

GRACO INC
Form 10-Q
October 26, 2011
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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 **September 30, 2011**

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 X No

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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 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

59,685,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of October 19, 2011.

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

(In thousands except per share amounts)

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---------------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net Sales | \$ 227,347 | \$ 189,963 | \$ 679,689 | \$ 546,772 |
| Cost of products sold | 100,998 | 85,405 | 296,497 | 250,999 |
| Gross Profit | 126,349 | 104,558 | 383,192 | 295,773 |
| Product development | 10,423 | 9,263 | 30,708 | 28,209 |
| Selling, marketing and distribution | 36,673 | 33,280 | 113,738 | 95,087 |
| General and administrative | 22,451 | 18,592 | 66,620 | 57,139 |
| Operating Earnings | 56,802 | 43,423 | 172,126 | 115,338 |
| Interest expense | 3,125 | 1,038 | 5,473 | 3,159 |
| Other expense, net | 325 | 254 | 649 | 147 |
| Earnings Before Income Taxes | 53,352 | 42,131 | 166,004 | 112,032 |
| Income taxes | 16,800 | 11,700 | 54,100 | 36,200 |
| Net Earnings | \$ 36,552 | \$ 30,431 | \$ 111,904 | \$ 75,832 |
| Basic Net Earnings per Common Share | \$ 0.60 | \$ 0.51 | \$ 1.85 | \$ 1.26 |
| Diluted Net Earnings per Common Share | \$ 0.60 | \$ 0.50 | \$ 1.82 | \$ 1.25 |

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| | | | | |
|--|---------|---------|---------|---------|
| Cash Dividends Declared per Common Share | \$ 0.21 | \$ 0.20 | \$ 0.63 | \$ 0.60 |
|--|---------|---------|---------|---------|

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

| | Sep 30, 2011 | Dec 31, 2010 |
|---|-----------------|-----------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 274,832 | \$ 9,591 |
| Accounts receivable, less allowances of \$5,400 and \$5,600 | 156,430 | 124,593 |
| Inventories | 111,727 | 91,620 |
| Deferred income taxes | 18,904 | 18,647 |
| Other current assets | 3,305 | 7,957 |
| Total current assets | 565,198 | 252,408 |
| Property, Plant and Equipment | | |
| Cost | 351,974 | 344,854 |
| Accumulated depreciation | (217,549) | (210,669) |
| Property, plant and equipment, net | 134,425 | 134,185 |
| Goodwill | 93,400 | 91,740 |
| Other Intangible Assets, net | 20,646 | 28,338 |
| Deferred Income Taxes | 15,230 | 14,696 |
| Other Assets | 10,710 | 9,107 |
| Total Assets | \$ 839,609 | \$ 530,474 |

LIABILITIES AND SHAREHOLDERS EQUITY

| | | |
|---|----------|----------|
| Current Liabilities | | |
| Notes payable to banks | \$ 8,088 | \$ 8,183 |
| Trade accounts payable | 29,889 | 19,669 |
| Salaries and incentives | 29,280 | 34,907 |
| Dividends payable | 12,608 | 12,610 |
| Other current liabilities | 48,618 | 44,385 |
| Total current liabilities | 128,483 | 119,754 |
| Long-term Debt | 300,000 | 70,255 |
| Retirement Benefits and Deferred Compensation | 77,564 | 76,351 |
| Shareholders Equity | | |

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| | | |
|---|----------------|----------------|
| Common stock | 59,811 | 60,048 |
| Additional paid-in-capital | 238,537 | 212,073 |
| Retained earnings | 84,648 | 44,436 |
| Accumulated other comprehensive income (loss) | (49,434) | (52,443) |
| Total shareholders equity | 333,562 | 264,114 |
| Total Liabilities and Shareholders Equity | \$ 839,609 | \$ 530,474 |

