

GRACO INC  
Form 10-Q  
April 24, 2007

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

Quarterly Report Pursuant to Section 13 or 15 (d) of the  
Securities Exchange Act of 1934

For the quarterly period ended **March 30, 2007**

Commission File Number: 001-9249

**GRACO INC.**

\_\_\_\_\_  
(Exact name of registrant as specified in its charter)

Minnesota

41-0285640

\_\_\_\_\_  
(State of incorporation)

\_\_\_\_\_  
(I.R.S. Employer Identification Number)

88 - 11th Avenue N.E.  
Minneapolis, Minnesota

55413

\_\_\_\_\_  
(Address of principal executive offices)

\_\_\_\_\_  
(Zip Code)

(612) 623-6000

\_\_\_\_\_  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

66,520,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of April 18, 2007.

**GRACO INC. AND SUBSIDIARIES****INDEX**

|   | <u>Page Number</u> |
|---|--------------------|
| <b>PART I FINANCIAL INFORMATION</b>   |                    |
| Item 1. Financial Statements  |                    |
| Consolidated Statements of Earnings   | 3                  |
| Consolidated Balance Sheets   | 4                  |
| Consolidated Statements of Cash Flows   | 5                  |
| Notes to Consolidated Financial Statements  | 6-12               |
| Item 2. Management's Discussion and Analysis<br>of Financial Condition and<br>Results of Operations | 13-15              |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk                                  | 16                 |
| Item 4. Controls and Procedures   | 16                 |
| <b>PART II OTHER INFORMATION</b>  |                    |
| Item 1A. Risk Factors   | 17                 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds                                 | 17                 |
| Item 4. Submission of Matters to a Vote of Security Holders   | 17                 |
| Item 6. Exhibits  | 18                 |

**SIGNATURES****EXHIBITS****PART I****GRACO INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

(In thousands, except per share amounts)

|                       | <u>Thirteen Weeks Ended</u> |                       |
|-----------------------|-----------------------------|-----------------------|
|                       | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Net Sales             | \$ 197,495                  | \$ 192,216            |
| Cost of products sold | 92,633                      | 88,989                |
| Gross Profit          | - 104,862                   | - 103,227             |
| Product development   | 8,272                       | 7,212                 |

Edgar Filing: GRACO INC - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Selling, marketing and distribution      | 29,263    | 27,942    |
| General and administrative               | 15,240    | 13,421    |
|  | -         | -         |
| Operating Earnings                       | 52,087    | 54,652    |
| Interest expense                         | 258       | 125       |
| Other expense (income), net              | (106)     | 5         |
|  | -         | -         |
| Earnings before Income Taxes             | 51,935    | 54,522    |
| Income taxes                             | 18,200    | 19,100    |
|  | -         | -         |
| Net Earnings                             | \$ 33,735 | \$ 35,422 |
|  | -         | -         |
| Basic Net Earnings per Common Share      | \$ .51    | \$ .52    |
| Diluted Net Earnings per Common Share    | \$ .50    | \$ .51    |
| Cash Dividends Declared per Common Share | \$ .17    | \$ .15    |

See notes to consolidated financial statements.

**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited)  
(In thousands)

|  | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Current Assets   |                       |                      |
| Cash and cash equivalents                                      | \$ 4,767              | \$ 5,871             |
| Accounts receivable, less allowances of<br>\$6,100 and \$5,800 | 142,137               | 134,105              |
| Inventories  | 87,366                | 76,311               |
| Deferred income taxes  | 22,772                | 20,682               |
| Other current assets   | 2,144                 | 2,014                |
|  | -                     | -                    |
| Total current assets   | 259,186               | 238,983              |
| Property, Plant and Equipment                                  |                       |                      |
| Cost   | 289,719               | 278,318              |
| Accumulated depreciation                                       | (156,579)             | (153,794)            |
|  | -                     | -                    |
| Property, plant and equipment, net                             | 133,140               | 124,524              |
| Prepaid Pension  | 27,703                | 26,903               |
| Goodwill   | 67,173                | 67,174               |
| Other Intangible Assets, net                                   | 48,195                | 50,325               |
| Other Assets   | 3,420                 | 3,694                |
|  | -                     | -                    |
| Total Assets   | \$ 538,817            | \$ 511,603           |
|  | -                     | -                    |

