

GRACO INC
Form 10-Q
April 22, 2009

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 27, 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

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(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, 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 | <input checked="" type="checkbox"/> | 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

59,888,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of April 15, 2009.

GRACO INC. AND SUBSIDIARIES**INDEX**Page Number**PART I FINANCIAL INFORMATION**

| | | |
|---------|--|----|
| 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 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 14 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 19 |
| Item 4. | Controls and Procedures | 19 |

PART II OTHER INFORMATION

| | | |
|----------|---|----|
| Item 1A. | Risk Factors | 20 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 20 |
| Item 4. | Submission of Matters to a Vote of Security Holders | 21 |
| Item 6. | Exhibits | 21 |

SIGNATURES**EXHIBITS**

PART I**Item 1.****GRACO INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

(In thousands except per share amounts)

| | Thirteen Weeks Ended | |
|--|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net Sales | \$ 137,880 | \$ 204,120 |
| Cost of products sold | 73,552 | 92,267 |
| Gross Profit | 64,328 | 111,853 |
| Product development | 10,051 | 7,940 |
| Selling, marketing and distribution | 31,933 | 33,821 |
| General and administrative | 16,215 | 17,738 |
| Operating Earnings | 6,129 | 52,354 |
| Interest expense | 1,366 | 1,603 |
| Other expense (income), net | 595 | (115) |
| Earnings Before Income Taxes | 4,168 | 50,866 |
| Income taxes | 1,400 | 15,300 |
| Net Earnings | \$ 2,768 | \$ 35,566 |
| Basic Net Earnings per Common Share | \$ 0.05 | \$ 0.58 |
| Diluted Net Earnings per Common Share | \$ 0.05 | \$ 0.57 |
| Cash Dividends Declared per Common Share | \$ 0.19 | \$ 0.19 |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

 (Unaudited)
 (In thousands)

| | March 27, 2009 | December 26, 2008 |
|--|-------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 14,799 | \$ 12,119 |
| Accounts receivable, less allowances of \$6,200 and \$6,600 | 106,860 | 127,505 |
| Inventories | 85,577 | 91,604 |
| Deferred income taxes | 21,706 | 23,007 |
| Other current assets | 5,844 | 6,360 |
| Total current assets | 234,786 | 260,595 |
| Property, Plant and Equipment | | |
| Cost | 330,857 | 326,729 |
| Accumulated depreciation | (181,070) | (176,975) |
| Property, plant and equipment, net | 149,787 | 149,754 |
| Goodwill | 91,740 | 91,740 |
| Other Intangible Assets, net | 49,397 | 52,231 |
| Deferred Income Taxes | 19,337 | 18,919 |
| Other Assets | 6,262 | 6,611 |
| Total Assets | \$ 551,309 | \$ 579,850 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Notes payable to banks | \$ 16,532 | \$ 18,311 |
| Trade accounts payable | 14,732 | 18,834 |
| Salaries, wages and commissions | 12,550 | 17,179 |
| Dividends payable | 11,321 | 11,312 |
| Other current liabilities | 48,910 | 55,524 |
| Total current liabilities | 104,045 | 121,160 |
| Long-term Debt | 166,811 | 180,000 |
| Retirement Benefits and Deferred Compensation | 109,496 | 108,656 |
| Uncertain Tax Positions | 2,550 | 2,400 |
| Shareholders' Equity | | |
| Common stock | 59,884 | 59,516 |
| Additional paid-in-capital | 181,460 | 174,161 |
| Retained earnings | (103) | 8,445 |
| Accumulated other comprehensive income (loss) | (72,834) | (74,488) |
| Total shareholders' equity | 168,407 | 167,634 |
| Total Liabilities and Shareholders' Equity | \$ 551,309 | \$ 579,850 |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

