

**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 **June 29, 2007**

Commission File Number: 001-9249

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

Large Accelerated Filer X Accelerated Filer Non-accelerated Filer

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

Yes No X

65,286,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of July 18, 2007.

GRACO INC. AND SUBSIDIARIES

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PART I

Item I.

GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

(In thousands except per share amounts)

| | Thirteen Weeks Ended | | Twenty-six Weeks Ended | |
|---|----------------------|------------------|------------------------|------------------|
| | June 29, 2007 | June 30, 2006 | June 29, 2007 | June 30, 2006 |
| Net Sales | \$ 231,384 | \$ 218,632 | \$ 428,879 | \$ 410,848 |
| Cost of products sold | <u>109,152</u> | <u>101,686</u> | <u>201,785</u> | <u>190,675</u> |
| Gross Profit | 122,232 | 116,946 | 227,094 | 220,173 |
| Product development | 7,544 | 7,538 | 15,816 | 14,750 |
| Selling, marketing and distribution | 31,917 | 30,524 | 61,180 | 58,466 |
| General and administrative | <u>15,057</u> | <u>15,056</u> | <u>30,297</u> | <u>28,477</u> |
| Operating Earnings | 67,714 | 63,828 | 119,801 | 118,480 |
| Interest expense | 642 | 189 | 900 | 314 |
| Other expense (income), net | <u>92</u> | <u>4</u> | <u>(14)</u> | <u>9</u> |
| Earnings Before Income Taxes | 66,980 | 63,635 | 118,915 | 118,157 |
| Income taxes | <u>22,800</u> | <u>22,300</u> | <u>41,000</u> | <u>41,400</u> |
| Net Earnings | <u>\$ 44,180</u> | <u>\$ 41,335</u> | <u>\$ 77,915</u> | <u>\$ 76,757</u> |
| Basic Net Earnings per Common Share | \$ 0.67 | \$ 0.61 | \$ 1.17 | \$ 1.12 |
| Diluted Net Earnings per Common Share | \$ 0.66 | \$ 0.60 | \$ 1.16 | \$ 1.11 |
| Cash Dividends Declared per Common Share | \$ 0.17 | \$ 0.15 | \$ 0.33 | \$ 0.29 |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)
(In thousands)

| | <u>June 29, 2007</u> | <u>Dec. 29, 2006</u> |
|--|--------------------------|--------------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 4,689 | \$ 5,871 |
| Accounts receivable, less allowances of \$6,300 and \$5,800 | 159,874 | 134,105 |
| Inventories | 81,833 | 76,311 |
| Deferred income taxes | 21,883 | 20,682 |
| Other current assets | 2,039 | 2,014 |
| Total current assets | <u>270,318</u> | <u>238,983</u> |
| Property, Plant and Equipment | | |
| Cost | 295,848 | 278,318 |
| Accumulated depreciation | (159,166) | (153,794) |
| Total property, plant and equipment, net | <u>136,682</u> | <u>124,524</u> |
| Prepaid Pension | 28,503 | 26,903 |
| Goodwill | 67,206 | 67,174 |
| Other Intangible Assets, net | 46,157 | 50,325 |
| Other Assets | 4,845 | 3,694 |
| Total Assets | <u><u>\$ 553,711</u></u> | <u><u>\$ 511,603</u></u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Notes payable to banks | \$ 65,168 | \$ 18,363 |
| Trade accounts payable | 31,330 | 27,442 |
| Salaries, wages and commissions | 16,132 | 26,303 |
| Dividends payable | 10,841 | 11,055 |
| Other current liabilities | 39,594 | 45,766 |
| Total current liabilities | <u>163,065</u> | <u>128,929</u> |
| Retirement Benefits and Deferred Compensation | 38,023 | 36,946 |
| Uncertain Tax Positions | 6,100 | - |
| Deferred Income Taxes | 11,651 | 14,724 |
| Shareholders' Equity | | |
| Common stock | 65,633 | 66,805 |
| Additional paid-in-capital | 154,186 | 130,621 |
| Retained earnings | 119,982 | 138,702 |
| Accumulated other comprehensive income (loss) | | |
| Cumulative translation adjustment | 54 | (60) |
| Pension liability adjustment | (4,983) | (5,064) |
| Total shareholders' equity | <u>334,872</u> | <u>331,004</u> |
| Total Liabilities and Shareholders' Equity | <u><u>\$ 553,711</u></u> | <u><u>\$ 511,603</u></u> |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