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

| | Thirty-nine Weeks Ended | |
|--|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 |
| Cash Flows From Operating Activities | | |
| Net Earnings | \$ 111,904 | \$ 75,832 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation and amortization | 26,308 | 25,496 |
| Deferred income taxes | (2,494) | (3,848) |
| Share-based compensation | 8,821 | 7,339 |
| Excess tax benefit related to share-based payment arrangements | (1,800) | (1,000) |
| Change in | | |
| Accounts receivable | (31,852) | (34,845) |
| Inventories | (19,790) | (26,740) |
| Trade accounts payable | 7,085 | 6,892 |
| Salaries and incentives | (6,420) | 14,637 |
| Retirement benefits and deferred compensation | 5,400 | (2,810) |
| Other accrued liabilities | 6,327 | (258) |
| Other | 5,281 | 1,744 |
| Net cash provided by operating activities | 108,770 | 62,439 |
| Cash Flows From Investing Activities | | |
| Property, plant and equipment additions | (17,334) | (9,416) |
| Proceeds from sale of property, plant and equipment | 211 | 180 |
| Acquisition of business | (2,139) | - |
| Investment in life insurance | (1,499) | (1,499) |
| Capitalized software and other intangible asset additions | (534) | (342) |
| Net cash used in investing activities | (21,295) | (11,077) |
| Cash Flows From Financing Activities | | |
| Borrowings on short-term lines of credit | 15,550 | 8,358 |
| Payments on short-term lines of credit | (15,737) | (8,692) |
| Borrowings on long-term notes and line of credit | 402,175 | 92,795 |
| Payments on long-term line of credit | (172,430) | (89,055) |
| Payments of debt issuance costs | (1,131) | - |
| Excess tax benefit related to share-based payment arrangements | 1,800 | 1,000 |
| Common stock issued | 20,563 | 9,667 |

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| | | |
|--|------------|----------|
| Common stock repurchased | (35,250) | (24,218) |
| Cash dividends paid | (38,116) | (36,171) |
| Net cash provided by (used in) financing activities | 177,424 | (46,316) |
| Effect of exchange rate changes on cash | 342 | (792) |
| Net increase (decrease) in cash and cash equivalents | 265,241 | 4,254 |
| Cash and cash equivalents | | |
| Beginning of year | 9,591 | 5,412 |
| End of period | \$ 274,832 | \$ 9,666 |

See notes to consolidated financial statements.

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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 30, 2011 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 30, 2011 and September 24, 2010, and cash flows for the thirty-nine weeks ended September 30, 2011 and September 24, 2010 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 30, 2011, and the results of operations and cash flows for all periods presented.

In the fourth quarter of 2010, the Company changed its cash flow presentation of notes payable activity, for all periods presented, to separately disclose borrowings and payments. The Company also changed the cash flow presentation of activity on the swingline portion of its long-term revolving credit arrangement by changing the method it uses to accumulate borrowing and payment amounts. In prior periods, such activity was disclosed on a net basis. The effect of this change was to increase both borrowings and payments on long-term line of credit by \$83 million in the first nine months of 2010. These changes had no impact on net cash used in financing activities.

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 2010 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.

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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 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net earnings available to common shareholders | \$ 36,552 | \$ 30,431 | \$ 111,904 | \$ 75,832 |
| Weighted average shares outstanding for basic earnings per share | 60,430 | 60,107 | 60,474 | 60,304 |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 985 | 517 | 1,141 | 536 |
| Weighted average shares outstanding for diluted earnings per share | 61,415 | 60,624 | 61,615 | 60,840 |
| Basic earnings per share | \$ 0.60 | \$ 0.51 | \$ 1.85 | \$ 1.26 |
| Diluted earnings per share | \$ 0.60 | \$ 0.50 | \$ 1.82 | \$ 1.25 |

Stock options to purchase 1,161,000 and 2,965,000 shares were not included in the 2011 and 2010 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 30, 2011 is shown below (in thousands, except per share amounts):

| | Option Shares | Weighted Average Exercise Price | Options Exercisable | Weighted Average Exercise Price |
|---------------------------------|------------------|--|------------------------|--|
| Outstanding, December 31, 2010 | 5,509 | \$ 30.42 | 2,980 | \$ 31.99 |
| Granted | 569 | 43.15 | | |
| Exercised | (479) | 26.91 | | |
| Canceled | (39) | 35.50 | | |
| Outstanding, September 30, 2011 | 5,560 | \$ 31.99 | 3,284 | \$ 32.03 |

The Company recognized year-to-date share-based compensation of \$8.8 million in 2011 and \$7.3 million in 2010. As of September 30, 2011, there was \$9.7 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.1 years.

