

GRACO INC
Form 10-Q/A
December 22, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q/A
Amendment No. 2

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

For the quarterly period ended September 25, 2009

Commission File Number: 001-09249

GRACO INC.

(Exact name of registrant as specified in its charter)

Minnesota
(State of incorporation)

41-0285640
(I.R.S. Employer Identification Number)

88 - 11th Avenue N.E.
Minneapolis, Minnesota
(Address of principal executive offices)

55413
(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 X No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer X Accelerated Filer
Non-accelerated Filer Smaller reporting company

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

Yes No X

59,972,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of October 15, 2009.

Explanatory Note

The sole purpose of this Amendment No. 2 to our Quarterly Report on Form 10-Q for the period ended September 25, 2009, as originally filed with the Securities and Exchange Commission on October 21, 2009, is to include the certifications required under Rule 13a-14(a) and Section 1350 currently dated and signed by our principal executive officer and principal financial officer.

No other changes have been made to the Form 10-Q other than those described above. This Amendment No. 2 does not reflect subsequent events occurring after the original filing date of the Form 10-Q or modify or update in any way disclosures made in the Form 10-Q.

GRACO INC. AND SUBSIDIARIES

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PART I

Item 1.

GRACO INC. AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF EARNINGS
 (Unaudited)
 (In thousands except per share amounts)

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net Sales | \$ 147,308 | \$ 207,231 | \$ 432,900 | \$ 650,581 |
| Cost of products sold | 69,167 | 97,071 | 217,423 | 299,805 |
| Gross Profit | 78,141 | 110,160 | 215,477 | 350,776 |
| Product development | 8,752 | 9,626 | 28,584 | 26,605 |
| Selling, marketing and distribution | 26,589 | 32,420 | 86,814 | 102,083 |
| General and administrative | 16,613 | 15,585 | 49,317 | 50,142 |
| Operating Earnings | 26,187 | 52,529 | 50,762 | 171,946 |
| Interest expense | 1,148 | 1,934 | 3,735 | 5,443 |
| Other expense, net | 203 | 623 | 889 | 606 |
| Earnings Before Income Taxes | 24,836 | 49,972 | 46,138 | 165,897 |
| Income taxes | 7,500 | 17,200 | 14,400 | 55,100 |
| Net Earnings | \$ 17,336 | \$ 32,772 | \$ 31,738 | \$ 110,797 |
| Basic Net Earnings per Common Share | \$ 0.29 | \$ 0.55 | \$ 0.53 | \$ 1.83 |
| Diluted Net Earnings per Common Share | \$ 0.29 | \$ 0.54 | \$ 0.53 | \$ 1.81 |
| Cash Dividends Declared per Common Share | \$ 0.19 | \$ 0.19 | \$ 0.57 | \$ 0.55 |

See notes to consolidated financial statements.

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

| | Sep 25, 2009 | Dec 26, 2008 |
|--|-----------------|-----------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 5,064 | \$ 12,119 |
| Accounts receivable, less allowances of \$6,400 and \$6,600 | 106,890 | 127,505 |
| Inventories | 60,581 | 91,604 |
| Deferred income taxes | 19,982 | 23,007 |
| Other current assets | 4,532 | 6,360 |
| Total current assets | 197,049 | 260,595 |
| Property, Plant and Equipment | | |
| Cost | 333,792 | 326,729 |
| Accumulated depreciation | (191,167) | (176,975) |
| Property, plant and equipment, net | 142,625 | 149,754 |
| Goodwill | 91,740 | 91,740 |
| Other Intangible Assets, net | 43,010 | 52,231 |
| Deferred Income Taxes | 14,425 | 18,919 |
| Other Assets | 8,223 | 6,611 |
| Total Assets | \$ 497,072 | \$ 579,850 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Notes payable to banks | \$ 13,866 | \$ 18,311 |
| Trade accounts payable | 16,663 | 18,834 |
| Salaries, wages and commissions | 13,477 | 17,179 |
| Dividends payable | 11,398 | 11,312 |
| Other current liabilities | 50,070 | 55,524 |
| Total current liabilities | 105,474 | 121,160 |
| Long-term Debt | 107,364 | 180,000 |
| Retirement Benefits and Deferred Compensation | 97,077 | 108,656 |
| Uncertain Tax Positions | 2,800 | 2,400 |
| Shareholders' Equity | | |
| Common stock | 59,965 | 59,516 |
| Additional paid-in-capital | 187,846 | 174,161 |