| | Twenty-six Weeks Ended | |
|---|------------------------|------------------|
| | June 29, 2007 | June 30, 2006 |
| Cash Flows From Operating Activities | | |
| Net Earnings | \$ 77,915 | \$ 76,757 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation and amortization | 13,994 | 12,093 |
| Deferred income taxes | (4,312) | (2,850) |
| Share-based compensation | 4,351 | 4,637 |
| Excess tax benefit related to share-based payment arrangements | (3,848) | (2,400) |
| Change in: | | |
| Accounts receivable | (24,733) | (13,780) |
| Inventories | (5,358) | (10,147) |
| Trade accounts payable | 1,465 | 2,411 |
| Salaries, wages and commissions | (10,313) | (5,178) |
| Retirement benefits and deferred compensation | (713) | 139 |
| Other accrued liabilities | (1,270) | 2,625 |
| Uncertain tax positions | 6,100 | - |
| Other | (114) | 220 |
| Net cash provided by operating activities | <u>53,164</u> | <u>64,527</u> |
| Cash Flows From Investing Activities | | |
| Property, plant and equipment additions | (21,646) | (9,467) |
| Proceeds from sale of property, plant and equipment | 207 | 86 |
| Investment in life insurance | (1,499) | - |
| Capitalized software and other intangible asset additions | (5) | (73) |
| Net cash used in investing activities | <u>(22,943)</u> | <u>(9,454)</u> |
| Cash Flows From Financing Activities: | | |
| Borrowings on notes payable and lines of credit | 96,557 | 21,912 |
| Payments on notes payable and lines of credit | (49,812) | (23,592) |
| Excess tax benefit related to share-based payment arrangements | 3,848 | 2,400 |
| Common stock issued | 19,194 | 11,101 |
| Common stock retired | (78,470) | (45,839) |
| Cash dividends paid | (21,984) | (19,841) |
| Net cash provided by (used in) financing activities | <u>(30,667)</u> | <u>(53,859)</u> |
| Effect of exchange rate changes on cash | (736) | (1,509) |
| Net increase (decrease) in cash and cash equivalents | (1,182) | (295) |
| Cash and cash equivalents: | | |
| Beginning of year | 5,871 | 18,664 |
| End of period | <u>\$ 4,689</u> | <u>\$ 18,369</u> |

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 June 29, 2007 and the related statements of earnings for the thirteen and twenty-six weeks ended June 29, 2007 and June 30, 2006, and cash flows for the twenty-six weeks ended June 29, 2007 and June 30, 2006 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of June 29, 2007, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2006 Annual Report on Form 10-K.

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

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

| | Thirteen Weeks Ended | | Twenty-six Weeks Ended | |
|--|----------------------|------------------|------------------------|------------------|
| | June 29, 2007 | June 30, 2006 | June 29, 2007 | June 30, 2006 |
| Net earnings available to common shareholders | \$ 44,180 | \$ 41,335 | \$ 77,915 | \$ 76,757 |
| Weighted average shares outstanding for basic earnings per share | 66,045 | 68,121 | 66,356 | 68,275 |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 1,025 | 1,199 | 1,036 | 1,159 |
| Weighted average shares outstanding for diluted earnings per share | 67,070 | 69,320 | 67,392 | 69,434 |
| Basic earnings per share | \$ 0.67 | \$ 0.61 | \$ 1.17 | \$ 1.12 |
| Diluted earnings per share | \$ 0.66 | \$ 0.60 | \$ 1.16 | \$ 1.11 |

Stock options to purchase 1,228,000 and 619,000 shares are not included in the 2007 and 2006 calculations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the twenty-six weeks ended June 29, 2007 is shown below (in thousands, except per share amounts):

| | Option Shares | Weighted Average Exercise Price | Options Exercisable | Weighted Average Exercise Price |
|--------------------------------|------------------|--|------------------------|--|
| Outstanding, December 29, 2006 | 3,956 | \$ 24.79 | 2,272 | \$ 16.94 |
| Granted | 648 | 41.23 | | |
| Exercised | (652) | 18.49 | | |
| Canceled | (353) | 39.10 | | |
| Outstanding, June 29, 2007 | <u>3,599</u> | \$ 27.48 | 2,112 | \$ 20.10 |

The aggregate intrinsic value of exercisable option shares was \$42.8 million as of June 29, 2007, with a weighted average contractual term of 4.9 years. There were approximately 3.5 million vested share options and share options expected to vest as of June 29, 2007, with an aggregate intrinsic value of \$47.0 million, a weighted average exercise price of \$27.19 and a weighted average contractual term of 6.3 years.

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

| | Twenty-six Weeks Ended | |
|---------------------------|------------------------|---------------|
| | June 29, 2007 | June 30, 2006 |
| Cash received | \$ 12,046 | \$ 4,197 |
| Aggregate intrinsic value | 14,535 | 7,802 |
| Tax benefit realized | 5,300 | 2,800 |

The Company recognized year-to-date share-based compensation of \$4.4 million in 2007 and \$4.6 million in 2006. As of June 29, 2007, there was \$12.2 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.2 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:

| | Twenty-six Weeks Ended | |
|---|------------------------|---------------|
| | June 29, 2007 | June 30, 2006 |
| Expected life in years | 6.0 | 6.3 |
| Interest rate | 4.7% | 4.6% |
| Volatility | 26.1% | 27.8% |
| Dividend yield | 1.6% | 1.4% |
| Weighted average fair value per share of options granted | \$ 12.01 | \$ 12.97 |