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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 30, 2011 | Sep 24, 2010 |
| Expected life in years | 6.5 | 6.0 |
| Interest rate | 2.8 % | 2.7 % |
| Volatility | 33.7 % | 34.0 % |
| Dividend yield | 2.0 % | 3.0 % |
| Weighted average fair value per share | \$ 13.35 | \$ 7.38 |

Under the Company's Employee Stock Purchase Plan, the Company issued 313,000 shares in 2011 and 436,000 shares in 2010. 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 30, 2011 | Sep 24, 2010 |
| Expected life in years | 1.0 | 1.0 |
| Interest rate | 0.3 % | 0.3 % |
| Volatility | 27.8 % | 42.8 % |
| Dividend yield | 2.1 % | 2.9 % |
| Weighted average fair value per share | \$ 10.05 | \$ 8.48 |

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Pension Benefits | | | | |
| Service cost | \$ 865 | \$ 1,038 | \$ 3,330 | \$ 3,173 |
| Interest cost | 3,076 | 3,160 | 9,816 | 9,575 |
| Expected return on assets | (3,852) | (3,564) | (11,852) | (10,364) |
| Amortization and other | 1,524 | 1,547 | 4,470 | 4,599 |
| Net periodic benefit cost | \$ 1,613 | \$ 2,181 | \$ 5,764 | \$ 6,983 |
| Postretirement Medical | | | | |
| Service cost | \$ 202 | \$ 138 | \$ 452 | \$ 413 |
| Interest cost | 264 | 310 | 914 | 930 |
| Amortization | (68) | (50) | (68) | (145) |
| Net periodic benefit cost | \$ 398 | \$ 398 | \$ 1,298 | \$ 1,198 |

The Company paid \$1.5 million in July 2011 and \$1.5 million in June 2010 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 \$7.3 million and \$6.2 million is included in other assets in the consolidated balance sheets as of September 30, 2011 and December 31, 2010, respectively.

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net earnings | \$ 36,552 | \$ 30,431 | \$ 111,904 | \$ 75,832 |
| Pension and postretirement medical liability adjustment | 1,525 | 1,507 | 4,317 | 4,466 |
| Gain on interest rate hedge contracts | - | 763 | 454 | 2,401 |
| Income taxes | (559) | (841) | (1,762) | (2,542) |
| Comprehensive income | \$ 37,518 | \$ 31,860 | \$ 114,913 | \$ 80,157 |

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

| | Sep 30, 2011 | Dec 31, 2010 |
|---|-----------------|-----------------|
| Pension and postretirement medical liability adjustment | \$ (48,611) | \$ (51,334) |
| Gain (loss) on interest rate hedge contracts | - | (286) |
| Cumulative translation adjustment | (823) | (823) |
| Total | \$ (49,434) | \$ (52,443) |

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. Sales and operating earnings by segment for the thirteen and thirty-nine weeks ended September 30, 2011 and September 24, 2010 were as follows (in thousands):

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net Sales | | | | |
| Industrial | \$ 124,502 | \$ 99,236 | \$ 376,636 | \$ 296,489 |
| Contractor | 77,757 | 70,362 | 228,664 | 194,941 |
| Lubrication | 25,088 | 20,365 | 74,389 | 55,342 |
| Total | \$ 227,347 | \$ 189,963 | \$ 679,689 | \$ 546,772 |
| Operating Earnings | | | | |
| Industrial | \$ 42,632 | \$ 31,195 | \$ 132,996 | \$ 91,234 |
| Contractor | 16,700 | 13,753 | 44,239 | 31,839 |
| Lubrication | 4,380 | 2,751 | 13,652 | 6,326 |
| Unallocated corporate (expense) | (6,910) | (4,276) | (18,761) | (14,061) |
| Total | \$ 56,802 | \$ 43,423 | \$ 172,126 | \$ 115,338 |

Unallocated corporate in 2011 includes \$3 million of expense for the quarter and \$6 million year-to-date related to the pending acquisition of ITW's finishing businesses.