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| | | |
|---|------------|------------|
| Retained earnings | 5,900 | 8,445 |
| Accumulated other comprehensive income (loss) | (69,354) | (74,488) |
| Total shareholder's equity | 184,357 | 167,634 |
| Total Liabilities and Shareholders' Equity | \$ 497,072 | \$ 579,850 |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited) (In thousands)

| | Thirty-nine Weeks Ended | |
|---|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 |
| Cash Flows From Operating Activities | | |
| Net Earnings | \$ 31,738 | \$ 110,797 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation, amortization and impairment | 26,200 | 23,310 |
| Deferred income taxes | 4,671 | (3,850) |
| Share-based compensation | 7,441 | 7,072 |
| Excess tax benefit related to share-based payment arrangements | (300) | (2,923) |
| Change in | | |
| Accounts receivable | 22,434 | (4,989) |
| Inventories | 30,745 | (16,466) |
| Trade accounts payable | (2,050) | (775) |
| Salaries, wages and commissions | (3,853) | (1,236) |
| Retirement benefits and deferred compensation | (4,741) | (2,141) |
| Other accrued liabilities | (2,437) | 788 |
| Other | 313 | 1,114 |
| Net cash provided by operating activities | 110,161 | 110,701 |
| Cash Flows From Investing Activities | | |
| Property, plant and equipment additions | (9,375) | (20,778) |
| Proceeds from sale of property, plant and equipment | 615 | 1,633 |
| Investment in life insurance | (1,499) | (1,499) |
| Capitalized software and other intangible asset additions | (501) | (1,130) |
| Acquisitions of businesses, net of cash acquired | - | (39,780) |
| Net cash used in investing activities | (10,760) | (61,554) |
| Cash Flows From Financing Activities | | |
| Net borrowings (payments) on short-term lines of credit | (4,700) | (2,779) |

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| | | |
|--|------------|------------|
| Borrowings on long-term line of credit | 75,491 | 188,869 |
| Payments on long-term line of credit | (148,127) | (104,074) |
| Excess tax benefit related to share-based payment arrangements | 300 | 2,923 |
| Common stock issued | 6,119 | 13,528 |
| Common stock retired | (157) | (114,341) |
| Cash dividends paid | (34,069) | (33,693) |
| Net cash provided by (used in) financing activities | (105,143) | (49,567) |
| Effect of exchange rate changes on cash | (1,313) | 748 |
| Net increase (decrease) in cash and cash equivalents | (7,055) | 328 |
| Cash and cash equivalents | | |
| Beginning of year | 12,119 | 4,922 |
| End of period | \$ 5,064 | \$ 5,250 |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 25, 2009 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 25, 2009 and September 26, 2008, and cash flows for the thirty-nine weeks ended September 25, 2009 and September 26, 2008 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of September 25, 2009, 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 statements and notes thereto included in the Company's 2008 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):

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net earnings available to common shareholders | \$ 17,336 | \$ 32,772 | \$ 31,738 | \$ 110,797 |

| | | | | |
|--|---------|---------|---------|---------|
| Weighted average shares outstanding for basic earnings per share | 59,940 | 59,769 | 59,827 | 60,521 |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 374 | 596 | 306 | 647 |
| Weighted average shares outstanding for diluted earnings per share | 60,314 | 60,365 | 60,133 | 61,168 |
| Basic earnings per share | \$ 0.29 | \$ 0.55 | \$ 0.53 | \$ 1.83 |
| Diluted earnings per share | \$ 0.29 | \$ 0.54 | \$ 0.53 | \$ 1.81 |