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

| | Twenty-six Weeks Ended | |
|---|------------------------|---------------|
| | June 29, 2007 | June 30, 2006 |
| Expected life in years | 1.0 | 1.0 |
| Interest rate | 4.9% | 4.6% |
| Volatility | 24.4% | 24.0% |
| Dividend yield | 1.6% | 1.4% |
| Weighted average fair value per share of options granted | \$ 9.79 | \$ 10.18 |

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

| | Thirteen Weeks Ended | | Twenty-six Weeks Ended | |
|------------------------------------|----------------------|------------------|------------------------|------------------|
| | June 29, 2007 | June 30, 2006 | June 29, 2007 | June 30, 2006 |
| Pension Benefits | | | | |
| Service cost | \$ 1,501 | \$ 1,634 | \$ 2,980 | \$ 3,074 |
| Interest cost | 2,885 | 2,609 | 5,767 | 5,217 |
| Expected return on assets | (4,800) | (4,175) | (9,600) | (8,350) |
| Amortization and other | 291 | 100 | 546 | 292 |
| Net periodic benefit cost (credit) | <u>\$ (123)</u> | <u>\$ 168</u> | <u>\$ (307)</u> | <u>\$ 233</u> |
| Postretirement Medical | | | | |
| Service cost | \$ 150 | \$ 250 | \$ 300 | \$ 500 |
| Interest cost | 315 | 420 | 615 | 840 |
| Amortization of net loss | 623 | 79 | 573 | 265 |
| Net periodic benefit cost | <u>\$ 1,088</u> | <u>\$ 749</u> | <u>\$ 1,488</u> | <u>\$ 1,605</u> |

In June 2007, the Company paid \$1.5 million 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 informally 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 \$1.4 million is included in other assets in the consolidated balance sheet as of June 29, 2007.

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

| | Thirteen Weeks Ended | | Twenty-six Weeks Ended | |
|--|----------------------|------------------|------------------------|------------------|
| | June 29, 2007 | June 30, 2006 | June 29, 2007 | June 30, 2006 |
| Net income | \$ 44,180 | \$ 41,335 | \$ 77,915 | \$ 76,757 |
| Foreign currency translation adjustments | 121 | 1,225 | 114 | 1,740 |
| Pension liability adjustment, net of tax | 90 | (37) | 81 | (56) |
| Comprehensive income | <u>\$ 44,391</u> | <u>\$ 42,523</u> | <u>\$ 78,110</u> | <u>\$ 78,441</u> |

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 twenty-six weeks ended June 29, 2007 and June 30, 2006 were as follows (in thousands):

| | <u>Thirteen Weeks Ended</u> | | <u>Twenty-six Weeks Ended</u> | |
|---------------------------|-----------------------------|--------------------------|-------------------------------|--------------------------|
| | <u>June 29, 2007</u> | <u>June 30, 2006</u> | <u>June 29, 2007</u> | <u>June 30, 2006</u> |
| Net Sales | | | | |
| Industrial | \$ 114,281 | \$ 104,555 | \$ 219,346 | \$ 204,715 |
| Contractor | 94,231 | 96,507 | 163,982 | 170,859 |
| Lubrication | 22,872 | 17,570 | 45,551 | 35,274 |
| Consolidated | <u>\$ 231,384</u> | <u>\$ 218,632</u> | <u>\$ 428,879</u> | <u>\$ 410,848</u> |
| Operating Earnings | | | | |
| Industrial | \$ 39,555 | \$ 32,479 | \$ 73,973 | \$ 64,562 |
| Contractor | 28,619 | 29,521 | 45,646 | 50,563 |
| Lubrication | 2,196 | 4,466 | 5,260 | 9,221 |
| Unallocated corporate | (2,656) | (2,638) | (5,078) | (5,866) |
| Consolidated | <u>\$ 67,714</u> | <u>\$ 63,828</u> | <u>\$ 119,801</u> | <u>\$ 118,480</u> |

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

| | <u>June 29, 2007</u> | <u>Dec. 29, 2006</u> |
|---|----------------------|----------------------|
| Finished products and components | \$ 51,073 | \$ 44,969 |
| Products and components in various stages of completion | 26,893 | 26,841 |
| Raw materials and purchased components | <u>34,728</u> | <u>35,258</u> |
| | 112,694 | 107,068 |
| Reduction to LIFO cost | (30,861) | (30,757) |
| Total | <u>\$ 81,833</u> | <u>\$ 76,311</u> |