Assets by segment were as follows (in thousands):

| | Sep 30, 2011 | Dec 31, 2010 |
|------------|-----------------|-----------------|
| Industrial | \$ 300,124 | \$ 270,160 |

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| | | |
|-----------------------|-------------------|-------------------|
| Contractor | 158,158 | 134,938 |
| Lubrication | 88,528 | 81,746 |
| Unallocated corporate | 292,799 | 43,630 |
| Total | \$ 839,609 | \$ 530,474 |

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

| | Sep 30, 2011 | Dec 31, 2010 |
|---|-----------------|-----------------|
| Finished products and components | \$ 57,701 | \$ 48,670 |
| Products and components in various stages of completion | 38,269 | 31,275 |
| Raw materials and purchased components | 54,378 | 46,693 |
| | 150,348 | 126,638 |
| Reduction to LIFO cost | (38,621) | (35,018) |
| Total | \$ 111,727 | \$ 91,620 |

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

| | Estimated Life (years) | Original Cost | Accumulated Amortization | Foreign Currency Translation | Book Value |
|---|------------------------------|------------------|-----------------------------|------------------------------------|---------------|
| September 30, 2011 | | | | | |
| Customer relationships | 2 - 8 | \$ 40,925 | \$ (29,252) | \$ (181) | \$ 11,492 |
| Patents, proprietary technology and product documentation | 3 - 10 | 14,668 | (10,090) | (87) | 4,491 |
| Trademarks, trade names and other | 2 - 3 | 6,140 | (4,657) | - | 1,483 |
| | | 61,733 | (43,999) | (268) | 17,466 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 3,180 | - | - | 3,180 |
| Total | | \$ 64,913 | \$ (43,999) | \$ (268) | \$ 20,646 |
| December 31, 2010 | | | | | |
| Customer relationships | 3 - 8 | \$ 41,075 | \$ (24,840) | \$ (181) | \$ 16,054 |
| Patents, proprietary technology and product documentation | 3 - 10 | 19,902 | (13,956) | (87) | 5,859 |
| Trademarks, trade names and other | 3 - 10 | 8,154 | (4,909) | - | 3,245 |
| | | 69,131 | (43,705) | (268) | 25,158 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 3,180 | - | - | 3,180 |

| | | | | |
|-------|-----------|-------------|----------|-----------|
| Total | \$ 72,311 | \$ (43,705) | \$ (268) | \$ 28,338 |
|-------|-----------|-------------|----------|-----------|

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Amortization of intangibles was \$2.6 million in the third quarter of 2011 and \$8.4 million year-to-date. Estimated annual amortization expense is as follows: \$10.9 million in 2011, \$9.0 million in 2012, \$4.3 million in 2013, \$0.9 million in 2014, \$0.5 million in 2015 and \$0.2 million thereafter.

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

| | Sep 30, 2011 | Dec 31, 2010 |
|--|------------------|------------------|
| Accrued self-insurance retentions | \$ 6,634 | \$ 6,675 |
| Accrued warranty and service liabilities | 6,753 | 6,862 |
| Accrued trade promotions | 4,771 | 5,947 |
| Payable for employee stock purchases | 4,904 | 5,655 |
| Income taxes payable | 3,168 | 733 |
| Other | 22,388 | 18,513 |
| Total other current liabilities | \$ 48,618 | \$ 44,385 |

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 30, 2011 | Year Ended Dec 31, 2010 |
|--------------------------------|---|-------------------------------|
| Balance, beginning of year | \$ 6,862 | \$ 7,437 |
| Charged to expense | 3,641 | 3,484 |
| Margin on parts sales reversed | 2,168 | 3,412 |
| Reductions for claims settled | (5,918) | (7,471) |
| Balance, end of period | \$ 6,753 | \$ 6,862 |

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.