Stock options to purchase 2,834,000 and 2,114,000 shares were not included in the 2009 and 2008 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirty-nine weeks ended September 25, 2009 is shown below (in thousands, except per share amounts):

| | Option Shares | Weighted Average Exercise Price | Options Exercisable | Weighted Average Exercise Price |
|---------------------------------|---------------|---------------------------------|---------------------|---------------------------------|
| Outstanding, December 26, 2008 | 3,955 | \$ 30.77 | 2,186 | \$ 24.98 |
| Granted | 1,180 | 20.74 | | |
| Exercised | (131) | 10.41 | | |
| Canceled | (127) | 31.69 | | |
| Outstanding, September 25, 2009 | 4,877 | \$ 28.87 | 2,465 | \$ 28.16 |

The aggregate intrinsic value of exercisable option shares was \$12.2 million as of September 25, 2009, with a weighted average contractual term of 4.4 years. There were approximately 4.8 million share options vested and expected to vest as of September 25, 2009, with an aggregate intrinsic value of \$20.9 million, a weighted average exercise price of \$28.87 and a weighted average contractual term of 6.5 years.

Information related to options exercised in the first nine months of 2009 and 2008 follows (in thousands):

| | Thirty-nine Weeks Ended | |
|---------------------------|-------------------------|--------------|
| | Sep 25, 2009 | Sep 26, 2008 |
| Cash received | \$ 1,363 | \$ 6,864 |
| Aggregate intrinsic value | 1,595 | 8,645 |
| Tax benefit realized | 600 | 3,100 |

The Company recognized year-to-date share-based compensation of \$7.7 million in 2009 and \$7.1 million in 2008. As of September 25, 2009, there was \$8.2 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.6 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:

| | Thirty-nine Weeks Ended | | | |
|---------------------------------------|-------------------------|------|-----------------|------|
| | Sep 25, 2009 | | Sep 26, 2008 | |
| Expected life in years | 6.0 | | 6.0 | |
| Interest rate | 2.1 | % | 3.2 | % |
| Volatility | 30.1 | % | 25.0 | % |
| Dividend yield | 3.7 | % | 2.1 | % |
| Weighted average fair value per share | \$ | 4.27 | \$ | 8.43 |

Under the Company's Employee Stock Purchase Plan, the Company issued 312,000 shares in 2009 and 216,000 shares in 2008. 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:

| | Thirty-nine Weeks Ended | | | |
|---------------------------------------|-------------------------|------|-----------------|------|
| | Sep 25, 2009 | | Sep 26, 2008 | |
| Expected life in years | 1.0 | | 1.0 | |
| Interest rate | 0.7 | % | 1.5 | % |
| Volatility | 51.5 | % | 27.1 | % |
| Dividend yield | 4.5 | % | 2.1 | % |
| Weighted average fair value per share | \$ | 5.60 | \$ | 8.14 |

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|------------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Pension Benefits | | | | |
| Service cost | \$ 1,078 | \$ 920 | \$ 3,498 | \$ 3,724 |
| Interest cost | 2,926 | 2,896 | 9,261 | 9,186 |
| Expected return on assets | (2,593) | (4,536) | (8,143) | (14,236) |
| Amortization and other | 2,034 | 233 | 6,761 | 528 |
| Net periodic benefit cost (credit) | \$ 3,445 | \$ (487) | \$ 11,377 | \$ (798) |

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| | | | | |
|------------------------------------|--------|--------|----------|----------|
| Postretirement Medical | | | | |
| Service cost | \$ 174 | \$ 168 | \$ 424 | \$ 418 |
| Interest cost | 335 | 286 | 985 | 1,036 |
| Amortization | (45) | (13) | (45) | (13) |
| Net periodic benefit cost (credit) | \$ 464 | \$ 441 | \$ 1,364 | \$ 1,441 |

In the third quarter of 2009, the Company made a voluntary \$15 million tax-deductible contribution to its funded defined benefit pension plan.