|   | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|---|-----------------------|----------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                       |                      |
| Current Liabilities                           |                       |                      |
| Notes payable to banks                        | \$ 33,361             | \$ 18,363            |
| Trade accounts payable                        | 28,761                | 27,442               |
| Salaries, wages and commissions               | 13,850                | 26,303               |
| Dividends payable                             | 11,006                | 11,055               |
| Other current liabilities                     | 53,994                | 45,766               |
|   | -                     | -                    |
| Total current liabilities                     | 140,972               | 128,929              |
| Retirement Benefits and Deferred Compensation | 37,011                | 36,946               |
| Uncertain Tax Positions                       | 5,800                 |                      |
| Deferred Income Taxes                         | 13,317                | 14,724               |
| Shareholders' Equity                          |                       |                      |
| Common stock                                  | 66,536                | 66,805               |
| Additional paid-in capital                    | 140,676               | 130,621              |
| Retained earnings                             | 139,645               | 138,702              |
| Accumulated other comprehensive income (loss) |                       |                      |
| Cumulative translation adjustment             | (67)                  | (60)                 |
| Pension liability adjustment                  | (5,073)               | (5,064)              |
|   | -                     | -                    |
| Total shareholders' equity                    | 341,717               | 331,004              |
|   | -                     | -                    |
| Total Liabilities and Shareholders' Equity    | \$ 538,817            | \$ 511,603           |
|   | -                     | -                    |

See notes to consolidated financial statements.

**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)  
(In thousands)

|  | <u>Thirteen Weeks Ended</u> |                       |
|--|-----------------------------|-----------------------|
|  | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| <b>Cash Flows from Operating Activities</b>  |                             |                       |
| Net Earnings   | \$ 33,735                   | \$ 35,422             |
| Adjustments to reconcile net earnings to net cash provided by operating activities |                             |                       |
| Depreciation and amortization  | 6,959                       | 5,781                 |
| Deferred income taxes  | (3,478)                     | (1,706)               |
| Share-based compensation   | 2,218                       | 2,164                 |
| Excess tax benefit related to share-based payment arrangements                     | (848)                       | (2,000)               |
| Change in:   |                             |                       |
| Accounts receivable  | (7,631)                     | (6,471)               |
| Inventories  | (10,985)                    | (7,934)               |
| Trade accounts payable   | 1,711                       | 4,906                 |
| Salaries, wages and commissions  | (12,469)                    | (9,825)               |
| Retirement benefits and deferred compensation                                      | (989)                       | 19                    |
| Other accrued liabilities  | 9,281                       | 11,883                |

Edgar Filing: GRACO INC - Form 10-Q

|  |                 |          |                 |
|--|-----------------|----------|-----------------|
| Uncertain tax positions  | 5,800           |          |                 |
| Other  | (165)           |          | 50              |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| <b>Net cash provided by operating activities</b>               | <b>23,139</b>   | <b>-</b> | <b>32,289</b>   |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| <b>Cash Flows from Investing Activities</b>                    |                 |          |                 |
| Property, plant and equipment additions                        | (13,267)        |          | (4,371)         |
| Proceeds from sale of property, plant and equipment            | 149             |          | 19              |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| <b>Net cash used in investing activities</b>                   | <b>(13,118)</b> | <b>-</b> | <b>(4,352)</b>  |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| <b>Cash Flows from Financing Activities</b>                    |                 |          |                 |
| Borrowings on notes payable and lines of credit                | 29,415          |          | 4,333           |
| Payments on notes payable and lines of credit                  | (14,476)        |          | (8,310)         |
| Excess tax benefit related to share-based payment arrangements | 848             |          | 2,000           |
| Common stock issued  | 8,355           |          | 10,200          |
| Common stock retired   | (23,985)        |          | (17,404)        |
| Cash dividends paid  | (11,010)        |          | (9,922)         |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| <b>Net cash provided by (used in) financing activities</b>     | <b>(10,853)</b> | <b>-</b> | <b>(19,103)</b> |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| Effect of exchange rate changes on cash                        | (272)           |          | (315)           |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| Net increase (decrease) in cash and cash equivalents           | (1,104)         |          | 8,519           |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| Cash and cash equivalents                                      |                 |          |                 |
| Beginning of year  | 5,871           |          | 18,664          |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |
| End of period  | \$ 4,767        |          | \$ 27,183       |
|  | <u>-</u>        | <u>-</u> | <u>-</u>        |