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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. The notional amount of contracts outstanding as of September 30, 2011, totaled \$21 million. 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, including reference to market prices and financial models that incorporate relevant market assumptions. The fair market value and balance sheet classification of such instruments follows (in thousands):

| | Balance Sheet Classification | Sep 30, 2011 | Dec 31, 2010 |
|--|---------------------------------|-----------------|-----------------|
| Gain (loss) on interest rate hedge contracts | Other current liabilities | \$ - | \$ (454) |
| Gain (loss) on foreign currency forward contracts | | | |
| Gains | | \$ 989 | \$ 92 |
| Losses | | (26) | (284) |
| Net | Accounts receivable | \$ 963 | |
| | Other current liabilities | | \$ (192) |

11. In March 2011, the Company entered into a note agreement and sold \$150 million of unsecured notes (series A and B) in a private placement. In July 2011, the Company sold an additional \$150 million in unsecured notes (series C and D). Proceeds were used to repay revolving line of credit borrowings and invested in cash and cash equivalents, mostly money market funds (carried at cost, which approximates market value).

Interest rates and maturity dates on the four series of notes are as follows (dollars in millions):

| Series | Amount | Rate | Maturity |
|--------|--------|--------|--------------|
| A | \$ 75 | 4.00 % | March 2018 |
| B | \$ 75 | 5.01 % | March 2023 |
| C | \$ 75 | 4.88 % | January 2020 |
| D | \$ 75 | 5.35 % | July 2026 |

The notes have a carrying amount of \$300 million and an estimated fair value of \$320 million as of September 30, 2011. Estimated fair value is based on the present value of future cash flows and rates that would be available for issuance of debt with similar terms and remaining maturities.

The note agreement requires the Company to maintain certain financial ratios as to cash flow leverage and interest coverage. The Company is in compliance with all financial covenants of its debt agreements.

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12. In April 2011, the Company entered into a definitive agreement to purchase the finishing businesses of Illinois Tool Works Inc. (ITW) in a \$650 million cash transaction. Closing on the purchase is subject to regulatory reviews and other customary closing conditions. The Company is cooperating with the Federal Trade Commission to obtain clearance to close on the transaction. The Company plans to finance the acquisition through a new committed \$450 million revolving credit facility that will be funded upon closing of the purchase, and funds available under the long-term notes referenced above.

Also in April 2011, the Company acquired the assets and assumed certain liabilities of Eccentric Pumps, LLC (Eccentric) for approximately \$2.1 million cash. Eccentric was engaged in the business of designing and selling peristaltic hose pumps for metering, dosing and transferring fluids. The Company expects to employ the Eccentric assets to expand and complement its Industrial segment business. The purchase price was allocated based on estimated fair values, including \$1.7 million of goodwill and \$0.7 million of other identifiable intangible assets.

Table of Contents**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 developing and marketing new products, expanding distribution globally, opening new markets with technology and channel expansion and completing strategic acquisitions.

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 30, 2011 | Sep 24, 2010 | % Change | Sep 30, 2011 | Sep 24, 2010 | % Change |
| Net Sales | \$ 227.3 | \$ 190.0 | 20% | \$ 679.7 | \$ 546.8 | 24% |
| Net Earnings | \$ 36.6 | \$ 30.4 | 20% | \$ 111.9 | \$ 75.8 | 48% |
| Diluted Net Earnings per Common Share | \$ 0.60 | \$ 0.50 | 20% | \$ 1.82 | \$ 1.25 | 46% |

All segments and geographic regions had revenue growth over last year for the quarter and year-to-date. Volume increases continued to drive improvement in net earnings. Changes in translation rates increased net earnings for the quarter by approximately \$3 million and increased year-to-date earnings by approximately \$7 million.