The Company paid \$1.5 million in June 2009 and \$1.5 million in June 2008 for contracts insuring the lives of certain employees who are eligible to participate in certain non-qualified pension and deferred compensation plans. These insurance contracts will be used to fund the non-qualified pension and deferred compensation arrangements. The insurance contracts are held in a trust and are available to general creditors in the event of the Company's insolvency. Cash surrender value of \$4.3 million and \$2.7 million is included in other assets in the consolidated balance sheet as of September 25, 2009 and December 28, 2008, respectively.

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net earnings | \$ 17,336 | \$ 32,772 | \$ 31,738 | \$ 110,797 |
| Cumulative translation adjustment | - | (346) | 234 | (377) |
| Pension and postretirement medical liability adjustment | 2,432 | 164 | 7,183 | 353 |
| Gain (loss) on interest rate hedge contracts | 303 | (211) | 594 | (634) |
| Income taxes | (1,011) | 23 | (2,877) | 107 |
| Comprehensive income | \$ 19,060 | \$ 32,402 | \$ 36,872 | \$ 110,246 |

Components of accumulated other comprehensive income (loss) were (in thousands):

| | Sep 25, 2009 | Dec 26, 2008 |
|---|-----------------|-----------------|
| Pension and postretirement medical liability adjustment | \$ (65,796) | \$ (70,322) |
| Gain (loss) on interest rate hedge contracts | (2,735) | (3,109) |
| Cumulative translation adjustment | (823) | (1,057) |
| Total | \$ (69,354) | \$ (74,488) |

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 and thirty-nine weeks ended September 25, 2009 and September 26, 2008 were as follows (in thousands):

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| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net Sales | | | | |
| Industrial | \$ 78,242 | \$ 117,685 | \$ 226,808 | \$ 365,028 |
| Contractor | 55,379 | 67,751 | 163,213 | 215,992 |
| Lubrication | 13,687 | 21,795 | 42,879 | 69,561 |
| Consolidated | \$ 147,308 | \$ 207,231 | \$ 432,900 | \$ 650,581 |
| Operating Earnings | | | | |
| Industrial | \$ 20,332 | \$ 35,874 | \$ 45,262 | \$ 117,847 |
| Contractor | 11,138 | 15,226 | 24,420 | 49,663 |
| Lubrication | (167) | 3,409 | (3,348) | 12,333 |
| Unallocated corporate (expense) | (5,116) | (1,980) | (15,572) | (7,897) |
| Consolidated | \$ 26,187 | \$ 52,529 | \$ 50,762 | \$ 171,946 |

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

| | Sep 25, 2009 | Dec 26, 2008 |
|---|-----------------|-----------------|
| Finished products and components | \$ 38,209 | \$ 50,703 |
| Products and components in various stages of completion | 24,359 | 24,938 |
| Raw materials and purchased components | 30,952 | 51,348 |
| | 93,520 | 126,989 |
| Reduction to LIFO cost | (32,939) | (35,385) |
| Total | \$ 60,581 | \$ 91,604 |

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

| | Estimated Life (years) | Original Cost | Accumulated Amortization | Foreign Currency Translation | Book Value |
|---|------------------------------|------------------|-----------------------------|------------------------------------|---------------|
| September 25, 2009 | | | | | |
| Customer relationships | 3 - 8 | \$ 41,075 | \$ (17,109) | \$ (181) | \$ 23,785 |
| Patents, proprietary technology and product documentation | 3 - 15 | 22,737 | (12,899) | (87) | 9,751 |
| Trademarks, trade names and other | 3 - 10 | 6,554 | (1,860) | - | 4,694 |
| | | 70,366 | (31,868) | (268) | 38,230 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 4,780 | - | - | 4,780 |
| Total | | \$ 75,146 | \$ (31,868) | \$ (268) | \$ 43,010 |