See notes to consolidated financial statements.

**GRACO INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

- The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of March 30, 2007 and the related statements of earnings and cash flows for the thirteen weeks then ended have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of March 30, 2007, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial

## Edgar Filing: GRACO INC - Form 10-Q

statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

|  | <u>Thirteen Weeks Ended</u> |                       |
|--|-----------------------------|-----------------------|
|  | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Net earnings available to common shareholders  | \$ 33,735                   | \$ 35,422             |
| Weighted average shares outstanding for basic earnings per share                                       | 66,667                      | 68,428                |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 1,048                       | 1,121                 |
| Weighted average shares outstanding for diluted earnings per share                                     | 67,715                      | 69,549                |
| Basic earnings per share   | \$ .51                      | \$ .52                |
| Diluted earnings per share   | \$ .50                      | \$ .51                |

Stock options to purchase 948,000 and 1,000 shares are not included in the 2007 and 2006 calculations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirteen weeks ended March 30, 2007 is shown below (in thousands, except per share amounts):

|                                | <u>Option<br/>Shares</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> | <u>Options<br/>Exercisable</u> | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> |
|--------------------------------|--------------------------|--|--------------------------------|--|
| Outstanding, December 29, 2006 | 3,956                    | \$24.79  | 2,272                          | \$16.94  |
| Granted                        | 539                      | 41.36  |                                |  |
| Exercised                      | (114)                    | 11.44  |                                |  |
| Canceled                       | (19)                     | 35.57  |                                |  |
|                                | <hr/>                    |  |                                |  |
| Outstanding, March 30, 2007    | 4,362                    | \$27.14  | 2,620                          | \$19.91  |

The aggregate intrinsic value of exercisable option shares was \$50.7 million as of March 30, 2007, with a weighted average contractual term of 5.2 years. There were approximately 4.3 million vested share options and share options expected to vest as of March 30, 2007, with an aggregate intrinsic value of \$54.9 million, a weighted average exercise price of \$26.81 and a weighted average contractual term of 6.5 years.

Information related to options exercised in the first three months of 2007 and 2006 follows (in thousands):

|                           | <u>Thirteen Weeks Ended</u> |                       |
|---------------------------|-----------------------------|-----------------------|
|                           | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Cash received             | \$1,305                     | \$3,409               |
| Aggregate intrinsic value | 3,407                       | 6,359                 |
| Tax benefit realized      | 1,200                       | 2,300                 |

## Edgar Filing: GRACO INC - Form 10-Q

The Company recognized share-based compensation of \$2.2 million in both the first quarter of 2007 and the first quarter of 2006. As of March 30, 2007, there was \$13.2 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.4 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

|                                       | <u>Thirteen Weeks Ended</u> |                       |
|---------------------------------------|-----------------------------|-----------------------|
|                                       | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Expected life in years                | 6.0                         | 6.3                   |
| Interest rate                         | 4.6%                        | 4.6%                  |
| Volatility                            | 26.2%                       | 27.8%                 |
| Dividend yield                        | 1.6%                        | 1.4%                  |
| Weighted average fair value per share | \$12.05                     | \$12.81               |