Table of Contents**Consolidated Results**

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-----------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Americas ¹ | \$ 122.8 | \$ 108.7 | \$ 364.1 | \$ 305.6 |
| Europe ² | 51.1 | 43.4 | 162.4 | 129.2 |
| Asia Pacific | 53.4 | 37.9 | 153.2 | 112.0 |
| Consolidated | \$ 227.3 | \$ 190.0 | \$ 679.7 | \$ 546.8 |

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

² Europe, Africa and Middle East

Sales for the quarter increased 20 percent (16 percent at consistent translation rates), including increases of 13 percent in the Americas, 18 percent in Europe (10 percent at consistent translation rates) and 41 percent in Asia Pacific (34 percent at consistent translation rates). Year-to-date sales increased 24 percent (21 percent at consistent translation rates), with increases of 19 percent in the Americas, 26 percent in Europe (19 percent at consistent translation rates) and 37 percent in Asia Pacific (31 percent at consistent translation rates).

Gross profit margin, expressed as a percentage of sales, was 56 percent for both the quarter and year-to-date, up ¹/₂ percentage point from the third quarter last year and 2 percentage points higher than last year-to-date. The favorable effects of translation and higher volume were partially offset by higher material costs for both the quarter and the year-to-date.

Total operating expenses increased \$8 million for the quarter and \$31 million year-to-date. Selling, marketing and distribution expenses were \$3 million higher for the quarter and were up \$19 million year-to-date. The increases came from translation, headcount increases (mostly in Asia Pacific) and higher marketing and promotion expenses (mainly in Contractor segment in the first half of the year). General and administrative expense for the quarter and year-to-date increased \$4 million and \$9 million, respectively, including \$3 million for the quarter and \$6 million year-to-date, related to the pending acquisition of ITW's finishing businesses.

The effective income tax rate of 32 percent for the quarter is higher than the 28 percent rate for third quarter last year. Last year's lower rate reflected the favorable effects of tax law rulings and expiring statutes of limitations. The effective rate of 33 percent for the year-to-date is consistent with the rate for the comparable period last year.

Table of Contents**Segment Results**

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

Industrial

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net sales (in millions) | | | | |
| Americas | \$ 53.8 | \$ 46.7 | \$ 162.6 | \$ 134.1 |
| Europe | 33.1 | 25.6 | 103.6 | 80.6 |
| Asia Pacific | 37.6 | 26.9 | 110.4 | 81.8 |
| Total | \$ 124.5 | \$ 99.2 | \$ 376.6 | \$ 296.5 |

Operating earnings as a percentage of

| | | | | |
|-----------|------|------|------|------|
| net sales | 34 % | 31 % | 35 % | 31 % |
|-----------|------|------|------|------|

Industrial segment sales for the quarter increased 15 percent in the Americas, 29 percent in Europe (21 percent at consistent translation rates) and 40 percent in Asia Pacific (34 percent at consistent translation rates). Year-to-date sales increased 21 percent in the Americas, 29 percent in Europe (22 percent at consistent translation rates) and 35 percent in Asia Pacific (30 percent at consistent translation rates).

Higher volume, expense leverage and currency translation contributed to the improvement in operating earnings as a percentage of sales.

Contractor

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net sales (in millions) | | | | |
| Americas | \$ 51.2 | \$ 46.8 | \$ 148.6 | \$ 130.2 |
| Europe | 16.0 | 16.2 | 52.3 | 44.1 |
| Asia Pacific | 10.6 | 7.4 | 27.8 | 20.6 |
| Total | \$ 77.8 | \$ 70.4 | \$ 228.7 | \$ 194.9 |

Operating earnings as a percentage of

| | | | | |
|-----------|------|------|------|------|
| net sales | 21 % | 20 % | 19 % | 16 % |
|-----------|------|------|------|------|

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Contractor segment sales for the quarter increased 10 percent in the Americas and 43 percent in Asia Pacific (34 percent at consistent translation rates). Sales were down 2 percent in Europe (down 9 percent at consistent translation rates) compared to the third quarter of 2010, which included substantial stocking shipments of new products. Year-to-date sales increased 14 percent in the Americas, 19 percent in Europe (12 percent at consistent translation rates) and 35 percent in Asia Pacific (26 percent at consistent translation rates).