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| | | | | | |
|---|--------|-----------|--------------|-----------|-----------|
| December 26, 2008 | | | | | |
| Customer relationships | 3 - 8 | \$ 41,075 | \$ (12,470) | \$ (181) | \$ 28,424 |
| Patents, proprietary technology and product documentation | 3 - 15 | 23,780 | (11,290) | (87) | 12,403 |
| Trademarks, trade names and other | 3 - 10 | 5,514 | (3,908) | (12) | 1,594 |
| | | 70,369 | (27,668) | (280) | 42,421 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 9,810 | - | - | 9,810 |
| Total | | \$ 80,179 | \$ (27,668) | \$ (280) | \$ 52,231 |

In 2009, the useful life of certain brand names was determined to be no longer indefinite. The cost of such brand names, totaling \$4.5 million (after an impairment charge of \$0.5 million in the third quarter), is being amortized over a three-year period. Amortization of intangibles was \$3.4 million in the third quarter of 2009 and \$9.2 million year-to-date. Estimated annual amortization expense is as follows: \$12.1 million in 2009, \$11.2 million in 2010, \$10.1 million in 2011, \$8.3 million in 2012, \$4.1 million in 2013 and \$1.6 million thereafter.

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

| | Sep 25, 2009 | Dec 26, 2008 |
|--|-----------------|-----------------|
| Accrued self-insurance retentions | \$ 7,901 | \$ 7,896 |
| Accrued warranty and service liabilities | 7,644 | 8,033 |
| Accrued trade promotions | 3,625 | 9,001 |
| Payable for employee stock purchases | 3,659 | 5,473 |
| Income taxes payable | 3,549 | 904 |
| Other | 23,692 | 24,217 |
| Total | \$ 50,070 | \$ 55,524 |

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):

| | Thirty-nine Weeks Ended Sep 25, 2009 | Year Ended Dec 26, 2008 |
|--------------------------------|---|-------------------------------|
| Balance, beginning of year | \$ 8,033 | \$ 7,084 |
| Charged to expense | 3,519 | 6,793 |
| Margin on parts sales reversed | 2,235 | 3,698 |
| Reductions for claims settled | (6,143) | (9,542) |
| Balance, end of period | \$ 7,644 | \$ 8,033 |

10. The Company accounts for all derivatives, including those embedded in other contracts, as either assets or liabilities and measures those financial instruments at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation.

As part of its risk management program, the Company may periodically use forward exchange contracts and interest rate swaps to manage known market exposures. Terms of derivative instruments are structured to match the terms of the risk being managed and are generally held to maturity. The Company does not hold or issue derivative financial instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales. The Company's policy is to not enter into contracts with terms that cannot be designated as normal purchases or sales.

In 2007, the Company entered into interest rate swap contracts that effectively fix the rates paid on a total of \$80 million of variable rate borrowings. One contract fixed the rate on \$40 million of borrowings at 4.7 percent plus the applicable spread (depending on cash flow leverage ratio) until December 2010. The second contract fixed an additional \$40 million of borrowings at 4.6 percent plus the applicable spread until January 2011. Both contracts have been designated as cash flow hedges against interest rate volatility. Consequently, changes in the fair market value are recorded in accumulated other comprehensive income (loss) (AOCI). Amounts included in AOCI will be reclassified to earnings as interest rates increase and as the swap contracts approach their expiration dates. Net amounts paid or payable under terms of the contracts were charged to interest expense and totaled \$2.2 million in the first nine months of 2009.

The Company periodically evaluates its monetary asset and liability positions denominated in foreign currencies. The Company enters into forward contracts or options, or borrows in various currencies, in order to hedge its net monetary positions. These instruments are recorded at current market values and the gains and losses are included in other expense (income), net. There were eight contracts outstanding as of September 25, 2009, with notional amounts totaling \$16 million. There were 50 contracts outstanding during all or part of the first nine months of 2009, with net losses of \$1.4 million offsetting \$0.8 million of exchange gains on net monetary positions, included in other expense (income), net. The Company believes it uses strong financial counterparts in these transactions and that the resulting credit risk under these hedging strategies is not significant.