Under the Company's Employee Stock Purchase Plan, the Company issued 202,000 shares in 2007 and 204,000 shares in 2006. The fair value of the employees' purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

|                                       | <u>Thirteen Weeks Ended</u> |                       |
|---------------------------------------|-----------------------------|-----------------------|
|                                       | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Expected life in years                | 1.0                         | 1.0                   |
| Interest rate                         | 4.9%                        | 4.6%                  |
| Volatility                            | 24.4%                       | 24.0%                 |
| Dividend yield                        | 1.6%                        | 1.4%                  |
| Weighted average fair value per share | \$9.79                      | \$10.18               |

4. The components of net periodic benefit cost for retirement benefit plans were as follows (in thousands):

|                                    | <u>Thirteen Weeks Ended</u> |                       |
|------------------------------------|-----------------------------|-----------------------|
|                                    | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| <b>Pension Benefits</b>            |                             |                       |
| Service cost                       | \$ 1,479                    | \$ 1,440              |
| Interest cost                      | 2,882                       | 2,608                 |
| Expected return on assets          | (4,800)                     | (4,175)               |
| Amortization and other             | 255                         | 192                   |
|                                    | - <u>          </u>         | - <u>          </u>   |
| Net periodic benefit cost (credit) | \$ (184)                    | \$ 65                 |
|                                    | - <u>          </u>         | - <u>          </u>   |
| <b>Postretirement Medical</b>      |                             |                       |
| Service cost                       | \$ 150                      | \$ 250                |
| Interest cost                      | 300                         | 420                   |
| Amortization and other             | (50)                        | 186                   |
|                                    | - <u>          </u>         | - <u>          </u>   |
| Net periodic benefit cost          | \$ 400                      | \$ 856                |
|                                    | - <u>          </u>         | - <u>          </u>   |

5. Total comprehensive income was as follows (in thousands):

|  | <u>Thirteen Weeks Ended</u> |                       |
|--|-----------------------------|-----------------------|
|  | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| Net income                               | \$ 33,735                   | \$ 35,422             |
| Foreign currency translation adjustments | (7)                         | 515                   |
| Pension liability adjustment, net of tax | (9)                         | (19)                  |
|  | - <u>          </u>         | - <u>          </u>   |
| Comprehensive income                     | \$ 33,719                   | \$ 35,918             |

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. The Company does not track assets by segment. Sales and operating earnings by segment for the thirteen weeks ended March 30, 2007 and March 31, 2006 were as follows (in thousands):

|                           | <u>Thirteen Weeks Ended</u> |                       |
|---------------------------|-----------------------------|-----------------------|
|                           | <u>March 30, 2007</u>       | <u>March 31, 2006</u> |
| <b>Net Sales</b>          |                             |                       |
| Industrial                | \$ 105,065                  | \$ 100,160            |
| Contractor                | 69,751                      | 74,352                |
| Lubrication               | 22,679                      | 17,704                |
|                           | <u>—</u>                    | <u>—</u>              |
| Consolidated              | \$ 197,495                  | \$ 192,216            |
|                           | <u>—</u>                    | <u>—</u>              |
| <b>Operating Earnings</b> |                             |                       |
| Industrial                | \$ 34,418                   | \$ 32,083             |
| Contractor                | 17,027                      | 21,042                |
| Lubrication               | 3,064                       | 4,755                 |
| Unallocated corporate     | (2,422)                     | (3,228)               |
|                           | <u>—</u>                    | <u>—</u>              |
| Consolidated              | \$ 52,087                   | \$ 54,652             |
|                           | <u>—</u>                    | <u>—</u>              |

7. Major components of inventories were as follows (in thousands):

|   | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|---|-----------------------|----------------------|
| Finished products and components                        | \$ 51,909             | \$ 44,969            |
| Products and components in various stages of completion | 29,795                | 26,841               |
| Raw materials and purchased components                  | 36,188                | 35,258               |
|   | <u>—</u>              | <u>—</u>             |
|   | 117,892               | 107,068              |
| Reduction to LIFO cost                                  | (30,526)              | (30,757)             |
|   | <u>—</u>              | <u>—</u>             |
| Total   | \$ 87,366             | \$ 76,311            |
|   | <u>—</u>              | <u>—</u>             |

