	1,300,000	$	1,304,456
1.375% 8/31/2020		2,693,000		2,726,220

See notes to financial statements.

		Principal Amount		Fair Value
1.375% 10/31/2020	$	891,000	$	901,513
TOTAL U.S. TREASURIES (Cost $4,907,128)			$	4,932,189
TOTAL BONDS & DEBENTURES 37.5% (Cost $129,744,798)			$	130,141,382
TOTAL INVESTMENT SECURITIES 93.0% (Cost $312,622,574)			$	322,934,574
Short-Term Investments 6.9%				
State Street Bank Repurchase Agreement 0.03% 10/3/2016 (Dated 09/30/2016, repurchase price of $24,129,060, collateralized by: $21,735,000 principal amount U.S. Treasury Bond - 2.875% 2045, fair value $24,614,888)	$	24,129,000	$	24,129,000
TOTAL SHORT-TERM INVESTMENTS (Cost $24,129,000)			$	24,129,000
TOTAL INVESTMENTS 99.9% (Cost $336,751,574)			$	347,063,574
Other Assets and Liabilities, net 0.1%				452,048
NET ASSETS 100.0% NOTE 2			$	347,515,622

*Non-income producing security.

@Variable/Floating Rate Security Interest rate changes on these instruments are based on changes in a designated base rate. The rates shown are those in effect on September 30, 2016.

**Restricted securities. These restricted securities constituted 19.82% of total net assets at September 30, 2016, most of which are considered liquid by the Adviser. These securities are not registered and may not be sold to the public. There are legal and/or contractual restrictions on resale. The Company does not have the right to demand that such securities be registered. The values of these securities are determined by valuations provided by pricing services, brokers, dealers, market makers, or in good faith under policies adopted by authority of the Company s Board of Directors.

These securities have been valued in good faith under policies adopted by authority of the Board of Director in accordance with the Company s fair value procedures. These securities constituted 1.21% of total net assets at September 30, 2016.

@@Step Coupon - Coupon rate increases in increments to maturity. Rate disclosed is as of September 30, 2016.

See notes to financial statements.

NOTE 1 Disclosure of Fair Value Measurements

The Company uses the following methods and inputs to establish the fair value of its assets and liabilities. Use of particular methods and inputs may vary over time based on availability and relevance as market and economic conditions evolve.

Equity securities are generally valued each day at the official closing price of, or the last reported sale price on, the exchange or market on which such securities principally are traded, as of the close of business on that day. If there have been no sales that day, equity securities are generally valued at the last available bid price. Securities that are unlisted and fixed-income and convertible securities listed on a national securities exchange for which the over-the-counter (OTC) market more accurately reflects the securities value in the judgment of the Company s officers, are valued at the most recent bid price. However, most fixed income securities are generally valued at prices obtained from pricing vendors and brokers. Short-term corporate notes with maturities of 60 days or less at the time of purchase are valued at amortized cost.

Securities for which representative market quotations are not readily available or are considered unreliable by the Adviser are valued as determined in good faith under procedures adopted by the authority of the Company s Board of Directors. Various inputs may be reviewed in order to make a good faith determination of a security s value. These inputs include, but are not limited to, the type and cost of the security; contractual or legal restrictions on resale of the security; relevant financial or business developments of the issuer; actively traded similar or related securities; conversion or exchange rights on the security; related corporate actions; significant events occurring after the close of trading in the security; and changes in overall market conditions. Fair valuations and valuations of investments that are not actively trading involve judgment and may differ materially from valuations of investments that would have been used had greater market activity occurred.