| | Thirteen Weeks Ended | |
|--|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Cash Flows From Operating Activities | | |
| Net Earnings | \$ 2,768 | \$ 35,566 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation and amortization | 8,475 | 7,395 |
| Deferred income taxes | (52) | (2,885) |
| Share-based compensation | 2,417 | 2,553 |
| Excess tax benefit related to share-based payment arrangements | (200) | (1,723) |
| Change in | | |
| Accounts receivable | 18,588 | (5,296) |
| Inventories | 5,525 | (9,836) |
| Trade accounts payable | (4,044) | 4,801 |
| Salaries, wages and commissions | (4,444) | (6,808) |
| Retirement benefits and deferred compensation | 3,602 | (887) |
| Other accrued liabilities | (5,692) | 9,204 |
| Other | 758 | (228) |
| Net cash provided by operating activities | 27,701 | 31,856 |
| Cash Flows From Investing Activities | | |
| Property, plant and equipment additions | (5,732) | (5,130) |
| Proceeds from sale of property, plant and equipment | 567 | 39 |
| Capitalized software and other intangible asset additions | (46) | (222) |
| Acquisitions of businesses, net of cash acquired | | - (35,266) |
| Net cash used in investing activities | (5,211) | (40,579) |
| Cash Flows From Financing Activities | | |
| Net borrowings (payments) on short-term lines of credit | (995) | (818) |
| Borrowings on long-term line of credit | 34,211 | 83,335 |
| Payments on long-term line of credit | (47,401) | (11,800) |
| Excess tax benefit related to share-based payment arrangements | 200 | 1,723 |
| Common stock issued | 4,949 | 9,811 |
| Common stock retired | | - (59,528) |
| Cash dividends paid | (11,308) | (11,376) |
| Net cash provided by (used in) financing activities | (20,344) | 11,347 |
| Effect of exchange rate changes on cash | 534 | (768) |
| Net increase (decrease) in cash and cash equivalents | 2,680 | 1,856 |

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| | | | |
|---------------------------|--------|--------|----------|
| Cash and cash equivalents | | | |
| Beginning of year | 12,119 | | 4,922 |
| End of period | \$ | 14,799 | \$ 6,778 |

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 27, 2009 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 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 March 27, 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.

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

| | Thirteen Weeks Ended | |
|--|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net earnings available to common shareholders | \$ 2,768 | \$ 35,566 |
| Weighted average shares outstanding for basic earnings per share | 59,638 | 61,254 |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 265 | 663 |

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| | | |
|--|---------|---------|
| Weighted average shares outstanding for diluted earnings per share | 59,903 | 61,917 |
| Basic earnings per share | \$ 0.05 | \$ 0.58 |
| Diluted earnings per share | \$ 0.05 | \$ 0.57 |

Stock options to purchase 4,034,000 and 2,215,000 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 thirteen weeks ended March 27, 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 | 1,111 | 20.78 | | |
| Exercised | (52) | 6.98 | | |
| Canceled | (45) | 33.27 | | |
| Outstanding, March 27, 2009 | 4,969 | \$ 28.76 | 2,494 | \$ 27.41 |

The aggregate intrinsic value of exercisable option shares was \$3.4 million as of March 27, 2009, with a weighted average contractual term of 4.7 years. There were approximately 4.9 million share options vested and expected to vest as of March 27, 2009, with an aggregate intrinsic value of \$3.4 million, a weighted average exercise price of \$28.76 and a weighted average contractual term of 6.8 years.

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

| | Thirteen Weeks Ended | |
|---------------------------|----------------------|----------------|
| | March 27, 2009 | March 28, 2008 |
| Cash received | \$ 360 | \$ 3,329 |
| Aggregate intrinsic value | 679 | 4,134 |
| Tax benefit realized | 250 | 1,500 |

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The Company recognized year-to-date share-based compensation of \$2.4 million in 2009 and \$2.6 million in 2008. As of March 27, 2009, there was \$11.4 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:

| | Thirteen Weeks Ended | |
|---------------------------------------|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Expected life in years | 6.0 | 6.0 |
| Interest rate | 2.1% | 3.1% |
| Volatility | 29.9% | 25.0% |
| Dividend yield | 3.7% | 2.1% |
| Weighted average fair value per share | \$ 4.25 | \$ 8.32 |