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

| | Estimated Life (years) | Original Cost | Accumulated Amortization | Foreign Currency Translation | Book Value |
|--|------------------------------|------------------|-----------------------------|------------------------------------|------------------|
| <u>June 29, 2007</u> | | | | | |
| Customer relationships and distribution network | 4 - 8 | \$ 26,102 | \$ (9,215) | \$ 32 | \$ 16,919 |
| Patents, proprietary technology and product documentation | 5 - 15 | 22,243 | (6,082) | 17 | 16,178 |
| Trademarks, trade names and other | 3 - 10 | <u>4,684</u> | <u>(1,908)</u> | <u>24</u> | <u>2,800</u> |
| | | 53,029 | (17,205) | 73 | 35,897 |
| Not Subject to Amortization: Brand names | | <u>10,260</u> | <u>-</u> | <u>-</u> | <u>10,260</u> |
| Total | | <u>\$ 63,289</u> | <u>\$ (17,205)</u> | <u>\$ 73</u> | <u>\$ 46,157</u> |
| <u>December 29, 2006</u> | | | | | |
| Customer relationships and distribution network | 4 - 8 | \$ 26,102 | \$ (7,335) | \$ 6 | \$ 18,773 |
| Patents, proprietary technology and product documentation | 5 - 15 | 22,243 | (4,443) | 5 | 17,805 |
| Trademarks, trade names and other | 3 - 10 | <u>5,114</u> | <u>(1,641)</u> | <u>14</u> | <u>3,487</u> |
| | | 53,459 | (13,419) | 25 | 40,065 |
| Not Subject to Amortization: Brand names | | <u>10,260</u> | <u>-</u> | <u>-</u> | <u>10,260</u> |
| Total | | <u>\$ 63,719</u> | <u>\$ (13,419)</u> | <u>\$ 25</u> | <u>\$ 50,325</u> |

Amortization of intangibles was \$2.1 million in the second quarter of 2007 and \$4.2 million year-to-date. Estimated annual amortization expense is as follows: \$8.2 million in 2007, \$7.8 million in 2008, \$6.9 million in 2009, \$5.8 million in 2010, \$4.9 million in 2011 and \$6.4 million thereafter.

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

| | <u>June 29, 2007</u> | <u>Dec. 29, 2006</u> |
|--|----------------------|----------------------|
| Accrued insurance liabilities | \$ 8,002 | \$ 7,833 |
| Accrued warranty and service liabilities | 6,405 | 6,675 |
| Accrued trade promotions | 4,706 | 7,265 |
| Payable for employee stock purchases | 2,793 | 5,846 |
| Income taxes payable | 1,177 | 3,920 |
| Other | 16,511 | 14,227 |
| Total | <u>\$ 39,594</u> | <u>\$ 45,766</u> |

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):

| | <u>Twenty-six Weeks Ended June 29, 2007</u> | <u>Year Ended Dec. 29, 2006</u> |
|--------------------------------|---|-------------------------------------|
| Balance, beginning of year | \$ 6,675 | \$ 7,649 |
| Charged to expense | 2,432 | 4,442 |
| Margin on parts sales reversed | 1,481 | 1,944 |
| Reductions for claims settled | (4,183) | (7,360) |
| Balance, end of period | <u>\$ 6,405</u> | <u>\$ 6,675</u> |

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

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

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

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

11. In July 2007, the Company entered into an agreement with a syndicate of lenders providing an unsecured credit facility for 5 years. The new credit facility provides \$250 million of unsecured committed credit with an option for an additional \$150 million. The facility is available for general corporate purposes, working capital needs, share repurchases and acquisitions. Borrowings under the facility bear interest at either the bank's prime rate, the federal funds effective rate plus 0.5 percent or the London Interbank Offered Rate plus a spread of between 0.23 percent and 0.57 percent, depending on the Company's cash flow leverage ratio (debt to earnings before interest, taxes, depreciation and amortization.) The Company is also required to pay a facility fee on the full amount of the loan commitment at an annual rate ranging from 0.07 percent to 0.15 percent, depending on the Company's cash flow leverage ratio. The agreement requires the Company to maintain certain financial ratios as to cash flow leverage and interest coverage.

Upon securing the new facility, certain committed lines of credit totaling \$50 million were terminated. Additional uncommitted lines totaling \$55 million will expire at the end of July 2007.

Item 2.**GRACO INC. AND SUBSIDIARIES**

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

Results of Operations

Net earnings of \$44.2 million for the quarter were 7 percent higher than net earnings in the second quarter last year. Sales of \$231.4 million were 6 percent higher than the same period last year. Year-to-date net earnings of \$77.9 million were 2 percent higher than last year and sales of \$428.9 million were up 4 percent. Higher sales in Europe and Asia were offset to a great extent by lower sales in the Americas.

Foreign currency translation rates had a favorable impact on sales and net earnings. Translated at consistent exchange rates, net earnings and sales for the quarter were each up 4 percent, and year-to-date net earnings and sales increased 1 percent and 3 percent, respectively.

Results include the operations of Lubriquip, which was acquired in July 2006. Sales of Lubriquip products contributed over 2 percentage points of sales growth for both the quarter and year-to-date. Year-to-date costs and expenses related to moving and consolidation activities (including the consolidation of Gusmer operations completed in the first quarter) totaled approximately \$1.5 million.