The Company uses significant other observable inputs to value the derivative instruments used to hedge interest rate volatility and net monetary positions. The fair market value and balance sheet classification of such instruments follows (in thousands):

| | Balance Sheet Classification | Sep 25, 2009 | Dec 26, 2008 |
|--|---------------------------------|-----------------|-----------------|
| Gain (loss) on interest rate hedge contracts | Other current liabilities | \$ (4,342) | \$ (4,936) |
| Gain (loss) on foreign currency forward contracts | | | |
| Gains | | \$ 113 | \$ 1,868 |
| Losses | | (282) | (670) |
| Net | Accounts receivable | | \$ 1,198 |
| Other current liabilities | | \$ (169) | |

11. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements." This accounting standard establishes a consistent framework for measuring fair value and expands disclosures on fair market value measurements. It was effective for the Company starting in fiscal 2008 for financial assets and liabilities. With respect to non-financial assets and

liabilities, it was effective for the Company starting in fiscal 2009. The adoption of this standard as it pertains to non-financial assets and liabilities had no significant impact on the consolidated financial statements.

12. The Company has evaluated subsequent events through the time the financial statements were approved for issuance on October 21, 2009.

Item 2. GRACO INC. AND SUBSIDIARIES

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

Overview

The Company designs, manufactures and markets systems and equipment to move, measure, control, dispense and spray fluid materials. Management classifies the Company's business into three reportable segments: Industrial, Contractor and Lubrication. Key strategies include development of new products, expansion of distribution and new market penetration.

The following Management's Discussion and Analysis reviews significant factors affecting the Company's results of operations and financial condition. This discussion should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

Results of Operations

Net sales, net earnings and earnings per share were as follows (in millions except per share amounts and percentages):

| | Thirteen Weeks Ended | | | Thirty-nine Weeks Ended | | |
|--|----------------------|-----------------|-------------|-------------------------|-----------------|-------------|
| | Sep 25, 2009 | Sep 26, 2008 | % Change | Sep 25, 2009 | Sep 26, 2008 | % Change |
| Net Sales | \$ 147.3 | \$ 207.2 | (29)% | \$ 432.9 | \$ 650.6 | (33)% |
| Net Earnings | \$ 17.3 | \$ 32.8 | (47)% | \$ 31.7 | \$ 110.8 | (71)% |
| Diluted Net Earnings per Common Share | \$ 0.29 | \$ 0.54 | (46)% | \$ 0.53 | \$ 1.81 | (71)% |

Weak economic conditions worldwide continued to affect the Company's operating results. Sales and orders decreased in all segments and regions. Currency translation had an unfavorable effect on sales (\$2 million for the quarter and \$14 million year-to-date) and net earnings (\$1 million for the quarter and \$5 million year-to-date). Year-to-date, the Company has recorded \$5 million of cost related to workforce reductions, mostly in the first quarter. The resulting decrease in cost structure contributed to improvements in second and third quarter net earnings compared to the first quarter.

Consolidated Results

Sales by geographic area were as follows (in millions):

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| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Americas 1 | \$ 84.1 | \$ 112.8 | \$ 252.6 | \$ 360.5 |
| Europe 2 | 35.6 | 57.8 | 105.9 | 189.4 |
| Asia Pacific | 27.6 | 36.6 | 74.4 | 100.7 |
| Consolidated | \$ 147.3 | \$ 207.2 | \$ 432.9 | \$ 650.6 |

1 North and South America, including the U.S.

2 Europe, Africa and Middle East

Sales for the quarter were down 25 percent in the Americas, 39 percent in Europe (36 percent at consistent translation rates) and 25 percent in Asia Pacific. Year-to-date sales were down 30 percent in the Americas, 44 percent in Europe (38 percent at consistent translation rates) and 26 percent in Asia Pacific. Consolidated sales were down 29 percent for the quarter and 33 percent year-to-date.