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:

| | Thirteen Weeks Ended | |
|---------------------------------------|----------------------|-------------------|
| | March 27, 2009 | March 28, 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 | |
|------------------------------------|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Pension Benefits | | |
| Service cost | \$ 1,279 | \$ 1,391 |
| Interest cost | 3,220 | 3,146 |
| Expected return on assets | (2,700) | (4,850) |
| Amortization and other | 2,414 | 152 |
| Net periodic benefit cost (credit) | \$ 4,213 | \$ (161) |

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Postretirement Medical

| | | | | |
|------------------------------------|-----|-----|-----|-----|
| Service cost | \$ | 150 | \$ | 125 |
| Interest cost | 350 | | 375 | |
| Amortization | | - | | - |
| Net periodic benefit cost (credit) | \$ | 500 | \$ | 500 |

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

| | Thirteen Weeks Ended | |
|--|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net earnings | \$ 2,768 | \$ 35,566 |
| Cumulative translation adjustment | 234 | (5) |
| Pension and postretirement medical liability adjustment | 2,329 | 124 |
| Gain (loss) on interest rate hedge contracts | (73) | (2,775) |
| Income taxes | (836) | 977 |
| Comprehensive income | \$ 4,422 | \$ 33,887 |

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

| | March 27, 2009 | December 26, 2008 |
|---|-------------------|----------------------|
| Pension and postretirement medical liability adjustment | \$ (68,855) | \$ (70,322) |
| Gain (loss) on interest rate hedge contracts | (3,156) | (3,109) |
| Cumulative translation adjustment | (823) | (1,057) |
| Total | \$ (72,834) | \$ (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 weeks ended March 27, 2009 and March 28, 2008 were as follows (in thousands):

| | Thirteen Weeks Ended | |
|------------------|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net Sales | | |
| Industrial | \$ 75,232 | \$ 114,251 |

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| | | |
|--------------|------------|------------|
| Contractor | 47,448 | 66,180 |
| Lubrication | 15,200 | 23,689 |
| Consolidated | \$ 137,880 | \$ 204,120 |

Operating Earnings

| | | |
|---------------------------------|-----------|-----------|
| Industrial | \$ 11,495 | \$ 37,898 |
| Contractor | 1,239 | 13,696 |
| Lubrication | (1,436) | 4,317 |
| Unallocated corporate (expense) | (5,169) | (3,557) |
| Consolidated | \$ 6,129 | \$ 52,354 |

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

| | March 27, 2009 | December 26, 2008 |
|---|-------------------|----------------------|
| Finished products and components | \$ 49,779 | \$ 50,703 |
| Products and components in various stages of completion | 32,070 | 24,938 |
| Raw materials and purchased components | 39,130 | 51,348 |
| | 120,979 | 126,989 |
| Reduction to LIFO cost | (35,402) | (35,385) |
| Total | \$ 85,577 | \$ 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 |
|---|------------------------------|------------------|-----------------------------|------------------------------------|---------------|
| March 27, 2009 | | | | | |
| Customer relationships | 3 - 8 | \$ 41,075 | \$ (14,017) | \$ (181) | \$ 26,877 |
| Patents, proprietary technology and product documentation | 3 - 15 | 22,737 | (11,153) | (87) | 11,497 |
| Trademarks, trade names and other | 3 - 10 | 5,514 | (4,290) | (11) | 1,213 |
| | | 69,326 | (29,460) | (279) | 39,587 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 9,810 | - | - | 9,810 |
| Total | | \$ 79,136 | \$ (29,460) | \$ (279) | \$ 49,397 |
| December 26, 2008 | | | | | |
| Customer relationships | 3 - 8 | \$ 41,075 | \$ (12,470) | \$ (181) | \$ 28,424 |

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| | | | | | |
|--|--------|-----------|-------------|----------|-----------|
| 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 |

Amortization of intangibles was \$2.8 million in the first quarter of 2009. Estimated annual amortization expense is as follows: \$10.7 million in 2009, \$9.7 million in 2010, \$8.6 million in 2011, \$7.7 million in 2012, \$4.1 million in 2013 and \$1.6 million thereafter.