The Company classifies its assets based on three valuation methodologies. Level 1 values are based on quoted market prices in active markets for identical assets. Level 2 values are based on significant observable market inputs, such as quoted prices for similar assets and quoted prices in inactive markets or other market observable inputs as noted above including spreads, cash flows, financial performance, prepayments, defaults, collateral, credit enhancements, and interest rate volatility. Level 3 values are based on significant unobservable inputs that reflect the Company s determination of assumptions that market participants might reasonably use in valuing the assets. The valuation levels are not necessarily an indication of the risk associated with investing in those securities. The following table presents the valuation levels of the Company s investments as of September 30, 2016:

Investments	**Level 1**	**Level 2**	**Level 3**	**Total**
Common Stocks				
Infrastructure Software	$ 26,901,785	$	$	$ 26,901,785
Diversified Banks	23,333,816			23,333,816
Base Metals	14,292,754			14,292,754
P&C Insurance	14,043,998			14,043,998
Aircraft & Parts	13,947,648			13,947,648
Insurance Brokers	12,917,227			12,917,227
Internet Media	12,337,046			12,337,046
Communications Equipment	11,465,194			11,465,194
Semiconductor Devices	9,427,912			9,427,912
Electrical Components	8,977,791			8,977,791
Consumer Finance	7,828,890			7,828,890
Advertising & Marketing	6,561,065			6,561,065
Investment Companies	6,445,199			6,445,199
Electrical Power Equipment	5,737,098			5,737,098
Life Science Equipment	5,718,207			5,718,207
Integrated Oils	3,963,853			3,963,853
Oil & Gas Services & Equipment	3,348,497			3,348,497
Food & Drug Stores	2,230,140			2,230,140
Household Products	2,230,022			2,230,022
Exploration & Production	1,085,050			1,085,050
Commercial Mortgage-Backed Securities				
Agency		637,686		637,686
Agency Stripped		18,301,206	653,517	18,954,723
Non-Agency		2,193,495	500,000	2,693,495
Residential Mortgage-Backed Securities				
Agency Collateralized Mortgage Obligation		8,438,298		8,438,298
Agency Pool Fixed Rate		5,441,110		5,441,110
Agency Stripped		244,765		244,765
Non-Agency Collateralized Mortgage Obligation		9,540,719	358,878	9,899,597
Asset-Backed Securities				
Auto		31,195,452	365,871	31,561,323
Credit Card		5,432,606		5,432,606
Other		34,894,154	1,252,402	36,146,556
Corporate Bonds & Notes		1,818,244	456,813	2,275,057
Corporate Bank Debt			2,864,465	2,864,465
Municipals			619,512	619,512
U.S. Treasuries		4,932,189		4,932,189
Short-Term Investment		24,129,000		24,129,000
	$ 192,793,192	$ 147,198,924	$ 7,071,458	$ 347,063,574

See notes to financial statements.

The following table summarizes the Company s Level 3 investment securities and related transactions during the period ended September 30, 2016:

Investments	Beginning Value at December 31, 2015	Net Realized and Unrealized Gains (Losses)*	Purchases	(Sales)	Transfers In	Transfers Out	Ending Value at September 30, 2016	Net Change in Unrealized Appreciation (Depreciation) related to Investments held at September 30, 2016
Commercial Mortgage-Backed Securities Agency Stripped		$ (6,135)	$ 659,652				$ 653,517	$ (866)
Commercial Mortgage-Backed Securities Non-Agency		4,844	495,156				500,000	4,505
Residential Mortgage-Backed Securities Agency Collateralized Mortgage Obligation	$ 1,284,490	23,211		$ (128,997)		$ (1,178,704)		
Residential Mortgage-Backed Securities Non-Agency Collateralized Mortgage Obligation		(131)	495,000	(135,991)			358,878	(132)
Asset-Backed Securities Auto		(108)	365,979				365,871	(107)
Asset-Backed Securities Other		18,191	1,234,211				1,252,402	17,077
Corporate Bonds & Notes		10,377	521,092	(74,656)			456,813	(8,640)
Corporate Bank Debt		63,757	2,815,169	(14,461)			2,864,465	61,085
Municipals	1,357,000	(11,507)	757,019	(1,483,000)			619,512	(607)
	$ 2,641,490	$ 102,499	$ 7,343,278	$ (1,837,105)	$	$ (1,178,704)	$ 7,071,458	$ 72,315