Net Sales

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

| | <u>Thirteen Weeks Ended</u> | | <u>Twenty-six Weeks Ended</u> | |
|---------------------------|-----------------------------|--------------------------|-------------------------------|--------------------------|
| | <u>June 29, 2007</u> | <u>June 30, 2006</u> | <u>June 29, 2007</u> | <u>June 30, 2006</u> |
| Net Sales | | | | |
| Industrial | \$ 114,281 | \$ 104,555 | \$ 219,346 | \$ 204,715 |
| Contractor | 94,231 | 96,507 | 163,982 | 170,859 |
| Lubrication | 22,872 | 17,570 | 45,551 | 35,274 |
| Consolidated | <u>\$ 231,384</u> | <u>\$ 218,632</u> | <u>\$ 428,879</u> | <u>\$ 410,848</u> |
| By Geographic Area | | | | |
| Americas ¹ | \$ 141,482 | \$ 144,371 | \$ 262,027 | \$ 276,583 |
| Europe ² | 58,667 | 45,355 | 108,045 | 84,901 |
| Asia Pacific | 31,235 | 28,906 | 58,807 | 49,364 |
| Consolidated | <u>\$ 231,384</u> | <u>\$ 218,632</u> | <u>\$ 428,879</u> | <u>\$ 410,848</u> |

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

² Europe, Africa and Middle East

Industrial segment sales increased 9 percent for the quarter and 7 percent year-to-date. For the quarter, segment sales were up in all geographic regions, with 28 percent growth in Europe. Year-to-date, a 5 percent decrease in the Americas was more than offset by double-digit percentage growth in Europe and Asia.

Contractor segment sales decreased 2 percent for the quarter and 4 percent year-to-date. Strong increases in Europe and Asia were not enough to offset the decrease in the Americas. Most of the decrease in the Americas for the quarter resulted from lower sales to the home center channel. Year-to-date, sales were down in both the home center and the professional paint store channels.

Lubrication segment sales increased 30 percent for the quarter and 29 percent year-to-date due to sales of Lubriquip products, acquired in mid-2006. Sales in this segment increased in all geographic areas.

Gross Profit

Gross profit as a percentage of sales was 52.8 percent for the quarter compared to 53.5 percent for the second quarter last year. Year-to-date gross profit percentage was 53.0 percent in 2007 compared to 53.6 percent in 2006. The decrease for both the quarter and year-to-date was due mainly to lower margin rates on Lubriquip products, consolidation costs and higher material costs, offset somewhat by the favorable impacts of currency translation and pricing.

Operating Expenses

Total operating expenses for the quarter increased 3 percent. Product development and general and administrative expenses were flat while higher selling, marketing and distribution spending was in line with the sales increase. Year-to-date operating expenses increased 6 percent, mostly due to expenses related to Lubriquip.

Income Taxes

The effective income tax rate of 34 percent for the quarter was 1 percentage point lower than last year's rate due to the recognition of benefits from foreign entities.

Liquidity and Capital Resources

Significant uses of cash in the first half of 2007 included \$78 million for purchases and retirement of Company common stock, \$22 million for capital additions and \$22 million for payment of dividends. The largest sources of cash in the first half of 2007 were from operations and borrowings. During the first half of 2006, significant uses of cash included \$46 million for purchases and retirement of Company common stock, \$9 million for capital additions and \$20 million for dividends. The largest source of cash in the first half of 2006 was from operations.

At June 29, 2007, the Company had various lines of credit totaling \$148 million, of which \$86 million was unused. In July 2007, the Company entered into an agreement with a syndicate of lenders providing \$250 million of unsecured committed credit with an option for an additional \$150 million. Upon securing the new facility, certain committed lines of credit totaling \$50 million were terminated. Additional uncommitted lines totaling \$55 million will expire at the end of July 2007.

The Company intends to use the new credit facility for general corporate purposes including acquisitions and share repurchases. The Company has authorization from its Board of Directors to repurchase up to 7 million shares of common stock. As of June 29, 2007, 3 million shares remained available for purchase under this authorization, which expires on February 29, 2008.

Internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

Outlook

While encouraged about the continued strength of the Company's international business and the improvement in the Industrial business in the second quarter, management believes that difficult conditions will persist for the Contractor business in the Americas for at least the rest of this year. The integration of Lubriquip is on track for completion by the end of the year and the consolidation of Gusmer operations was completed in the first quarter. These integration activities will improve the contribution of the acquired products. Management believes it can continue to drive the business to higher sales and earnings by making long-term investments in key growth strategies including new product development, expanding distribution, entering new markets and pursuing strategic acquisitions.

SAFE HARBOR CAUTIONARY STATEMENT

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

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's 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 2006 Annual Report on Form 10-K.