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

| | March 27, 2009 | December 26, 2008 |
|--|-------------------|----------------------|
| Accrued self-insured retentions | \$ 7,967 | \$ 7,896 |
| Accrued warranty and service liabilities | 7,677 | 8,033 |
| Accrued trade promotions | 5,348 | 9,001 |
| Payable for employee stock purchases | 619 | 5,473 |
| Income taxes payable | 965 | 904 |
| Other | 26,334 | 24,217 |
| Total | \$ 48,910 | \$ 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):

| | Thirteen Weeks Ended March 27, 2009 | Year Ended December 26, 2008 |
|--------------------------------|--|------------------------------------|
| Balance, beginning of year | \$ 8,033 | \$ 7,084 |
| Charged to expense | 1,078 | 6,793 |
| Margin on parts sales reversed | 902 | 3,698 |
| Reductions for claims settled | (2,336) | (9,542) |
| Balance, end of period | \$ 7,677 | \$ 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.

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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 \$0.6 million in the first quarter 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 March 27, 2009, with notional amounts totaling \$15.6 million. There were 26 contracts outstanding during all or part of the first quarter of 2009, with net gains of \$0.4 million partially offsetting \$0.6 million of exchange losses 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:

| | Balance Sheet Classification | March 27, 2009 | December 26, 2008 |
|----------------------------|---------------------------------|-------------------|----------------------|
| Gain (loss) on interest | | | |
| rate hedge contracts | Other current liabilities | \$ (5,009) | \$ (4,936) |
| Gain (loss) on foreign | | | |
| currency forward contracts | | | |
| Gains | | 706 | 1,868 |
| Losses | | (555) | (670) |
| Net | Accounts receivable | 151 | 1,198 |

11. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." This statement establishes a consistent framework for measuring fair value and expands disclosures on fair market value measurements. SFAS No. 157 was effective for the Company starting in fiscal 2008 for financial assets and liabilities. With respect to non-financial assets and liabilities, the statement was effective for the Company starting in fiscal 2009. The adoption of this statement as it pertains to non-financial assets and liabilities had no significant impact on the consolidated financial statements.

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 | | | % Change |
|---------------------------------------|----------------------|-------------------|-------|-------------|
| | March 27, 2009 | March 28, 2008 | | |
| Net Sales | \$ 137.9 | \$ 204.1 | (32)% | |
| Net Earnings | \$ 2.8 | \$ 35.6 | (92)% | |
| Diluted Net Earnings per Common Share | \$ 0.05 | \$ 0.57 | (91)% | |

Operating results were severely affected by the depth of the recession and its impact on the markets served by the Company. Sales and orders decreased in all segments and regions. Currency translation had an unfavorable effect on sales (\$6 million) and net earnings (\$2 million). The Company recorded \$4 million of cost related to an additional workforce reduction in March, as part of continued efforts to align operations with market and economic conditions.

Consolidated Results

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

| | Thirteen Weeks Ended | |
|-----------------------|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Americas ¹ | \$ 80.2 | \$ 115.8 |
| Europe ² | 35.8 | 59.5 |
| Asia Pacific | 21.9 | 28.8 |
| Consolidated | \$ 137.9 | \$ 204.1 |

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

² Europe, Africa and Middle East

Consolidated sales decreased 32 percent (29 percent at consistent exchange rates). Sales decreased 31 percent in the Americas, 40 percent in Europe (32 percent at consistent exchange rates) and 24 percent in Asia Pacific.

Gross profit margin, expressed as a percentage of sales, was 46.7 percent, down from 54.8 percent last year, due to lower production volumes (approximately 4 percentage points), unfavorable currency translation rates (approximately 2 percentage points), workforce reduction costs (approximately 1½ percentage points) and increased pension cost (approximately 1 percentage point).

Total operating expenses were slightly lower than last year. Product development expense increased by \$2 million as continued investment in new and improved products is a key component of the Company's strategy for future growth. Offsetting this increase was a decrease of \$2 million from translation effects. Increases in pension expense (\$3 million) and severance expense related to the additional workforce reduction in 2009 (\$1 million) were offset by the effects of the work force reduction in the fourth quarter of 2008, lower incentive and bonus provisions and other spending reductions.