Gross profit margin, expressed as a percentage of sales, was 53 percent for the quarter and 50 percent year-to-date, compared to 53 percent and 54 percent, respectively, for the comparable periods last year. For the quarter, the favorable effects of pricing, material costs and cost reduction actions were offset by decreases from lower production volume and increased pension cost. Decreases in the year-to-date rate were due to lower production volumes (approximately 5 percentage points), unfavorable currency translation rates (approximately 1 percentage point) and increased pension cost (approximately 1 percentage point). Decreases were offset somewhat by the effects of favorable material costs and pricing.

Total operating expenses for the quarter and year-to-date were down 10 percent and 8 percent, respectively. For both the quarter and year-to-date, the effects of spending reductions and lower volume were partially offset by higher pension expenses. Year-to-date, a \$4 million decrease from translation effects was partially offset by \$2 million related to workforce reductions.

Effective income tax rates were 30 percent for the quarter and 31 percent year-to-date, down from last year's rates of 34 percent for the quarter and 33 percent year-to-date. A higher-than-expected benefit upon filing of prior year tax returns contributed to lower rates in 2009. Effective rates were higher in 2008 because the R&D tax credit was not renewed until the fourth quarter and no credit was included in the provisions for the first three quarters.

Segment Results

Certain measurements of segment operations compared to last year are summarized below:

Industrial

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net sales (in millions) | | | | |
| Americas | \$ 37.0 | \$ 54.1 | \$ 108.3 | \$ 169.0 |
| Europe | 22.0 | 36.4 | 65.7 | 122.2 |
| Asia Pacific | 19.2 | 27.2 | 52.8 | 73.8 |
| Total | \$ 78.2 | \$ 117.7 | \$ 226.8 | \$ 365.0 |

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| | | | | | | | | |
|---|----|---|----|---|----|---|----|---|
| Operating earnings as a percentage of net sales | 26 | % | 30 | % | 20 | % | 32 | % |
|---|----|---|----|---|----|---|----|---|

For the quarter, Industrial segment sales decreased 32 percent in the Americas, 40 percent in Europe (37 percent at consistent translation rates) and 29 percent in Asia Pacific. Year-to-date sales decreased 36 percent in the Americas, 46 percent in Europe (41 percent at consistent translation rates) and 28 percent in Asia Pacific.

In the third quarter, the impact of low volume on operating earnings was partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce reduction costs and currency translation affected year-to-date operating earnings as a percentage of sales.

Contractor

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|--------------|-------------------------|--------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net sales (in millions) | | | | |
| Americas | \$ 36.2 | \$ 41.7 | \$ 109.0 | \$ 135.5 |
| Europe | 12.5 | 19.4 | 37.3 | 61.3 |
| Asia Pacific | 6.7 | 6.7 | 16.9 | 19.2 |
| Total | \$ 55.4 | \$ 67.8 | \$ 163.2 | \$ 216.0 |

| | | | | | | | | |
|---|----|---|----|---|----|---|----|---|
| Operating earnings as a percentage of net sales | 20 | % | 22 | % | 15 | % | 23 | % |
|---|----|---|----|---|----|---|----|---|

For the quarter, Contractor segment sales decreased 13 percent in the Americas and 35 percent in Europe (32 percent at consistent translation rates). Year-to-date sales decreased 20 percent in the Americas, 39 percent in Europe (33 percent at consistent translation rates) and 12 percent in Asia Pacific.

In the third quarter, the impact of low volume on operating earnings was partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce reduction costs, currency translation and sustained product development spending affected year-to-date operating earnings as a percentage of sales. Contractor year-to-date operating results were also affected by sales, costs and expenses related to the rollout of entry-level paint sprayers to additional paint and home center stores in both 2009 and 2008.