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

Issuer Purchases of Equity Securities

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

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

Information on issuer purchases of equity securities follows:

| 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) |
|-----------------------------|---|---------------------------------------|--|--|
| Mar 31, 2007 – Apr 27, 2007 | 59,900 | \$ 39.67 | 59,900 | 4,414,700 |
| Apr 28, 2007 – May 25, 2007 | 842,063 | \$ 39.43 | 838,900 | 3,575,800 |
| May 26, 2007 – Jun 29, 2007 | 541,000 | \$ 40.15 | 541,000 | 3,034,800 |

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

At the Annual Meeting of Shareholders held on April 20, 2007, three directors were elected to the Board of Directors with the following votes:

| | <u>For</u> | <u>Withheld</u> |
|---------------------|------------|-----------------|
| J. Kevin Gilligan | 58,434,030 | 1,651,530 |
| Mark H. Rauenhorst | 58,414,542 | 1,671,019 |
| William G. Van Dyke | 52,699,744 | 7,385,817 |

At the same meeting, the following proposals were voted upon and approved, with the votes on each proposal as indicated below:

Ratification of Appointment of Deloitte & Touche LLP as the Independent Registered Public Accounting Firm:

| <u>For</u> | <u>Against</u> | <u>Abstentions</u> | <u>Broker Non-Vote</u> |
|------------|----------------|--------------------|------------------------|
| 58,078,860 | 1,873,902 | 132,799 | - |

Approval of the Executive Officer Annual Incentive Bonus Plan:

| <u>For</u> | <u>Against</u> | <u>Abstentions</u> | <u>Broker Non-Vote</u> |
|------------|----------------|--------------------|------------------------|
| 56,263,012 | 1,965,172 | 1,857,377 | - |

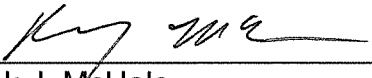
Item 6. Exhibits

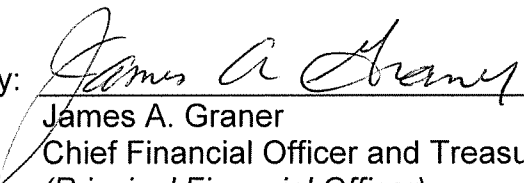
- 3.1 Restated Articles of Incorporation as amended June 14, 2007.
- 4.1 Credit Agreement dated April 1, 2006, between the Company and Wachovia Bank, N.A. (Promissory Note); as extended by letter from Wachovia Bank, N.A. to Graco Inc., dated May 23, 2007.
- 10.1 Graco Inc. Executive Officers Annual Incentive Bonus Plan effective January 1, 2008. (Incorporated by reference to Appendix A to the Company's Proxy Statement for the Annual Meeting of Shareholders held on April 20, 2007.)
- 10.2 Deferred Compensation Plan (1992 Restatement) Amendment 4 adopted June 14, 2007.
- 10.3 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Graco Inc. Amended and Restated Stock Incentive Plan (2006).
- 10.4 Election form. Amended form of agreement used for the 2006 plan year issuance of stock or deferred stock in lieu of cash payment of retainer and/or meeting fees to nonemployee directors under the Graco Inc. Stock Incentive Plan.
- 10.5 Election form. Form of agreement used for the 2007 plan year for issuance of stock or deferred stock in lieu of cash payment of retainer and/or meeting fees to nonemployee directors under the Graco Inc. Amended and Restated Stock Incentive Plan (2006).
- 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: 7/25/07 By: 
Patrick J. McHale
President and Chief Executive Officer
(Principal Executive Officer)

Date: July 25, 2007 By: 
James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

**RESTATED ARTICLES OF INCORPORATION
OF
GRACO INC.**

(Approved by the Board of Directors of Graco Inc. on June 14, 2007)

ARTICLE I

1. The name of this corporation shall be Graco Inc.

ARTICLE 2

2. Corporation Service Company, is this Corporation's registered agent in the State of Minnesota, and Suite 418, 380 Jackson Street, St. Paul, Minnesota 55101, the business office address of Corporation Service Company, is the registered office of this Corporation.

ARTICLE 3

3. Any action required or permitted to be taken at a meeting of the Board of Directors of this corporation not needing approval by the shareholders under Minnesota Statutes, Chapter 302A, may be taken by written action signed by the number of directors that would be required to take such action at a meeting of the Board of Directors at which all directors are present.

ARTICLE 4

4.1(a) The total number of shares which this corporation shall be authorized to issue is One Hundred Million Twenty-two Thousand Five Hundred Forty-nine (100,022,549) shares of which Ninety-seven Million (97,000,000) shares of the par value of \$1.00 per share shall be Common Shares, Three Million (3,000,000) shares of the par value of \$1.00 per share shall be Preferred Shares and Twenty-two Thousand Five Hundred Forty-nine (22,549) shares of the par value of \$100.00 per share shall be Cumulative Preferred Shares.