The effective tax rate of 34 percent for the first quarter was higher than last year's first quarter rate of 30 percent due to the settlement of the examination of the Company's income tax returns in the first quarter of 2008.

Segment Results

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

Industrial

| | Thirteen Weeks Ended | |
|---|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net sales (in millions) | | |
| Americas | \$ 35.8 | \$ 53.4 |
| Europe | 23.8 | 39.7 |
| Asia Pacific | 15.6 | 21.2 |
| Total | \$ 75.2 | \$ 114.3 |
| Operating earnings as a percentage of net sales | 15% | 33% |

Industrial segment sales decreased 33 percent in the Americas, 40 percent in Europe (32 percent at consistent translation rates) and 27 percent in Asia Pacific.

The impacts of low factory volume, workforce reduction costs, currency translation and increased product development spending contributed to the decrease in operating earnings as a percentage of sales.

Contractor

| | Thirteen Weeks Ended | |
|---|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net sales (in millions) | | |
| Americas | \$ 31.7 | \$ 42.4 |
| Europe | 10.9 | 18.0 |
| Asia Pacific | 4.8 | 5.8 |
| Total | \$ 47.4 | \$ 66.2 |
| Operating earnings as a percentage of net sales | 3% | 21% |

Contractor segment sales decreased 25 percent in the Americas, 40 percent in Europe (31 percent at consistent translation rates) and 17 percent in Asia Pacific.

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The impacts of low factory volume, channel sales mix, workforce reduction costs, currency translation and increased product development spending contributed to the decrease in operating earnings as a percentage of sales. This segment continued to incur expenses related to the rollout of entry-level paint sprayers to additional paint and home center stores in 2009.

Lubrication

| | Thirteen Weeks Ended | |
|---|----------------------|-------------------|
| | March 27, 2009 | March 28, 2008 |
| Net sales (in millions) | | |
| Americas | \$ 12.6 | \$ 20.1 |
| Europe | 1.1 | 1.9 |
| Asia Pacific | 1.5 | 1.7 |
| Total | \$ 15.2 | \$ 23.7 |
| Operating earnings as a percentage of net sales | (9)% | 18% |

Lubrication segment sales decreased 37 percent in the Americas, 43 percent in Europe (39 percent at consistent translation rates) and 15 percent in Asia Pacific.

The impacts of low factory volume, product sales mix, workforce reduction costs, increased product development spending and costs related to discontinued products contributed to the decrease in operating earnings as a percentage of sales.

Liquidity and Capital Resources

In the first quarter of 2009, the Company used cash to reduce the borrowings under its long-term line of credit by \$13 million and paid dividends of \$11 million. Significant uses of cash and borrowings in the first quarter of 2008 included \$60 million for purchases and retirement of Company common stock, \$35 million for a business acquisition and \$11 million for payment of dividends.

Since the end of 2008, inventories have been reduced by \$6 million. Accounts receivable decreased by \$21 million from continuing collections and lower sales levels.

At March 27, 2009, the Company had various lines of credit totaling \$279 million, of which \$98 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

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Management expects that global economic conditions will continue to present a challenging operating environment in the near term. Workforce reductions initiated in 2008 and the further reduction announced in March of 2009 were made to align operations with market conditions and are expected to yield \$18 million in annualized savings. To the extent permitted by working capital resources, management intends to protect its human capital and continue making targeted investments in strategic operating and growth initiatives, including new product development, improving manufacturing efficiencies, expanding distribution and entering new markets.

Working capital management will continue to be a high priority for the remainder of 2009. The Company plans to reduce inventory by an additional \$25 million. Additional focus will be on collection of receivables over their normal cycle. Given the uncertainty in world economies and the possibility of continued weakness in markets served, the Company is considering cost-effective alternative liquidity options.

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 expires on September 30, 2009.

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.

No shares were purchased in the first quarter of 2009. As of March 27, 2009, there were 3,068,234 shares that may yet be purchased under the Board authorization.

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

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

Date: _____ By: James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

Date: _____ By: Caroline M. Chambers
Vice President and Controller
(Principal Accounting Officer)