Higher volume, expense leverage and currency translation contributed to the improvement in operating earnings as a percentage of sales. Increased marketing, including product launch and promotion expenses in the first half of the year, moderated the improvement in 2011.

Table of Contents**Lubrication**

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--|----------------------|-----------------|-------------------------|-----------------|
| | Sep 30, 2011 | Sep 24, 2010 | Sep 30, 2011 | Sep 24, 2010 |
| Net sales (in millions) | | | | |
| Americas | \$ 17.8 | \$ 15.2 | \$ 52.8 | \$ 41.2 |
| Europe | 2.1 | 1.6 | 6.6 | 4.5 |
| Asia Pacific | 5.2 | 3.6 | 15.0 | 9.6 |
| Total | \$ 25.1 | \$ 20.4 | \$ 74.4 | \$ 55.3 |
| Operating earnings as a percentage of net sales | 17 % | 14 % | 18 % | 11 % |

Lubrication segment sales for the quarter increased 17 percent in the Americas, 29 percent in Europe and 46 percent in Asia Pacific. Year-to-date sales increased 28 percent in the Americas, 46 percent in Europe and 56 percent in Asia Pacific.

Higher volume, expense leverage and currency translation contributed to the improvement in operating earnings as a percentage of sales. Increasing material and production costs moderated the improvement in the third quarter.

Liquidity and Capital Resources

Net cash provided by operating activities was \$109 million in 2011 and \$62 million in 2010.

Since the end of 2010, inventories increased by \$20 million to meet higher demand, and accounts receivable increased by \$32 million due to higher sales levels. The increases in inventories and receivables occurred in the first half of the year, with balances leveling off in the third quarter. The Company purchased and retired \$38 million of Company common stock in the third quarter, of which \$3 million settled in the first week of the fourth quarter and was included in accounts payable as of September 30, 2011.

At September 30, 2011, the Company had various lines of credit totaling \$270 million, of which \$264 million was unused.

In March 2011, the Company entered into a note agreement and sold \$150 million of unsecured notes in a private placement. One series of notes totaling \$75 million bears interest at 4.0 percent and matures in 2018. Another series of notes totaling \$75 million bears interest at 5.01 percent and matures in 2023. Under terms of the agreement, the Company sold an additional \$150 million of unsecured notes on July 26, 2011. One series of notes issued in July totaling \$75 million bears interest at 4.88 percent and matures in 2020. Another series of notes issued in July totaling \$75 million bears interest at 5.35 percent and matures in 2026. Proceeds were used to repay revolving line of credit borrowings and invested in cash and cash equivalents, mostly money market funds.

Under terms of the note agreement, interest is payable quarterly. The Company is required to maintain a cash flow leverage ratio of not more than 3.25 to 1.00 and an interest coverage ratio of not less than 3.00 to 1.00. If a significant

acquisition is consummated, the agreement allows, for a one-year period, for a cash flow leverage ratio of 3.75 to 1.00 and an interest

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coverage ratio of not less than 2.50 to 1.00. The note agreement contains covenants typical of unsecured credit facilities, including customary default provisions. If an event of default occurs, all outstanding obligations may become immediately due and payable. The Company was in compliance with all financial covenants at September 30, 2011.

In April 2011, the Company entered into a definitive agreement to purchase the finishing business operations of Illinois Tool Works Inc. (ITW) in a \$650 million cash transaction. Closing on the purchase is subject to regulatory reviews and other customary closing conditions. On July 5, 2011, the Company received a request for additional information from the Federal Trade Commission. The issuance of this second request extends the waiting period to close the acquisition to thirty days after the Company and ITW have substantially complied with their respective requests. Both parties had certified to substantial compliance to the FTC's second requests as of October 18, 2011, and also agreed to extend the waiting period by an additional thirty days.