(b) Preferred Shares may be issued from time to time in one or more series as the Board of Directors may determine, as hereinafter provided. The Board of Directors is hereby authorized by resolution or resolutions, to provide from time to time for series of Preferred Shares out of the unissued Preferred Shares not then allocated to any series of Preferred Shares. Before any shares of any such series are issued, the Board of Directors shall fix and determine, and is hereby expressly empowered to fix and determine, by resolution or resolutions,

the designations and the relative rights and preferences thereof, of the shares of such series. Preferred Shares will be senior to the Cumulative Preferred Shares in terms of dividend and liquidation rights unless the Board of Directors specifically provides otherwise in the resolution or resolutions establishing a series of Preferred Shares.

The Board of Directors is expressly authorized to vary the provisions relating to the foregoing matters among the various series of Preferred Shares.

Preferred Shares of any series that shall be issued and thereafter acquired by the corporation through purchase, redemption (whether through the operation of a sinking fund or otherwise), conversion, exchange or otherwise, shall, upon appropriate filing and recording to the extent required by law, have the status of authorized and unissued Preferred Shares and may be reissued as part of such series or as part of any other series of Preferred Shares. Unless otherwise provided in the resolution or resolutions of the Board of Directors providing for the issue thereof, the number of authorized shares of any series of Preferred Shares may be increased or decreased (but not below the number of shares thereof then outstanding) by resolution or resolutions of the Board of Directors and appropriate filing and recording to the extent required by law. In case the number of shares of any such series of Preferred Shares shall be decreased, the shares representing such decrease shall, unless otherwise provided in the resolution or resolutions of the Board of Directors providing for the issuance thereof, resume the status of authorized but unissued Preferred Shares, undesignated as to series.

4.2 The designations, relative rights, voting powers, preferences and restrictions granted to or imposed upon the Common Shares and Cumulative Preferred Shares, which shall be subject to the rights granted to any series of Preferred Shares in the resolutions authorizing the series, are as follows:

(a) *Voting.* Except as expressly set forth in sub-division (f) below and except as otherwise provided in the resolutions authorizing any series of Preferred Shares or by law, the holders of Common Shares shall have the sole voting rights of shareholders of the corporation and shall be entitled to one vote for each share held. The shareholders of the corporation shall have no right to cumulate votes for the election of directors.

(b) *No Pre-emptive Rights.* Except as provided in the resolutions authorizing any series of Preferred Shares, no holders of any share of stock of any class of this corporation shall have any pre-emptive right to subscribe to any issue of shares of any class of this corporation now or hereafter authorized or any security hereafter issued by this corporation convertible into shares of this corporation.

(c) *Dividends.* The holders of Cumulative Preferred Shares shall be entitled to receive out of any assets legally available therefor, when and as declared by the Board of Directors, fixed cumulative dividends at the rate of five percent (5%) per annum upon the par value thereof, and no more, payable

semiannually on January 1 and July 1 of each year. Such dividends shall be cumulative from January 1, 1969.

In no event shall any dividend be paid or declared (other than dividends payable in Common Shares of any class), nor shall any distribution be made on the Common Shares of any class of the corporation, nor shall any Common Shares of any class be purchased, redeemed or otherwise acquired by the corporation for value unless all dividends on the Cumulative Preferred Shares for all past semiannual dividend periods and for the then current semiannual dividend period shall have been paid, or declared and a sum sufficient for the payment thereof set apart for payment.

Subject to the provisions of this Article 4 and not otherwise, dividends may be declared by the Board of Directors and paid from time to time, out of any funds legally available therefor, upon the Common Shares, and the holders of Cumulative Preferred Shares shall not be entitled to participate in any such dividends.

(d) *Redemption.* The Cumulative Preferred Shares of the corporation may be redeemed as a whole at any time or in part from time to time at the option of the corporation by resolution of the Board of Directors at the redemption price of \$105 per share together with an amount equal to all accrued and unpaid cumulative dividends thereon from the date on which dividends thereon became cumulative to the redemption date. If less than all of the outstanding Cumulative Preferred Shares are to be redeemed, the shares to be redeemed shall be selected by the Board of Directors or by a person appointed for such purpose by the Board of Directors.

Notice of every redemption of Cumulative Preferred Shares shall be mailed addressed to the holders of record of the shares to be redeemed at their respective addresses as they appear on the stock books of the corporation not less than thirty (30) and not more than sixty (60) days prior to the date fixed for redemption.

If notice of redemption shall have been duly given as aforesaid and if on or before the redemption date specified in the notice, all funds necessary for the redemption shall have been deposited in trust with a bank or trust company in good standing and doing business at any place within the United States, and designated in the notice of redemption, for the pro rata benefit of the shares so called for redemption, so as to be and continue to be available therefor, then, from and after the date of such deposit, notwithstanding that any certificate for Cumulative Preferred Shares so called for redemption shall not have been surrendered for cancellation, the shares represented thereby shall no longer be deemed outstanding, and the dividends thereon shall cease to accumulate from and after the date fixed for redemption, and all rights with respect to the Cumulative Preferred Shares so called for redemption shall forthwith, on the date of such deposit, cease and terminate except only the right of the holders thereof to receive the redemption price of the shares so redeemed, including accrued

cumulative dividends to the redemption date, but without interest. Any funds deposited by the corporation pursuant to this paragraph and unclaimed at the end of six (6) years after the date fixed for redemption shall be repaid to the corporation upon its request expressed in a resolution of its Board of Directors, after which repayment the holders of the shares so called for redemption shall look only to the corporation for the payment thereof.