Investments classified within Level 3 of the fair value hierarchy are valued by the Adviser in good faith under procedures adopted by authority of the Company s Board of Directors. The Adviser employs various methods to determine fair valuations including regular review of key inputs and assumptions, and review of related market activity, if any. However, there are generally no observable trade activities in these securities. The Adviser reports to the Board of Directors at their regularly scheduled quarterly meetings, or more often if warranted. The report includes a summary of the results of the process, the key inputs and assumptions noted, and any changes to the inputs and assumptions used. When appropriate, the Adviser will recommend changes to the procedures and process employed. The value determined for an investment using the fair value procedures may differ significantly from the value realized upon the sale of such investment. Transfers of investments between different levels of the fair value hierarchy are recorded at market value as of the end of the reporting period. There were transfers of $1,178,704 out of Level 3 into Level 2 during the period ended September 30, 2016.

The following table summarizes the quantitative inputs and assumptions used for items categorized as items categorized as Level 3 of the fair value hierarchy as of September 30, 2016:

Financial Assets		Fair Value at September 30, 2016	Valuation Technique(s)	Unobservable Inputs	Price/Range
Commercial Mortgage-Backed Securities					
Agency Stripped	$	653,517	Third-Party Broker Quote*	Quotes/Prices	$8.89
Non-Agency	$	500,000	Third-Party Broker Quote*	Quotes/Prices	$100.00
Residential Mortgage-Backed					
Non-agency CMO	$	358,878	Third-Party Broker Quote*	Quotes/Prices	$99.92 - $100.08
Asset-Backed Securities					
Auto	$	365,871	Third-Party Broker Quote*	Quotes/Prices	$99.96
Other	$	1,252,402	Third-Party Broker Quote*	Quotes/Prices	$99.38 - $100.09
Corporate Bonds and Notes	$	456,813	Third-Party Broker Quote*	Quotes/Prices	$34.00 - $102.00
Corporate Bank Debt	$	2,799	Pricing Model **	Reference prices	$99.91 - $101.26
	$	2,861,666	Pricing Vendor	Prices	$99.91 - $101.26
Municipals	$	619,512	Third-Party Broker Quote*	Quotes/Prices	$100.00 - $100.25

* The Third-Party Broker Quote technique involves obtaining an independent third-party broker quote for the security.

** The Pricing Model technique for Level 3 securities involves calculating the difference between the fair value of the funded portion of the securitiy and the price at which the Fund is committed to fund the unfunded committment.

NOTE 2 Federal Income Tax

The cost of investment securities held at September 30, 2016 (excluding short-term investments), was $312,733,961 for federal income tax purposes. Net Unrealized appreciation consists of:

Gross unrealized appreciation:	$	12,500,742
Gross unrealized depreciation:		(2,300,129)
Net unrealized appreciation:	$	10,200,613

ITEM 2. CONTROLS AND PROCEDURES.

(a) The registrant s principal executive and principal financial officers have concluded that the registrant s disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940, as amended (the 1940 Act)) are effective, as of a date within 90 days of the filing date of this Form N-Q based on their evaluation of these controls and procedures required by Rule 30a-3(b) under the 1940 Act and Rules 13a-15(b) or 15d-15(b) under the Securities Exchange Act of 1934.

(b) There were no changes in the registrant s internal control over financial reporting (as defined in Rule 30a-3(d))under the 1940 Act that occurred during the registrant s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the registrant s internal control over financial reporting.

ITEM 3. EXHIBITS.

(a) The certifications required by Rule 30a-2(a) under the 1940 Act are attached hereto.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOURCE CAPITAL, INC.

By: /s/ J. Richard Atwood
J. Richard Atwood,
President (Principal Executive Officer)

Date: November 29, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934 and the Investment Company Act of 1940, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ J. Richard Atwood
J. Richard Atwood,
President (Principal Executive Officer)

Date: November 29, 2016

By: /s/ E. Lake Setzler III
E. Lake Setzler III,
Treasurer (Principal Financial Officer)

Date: November 29, 2016