Lubrication

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|--------------|-------------------------|--------------|
| | Sep 25, 2009 | Sep 26, 2008 | Sep 25, 2009 | Sep 26, 2008 |
| Net sales (in millions) | | | | |
| Americas | \$ 10.9 | \$ 17.0 | \$ 35.4 | \$ 56.1 |
| Europe | 1.1 | 2.1 | 2.9 | 5.8 |
| Asia Pacific | 1.7 | 2.7 | 4.6 | 7.7 |
| Total | \$ 13.7 | \$ 21.8 | \$ 42.9 | \$ 69.6 |

| | | | | | | | | |
|---|-----|----|----|---|-----|----|----|---|
| Operating earnings as a percentage of net sales | (1) |)% | 16 | % | (8) |)% | 18 | % |
|---|-----|----|----|---|-----|----|----|---|

For the quarter, Lubrication segment sales decreased 35 percent in the Americas, 49 percent in Europe (47 percent at consistent translation rates) and 39 percent in Asia Pacific. Year-to-date sales decreased 37 percent in the Americas, 50 percent in Europe (47 percent at consistent translation rates) and 41 percent in Asia Pacific.

In the third quarter, the impact of low volume on operating earnings was partially offset by the impacts of lower selling-related expenses and spending reductions initiated in prior quarters. Low volume, workforce reduction costs and increased product development expense affected year-to-date operating earnings as a percentage of sales. Mix of products sold and costs related to discontinued products contributed to lower margin rates in the Lubrication segment.

Liquidity and Capital Resources

In the first nine months of 2009, the Company used cash to reduce the borrowings under its long-term line of credit by \$73 million and paid dividends of \$34 million. The Company also made a \$15 million voluntary contribution to a funded defined benefit pension plan. Significant uses of cash and borrowings in the first nine months of 2008 included \$114 million for purchases and retirement of Company common stock, \$40 million for business acquisitions and \$34 million for payment of dividends.

Since the end of 2008, inventories have been reduced by \$31 million. Accounts receivable decreased by \$21 million from continuing collections and lower sales levels.

At September 25, 2009, the Company had various lines of credit totaling \$282 million, of which \$162 million was unused. Internally generated funds and unused financing sources are expected to provide the Company with the flexibility to meet its liquidity needs in 2009.

Outlook

While economic conditions continue to create headwinds for the business, management is encouraged by improved profitability in each of the last two quarters, resulting from efforts to improve production costs and control expenses. While management is cautious about predicting stronger sales and further improvement in profitability in the near-term, it expects to continue investing in growth initiatives including product development, international expansion and entering new markets. Management remains confident that the Company will emerge from the recession with strong, profitable growth.

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 2008 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 have been no material changes related to market risk from the disclosures made in the Company's 2008 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 President and Chief Executive Officer, the Chief Financial Officer and Treasurer, the Vice President and Controller, and the 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 2008 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Issuer Purchases of Equity Securities

On September 28, 2007, the Board of Directors authorized the Company to purchase up to 7,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization expired on September 30, 2009.

On September 18, 2009, the Board of Directors authorized the Company to purchase up to an additional 6,000,000 shares. The new authorization expires on September 30, 2012.

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In addition to shares purchased under the Board authorizations, 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:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period) |
|-----------------------------|----------------------------------|------------------------------|--|---|
| Jun 27, 2009 – Jul 24, 2009 | - | \$ - | - | 3,068,234 |
| Jul 25, 2009 – Aug 21, 2009 | - | \$ - | - | 3,068,234 |
| Aug 22, 2009 – Sep 25, 2009 | 577 | \$ 25.28 | - | 9,068,234 ¹ |

¹ Authorization for purchases of up to 3,068,234 shares expired on September 30, 2009.

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

None

Item 6. Exhibits

- 31.1 Certification of 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 the President and Chief Executive Officer and the Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

SIGNATURES

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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: December 22, 2009

By: /s/Patrick J. McHale
Patrick J. McHale
President and Chief Executive Officer
(Principal Executive Officer)

Date: December 22, 2009

By: /s/James A. Graner
James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

Date: December 22, 2009

By: /s/Caroline M. Chambers
Caroline M. Chambers
Vice President and Controller
(Principal Accounting Officer)