8. Information related to other intangible assets follows (dollars in thousands):

|   | <u>Estimated<br/>Life (Years)</u> | <u>Original<br/>Cost</u> | <u>Amorti-<br/>zation</u> | <u>Foreign<br/>Currency<br/>Translation</u> | <u>Book<br/>Value</u> |
|---|-----------------------------------|--------------------------|---------------------------|---|-----------------------|
| <u>March 30, 2007</u>                                     |                                   |                          |                           |   |                       |
| Customer relationships and distribution network           | 4 - 8                             | \$ 26,102                | \$ (8,272)                | \$ 4  | \$ 17,834             |
| Patents, proprietary technology and product documentation | 5 - 15                            | 22,243                   | (5,261)                   | 4   | 16,986                |
| Trademarks and trade names                                | 3 - 10                            | 4,684                    | (1,582)                   | 13  | 3,115                 |
|   |                                   | <u>53,029</u>            | <u>(15,115)</u>           | <u>21</u>                                   | <u>37,935</u>         |
| Not Subject to Amortization:<br>Brand names               |                                   | 10,260                   |                           |   | 10,260                |
|   |                                   | <u>10,260</u>            |                           |   | <u>10,260</u>         |
| Total   |                                   | \$ 63,289                | \$ (15,115)               | \$ 21                                       | \$ 48,195             |



Edgar Filing: GRACO INC - Form 10-Q

|   |        | _____     | _____       | _____ | _____     |
|---|--------|-----------|-------------|-------|-----------|
| <u>December 29, 2006</u>                                  |        |           |             |       |           |
| Customer relationships and distribution network           | 4 - 8  | \$ 26,102 | \$ (7,335)  | \$ 6  | \$ 18,773 |
| Patents, proprietary technology and product documentation | 5 - 15 | 22,243    | (4,443)     | 5     | 17,805    |
| Trademarks, trade names and other                         | 3 - 10 | 5,114     | (1,641)     | 14    | 3,487     |
|   |        | _____     | _____       | _____ | _____     |
|   |        | 53,459    | (13,419)    | 25    | 40,065    |
| Not Subject to Amortization:                              |        |           |             |       |           |
| Brand names   |        | 10,260    |             |       | 10,260    |
|   |        | _____     | _____       | _____ | _____     |
| Total   |        | \$ 63,719 | \$ (13,419) | \$ 25 | \$ 50,325 |
|   |        | _____     | _____       | _____ | _____     |

Amortization of intangibles was \$2.1 million in the first quarter of 2007. Estimated annual amortization expense is as follows: \$8.2 million in 2007, \$7.8 million in 2008, \$6.9 million in 2009, \$5.8 million in 2010, \$4.9 million in 2011 and \$6.4 million thereafter.

9. Components of other current liabilities were (in thousands):

|  | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|--|-----------------------|----------------------|
| Accrued insurance liabilities            | \$ 7,959              | \$ 7,833             |
| Accrued warranty and service liabilities | 6,380                 | 6,675                |
| Accrued trade promotions                 | 5,113                 | 7,265                |
| Payable for employee stock purchases     | 1,069                 | 5,846                |
| Income taxes payable                     | 16,971                | 3,920                |
| Other                                    | 16,502                | 14,227               |
|  | _____                 | _____                |
|  | \$53,994              | \$45,766             |
|  | _____                 | _____                |

A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific product warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

|                                | Thirteen Weeks<br>Ended<br><u>March 30, 2007</u> | Year Ended<br><u>Dec. 29, 2006</u> |
|--------------------------------|--|------------------------------------|
| Balance, beginning of year     | \$ 6,675   | \$ 7,649                           |
| Charged to expense             | 991  | 4,442                              |
| Margin on parts sales reversed | 758  | 1,944                              |
| Reductions for claims settled  | (2,044)  | (7,360)                            |
|                                | _____  | _____                              |
| Balance, end of period         | \$ 6,380   | \$ 6,675                           |
|                                | _____  | _____                              |

10. Effective at the beginning of 2007, the Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes. The adoption of FIN 48 resulted in no adjustment to beginning retained earnings.