The Company plans to finance the acquisition with borrowings under the long-term notes referenced above and with borrowings under a new revolving credit facility that will be funded upon closing of the purchase. In May 2011, the Company entered into a credit agreement providing the Company access to a \$450 million unsecured revolving credit facility until May 2016. The Company may not obtain any loans under the credit agreement until certain conditions are met, including the closing of the acquisition of ITW's finishing businesses and the Company receiving not less than \$75 million in proceeds from the issuance of additional long-term notes.

Internally generated funds and unused financing sources are expected to provide the Company with the flexibility to meet its liquidity needs in 2011.

Outlook

For the fourth quarter of 2011, management expects the global demand to be generally favorable compared to last year, with the exception of the U.S. housing and commercial construction markets, which remain at historic lows. Management is closely monitoring demand trends in Europe, watching for any order impact resulting from the Eurozone financial crisis. Fourth quarter percentage growth trends are expected to be lower, reflecting more difficult comparisons to the prior year and an additional week of shipments that occurred in the fourth fiscal quarter of 2010.

The pending acquisition of the ITW finishing businesses would advance all of the Company's stated core growth strategies, including new products and technology, geographic expansion, and new markets.

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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 the acquisition of the finishing businesses of ITW, 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 undertakes no obligation to update these statements in light of new information or future events.

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. In addition, risk factors related to the Company's pending acquisition of the ITW finishing businesses include: whether and when the required regulatory approvals will be obtained, whether and when the closing conditions will be satisfied and whether and when the transaction will close, the ability to close on committed financing on satisfactory terms, the amount of debt that the Company will incur to complete the transaction, completion of purchase price valuation for acquired assets, whether and when the Company will be able to realize the expected financial results and accretive effect of the transaction, how customers, competitors, suppliers and employees will react to the transaction, and economic changes in global markets. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2010 and Item 1A of this Quarterly Report on Form 10-Q 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.

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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 2010 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, 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.

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.

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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 2010 Annual Report on Form 10-K, except for the addition of the risk factor described below:

Pending Acquisition - Our pending acquisition of the finishing business operations of Illinois Tool Works Inc. is subject to regulatory approvals and the expected benefits from the acquisition may not be fully realized.

We have entered into a definitive agreement to purchase the finishing business of Illinois Tools Works Inc. (ITW) in a \$650 million cash transaction. We cannot predict whether or when the required regulatory approvals will be obtained or if the closing conditions will be satisfied. If we terminate the agreement before April 1, 2012 due to failure to obtain regulatory approval, we will be required to pay a \$20 million termination fee. After the transaction closes, significant changes to our financial condition as a result of global economic changes or difficulties in the integration of the newly acquired businesses may affect our ability to obtain the expected benefits from the transaction or to satisfy the financial covenants included in the terms of the financing arrangements.

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

On September 18, 2009, the Board of Directors authorized the Company to purchase up to 6,000,000 shares of its outstanding common stock, primarily through open-market transactions. The authorization expires on September 30, 2012.

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) |
|--------------|--------------|---|---------------------------------------|--|--|
| Jul 2, 2011 | Jul 29, 2011 | 674 | 51.53 | - | 5,179,638 |
| Jul 30, 2011 | Aug 26, 2011 | 748,550 | 36.76 | 748,550 | 4,431,088 |
| Aug 27, 2011 | Sep 30, 2011 | 310,110 | 34.90 | 310,110 | 4,120,978 |

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Item 6. Exhibits

- 10.1 Amendment No. 1 Dated as of August 15, 2011 to Pledge Agreement Dated as of July 12, 2007.
- 10.2 Amendment No. 1 Dated as of August 15, 2011 to Pledge Agreement Dated as of May 23, 2011.
- 31.1 Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a).
- 32 Certification of President and Chief Executive Officer and Chief Financial Officer pursuant to Section 1350 of Title 18, U.S.C.
- 99.1 Press Release, Reporting Third Quarter Earnings, dated October 26, 2011.
- 101 Interactive Data File.

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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: October 26, 2011

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

Date: October 26, 2011

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

Date: October 26, 2011

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