At the beginning of 2007, the Company's liability for uncertain tax positions was \$5.5 million. Unrecognized tax benefits of \$4.9 million would affect the Company's effective tax rate if recognized. The Company records penalties and accrued interest related to uncertain tax positions in income tax expense. At the beginning of 2007, approximately \$0.6 million was included in the liability for uncertain tax positions for the possible payment of interest and penalties. There were no significant changes in components of the liability in the first quarter of 2007.

With few exceptions, the Company is no longer subject to U.S. federal, state and local, or foreign income tax examinations by tax authorities for years prior to 2001. The Company's U.S. income tax returns for 2004 and 2005 are currently under examination by the IRS. An estimate of the range of possible changes that may result from the examination cannot be made at this time.

Approximately \$1 million of unrecognized tax benefits relate to items that are affected by expiring statute of limitations within the next 12 months.

**Item 2.**

**GRACO INC. AND SUBSIDIARIES**

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

**Results of Operations**

First quarter net earnings of \$33.7 million were 5 percent below net earnings in the first quarter last year. The decrease resulted from a lower gross margin rate and higher expenses, which more than offset the favorable impact of a 3 percent increase in sales.

Results include the operations of Lubriquip, which was acquired in July 2006. The integration of Lubriquip is on track for completion by the end of the year and the consolidation of Gusmer operations was completed in the first quarter. Costs and expenses related to the integration and consolidation activities totaled approximately \$1 million in the first quarter of 2007.

Foreign currency translation rates had a favorable impact on first quarter sales and net earnings. Translated at consistent exchange rates, sales increased 1 percent and net earnings decreased 8 percent.

**Net Sales**

Sales by reportable segment and geographic area were as follows (in thousands):

|                           | <u>Thirteen Weeks Ended</u> |                       |
|---------------------------|-----------------------------|-----------------------|
|                           | <u>March 20, 2007</u>       | <u>March 31, 2006</u> |
| <b>By Segment</b>         |                             |                       |
| Industrial                | \$105,065                   | \$100,160             |
| Contractor                | 69,751                      | 74,352                |
| Lubrication               | 22,679                      | 17,704                |
|                           | <hr/>                       | <hr/>                 |
| Consolidated              | \$197,495                   | \$192,216             |
|                           | <hr/>                       | <hr/>                 |
| <b>By Geographic Area</b> |                             |                       |
| Americas <sup>1</sup>     | \$120,546                   | \$132,212             |
| Europe <sup>2</sup>       | 49,377                      | 39,546                |
| Asia Pacific              | 27,572                      | 20,458                |
|                           | <hr/>                       | <hr/>                 |
| Consolidated              | \$197,495                   | \$192,216             |
|                           | <hr/>                       | <hr/>                 |

<sup>1</sup> North and South America, including the U.S.

<sup>2</sup> Europe, Africa and Middle East

Industrial segment sales increased 5 percent. A decrease in the Americas was more than offset by double-digit percentage increases in Europe and Asia Pacific.

Contractor segment sales decreased 6 percent. Segment sales in Europe increased 40 percent while sales were lower in the Americas and Asia Pacific. In the Americas, growth in the home center channel was not enough to offset the decline in the professional paint stores channel.

Lubrication segment sales increased 28 percent due to sales of Lubriquip products, acquired in mid-2006. Sales in this segment increased in all geographic areas.

## Gross Profit

Gross profit as a percentage of sales was 53.1 percent compared to 53.7 percent for the first quarter last year. The decrease was due mainly to lower margin rates on Lubriquip products and higher production and material costs, offset somewhat by the favorable impacts of currency translation and pricing.

## Operating Expenses

Total operating expenses increased \$4 million including approximately \$1.5 million related to Lubriquip. The Contractor segment incurred approximately \$1 million of expenses related to the market testing of a new line of sprayers in the home center channel.

## Income Taxes

The effective tax rate of 35 percent was the same as last year's rate for the first quarter.

## Liquidity and Capital Resources

Significant uses of cash in the first quarter of 2007 included \$24 million for purchases and retirement of Company common stock, \$13 million for capital additions and \$11 million for payment of dividends. During the first quarter of 2006, significant uses of cash included \$17 million for purchases and retirement of Company common stock and \$10 million for dividends.

At March 30, 2007, the Company had various lines of credit totaling \$145 million, of which \$115 million was unused. Internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

## Outlook

First quarter sales fell short of expectations due mostly to soft demand in the North American Industrial and Contractor businesses. Management expects that 2007 will continue to be a challenging sales growth environment in North America. Spending over the remainder of the year will be adjusted accordingly, however, the Company will continue to invest for the future by funding key growth strategies.

## SAFE HARBOR CAUTIONARY STATEMENT

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, or in press or earnings releases, analyst briefings and conference calls, which reflects the Company's current thinking on market trends and the Company's future financial performance at the time they are made. All forecasts and projections are forward-looking statements.

The Company desires to take advantage of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2006 for a more comprehensive discussion of these and other risk factors.

Investors should realize that factors other than those identified above and in Item 1A and Exhibit 99 might prove important to the Company's future results. It is not possible for management to identify each and every factor that may have an impact on the Company's operations in the future as new factors can develop from time to time.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk

There are no material changes related to market risk from the disclosures made in the Company's 2006 Annual Report on Form 10-K.

**Item 4. Controls and Procedures****Evaluation of disclosure controls and procedures**

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's Chairman, President and Chief Executive Officer, Chief Financial Officer and Treasurer, Vice President and Controller and Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

**Changes in internal controls**

During the quarter, there was no change in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

**PART II OTHER INFORMATION****Item 1A. Risk Factors**

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2006 Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

On February 17, 2006, the Board of Directors authorized the Company to purchase up to a total of 7,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization expires on February 29, 2008.

In addition to shares purchased under the Board authorization, the Company purchases shares of common stock held by employees who wish to tender owned shares to satisfy the exercise price or tax withholding on option exercises.

Information on issuer purchases of equity securities follows:

| <u>Period</u>                | (a)<br>Total Number<br>of Shares<br><u>Purchased</u> | (b)<br>Average<br>Price Paid<br><u>per Share</u> | (c)<br>Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or<br><u>Programs</u> | (d)<br>Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs (at<br><u>end of period</u> ) |
|------------------------------|--|--|--|--|
| Dec. 30, 2006 - Jan 26, 2007 | 133,600  | \$40.27  | 133,600  | 4,909,900  |
| Jan 27, 2007 - Feb 23, 2007  | 170,000  | \$41.11  | 170,000  | 4,739,900  |
| Feb 24, 2007 - Mar 30, 2007  | 283,800  | \$39.46  | 283,800  | 4,456,100  |

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 6. Exhibits**

## Edgar Filing: GRACO INC - Form 10-Q

- 4.1 Credit agreement dated April 1, 2006, between the Company and Wachovia Bank, N.A. (Promissory Note and Offering Basis Loan Agreement) (Incorporated by reference to Exhibit 4.1 to the Company's Report on Form 10-Q for the thirteen weeks ended March 31, 2006.); as extended by letter from Wachovia Bank, N.A. to Graco Inc., dated March 26, 2007.
- 10.1 Stock Option Agreement. Form of agreement used for award in 2007 of non-incentive stock options to executive officers under the Graco Inc. Amended and Restated Stock Incentive Plan (2006). Form of agreement for award made to Chief Executive Officer in 2007.
- 31.1 Certification of Chairman, President and Chief Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a)
- 32 Certification of Chairman, President and Chief Executive Officer and Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

### SIGNATURES

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

#### GRACO INC.

Date: April 24, 2007

---

By: /s/ David A. Roberts

---

David A. Roberts  
Chairman, President and Chief Executive Officer  
*(Principal Executive Officer)*

Date: April 24, 2007

---

By: /s/ James A. Graner

---

James A. Graner  
Chief Financial Officer and Treasurer  
*(Principal Financial Officer)*