(e) *Dissolution, Liquidation, etc.* In the event of any dissolution, liquidation or winding up of the affairs of the corporation, before any distribution or payment shall be made to the holders of Common Shares, the holders of the Cumulative Preferred Shares shall be entitled to be paid in full the par value thereof if such liquidation, dissolution or winding up shall be involuntary, and the sum of \$105 per share if such liquidation, dissolution or winding up shall be voluntary, together, in either event, with a sum, in the case of each share, equal to the cumulative accrued and unpaid dividends thereon to the date fixed for such distribution or payment. If such distribution or payment shall have been made to the holders of the Cumulative Preferred Shares or moneys made available for such payment in full, the remaining assets and funds of the corporation shall be distributed ratably to the holders of the Common Shares. If there shall be insufficient assets to make full payment to the holders of Cumulative Preferred Shares as above provided, the assets of the corporation shall be distributed among the holders of Cumulative Preferred Shares ratably. Except as herein otherwise expressly provided, the Cumulative Preferred Shares shall not be entitled to participate in any of the profits, surplus or assets of the corporation. The consolidation or merger of the corporation into or with any other corporation or corporations pursuant to the statutes of the State of Minnesota shall not be deemed a liquidation, dissolution or winding up of the affairs of the corporation within the meaning of any of the provisions of this paragraph.

(f) *Special Voting Rights.* The holders of Cumulative Preferred Shares shall not be entitled as such to vote at any meeting of the shareholders of the corporation except as required by law or as hereinafter otherwise provided.

(i) If an amendment to the Articles of Incorporation of the corporation would adversely affect the rights of the holders of Cumulative Preferred Shares, then in addition to the vote thereon by the holders of the Common Shares, the holders of Cumulative Preferred Shares shall be entitled to vote separately as a class thereon, and such amendment shall be adopted only if it receives the affirmative vote of the holders of a majority of the Cumulative Preferred Shares.

(ii) After an amount equivalent to three (3) full semi-annual dividend installments of the Cumulative Preferred Shares shall be in default, the holders of Cumulative Preferred Shares at the time outstanding, voting separately as a class shall, at any annual meeting of the shareholders or any special meeting of the shareholders called as herein provided occurring during such

period, elect two (2) members of the Board of Directors, and the holders of the Common Shares, voting separately as a class, shall elect the remaining directors of the corporation.

(iii) After an amount equivalent to six (6) full semi-annual dividend installments of the Cumulative Preferred Shares shall be in default, the holders of Cumulative Preferred Shares, voting separately as a class, shall, at any annual meeting of the shareholders or any special meeting of the shareholders called as herein provided occurring during such period, elect the smallest number of directors necessary to constitute a majority of the full Board of Directors, and the holders of the Common Shares, voting separately as a class, shall elect the remaining directors of the corporation.

At any annual meeting or special meeting of shareholders for the election of directors occurring after all cumulative dividends then in default on the Cumulative Preferred Shares then outstanding, including the dividend for the then current semi-annual period, shall have been paid, or declared and set apart for payment, the Cumulative Preferred Shares shall thereupon be divested of any rights with respect to the election of directors as above provided, but always subject to the same provisions for the revesting of such voting power in the Cumulative Preferred Shares in the case of a future like default or defaults in dividends on Preferred Shares.

Voting power for the election of directors vested in the holders of the Cumulative Preferred Shares as above provided may be exercised at any annual meeting of shareholders or at a special meeting of shareholders held for such purpose, which special meeting of shareholders shall be called by the proper officers of the corporation at any time when such voting power shall be vested within twenty (20) days after written request therefor signed by the holder or holders of not less than ten percent (10%) of the Cumulative Preferred Shares then outstanding, the date of such special meeting to be not more than twenty (20) days from the date of giving notice thereof, and such notice shall be given to all holders of Cumulative Preferred Shares and Common Shares not less than ten (10) days prior to said meeting. In each such case such notice shall direct attention to the voting rights of the holders of Cumulative Preferred Shares. At any such meeting the presence in person or by proxy of the holders of a majority of the Cumulative Preferred Shares outstanding shall be required to constitute a quorum for the election of directors whom the holders of Cumulative Preferred Shares are entitled to elect and, likewise, the presence in person or by proxy of the holders of a majority of the Common Shares outstanding shall be required to constitute a quorum for the election of directors whom the holder of Common Shares are entitled to elect; provided that either the Cumulative Preferred shareholders or the Common shareholders who are present in person or by proxy at such a meeting shall have power to adjourn such meeting for the election of directors to be elected by them from time to time, without notice other than announcement at the meeting and, provided further, that the adjournment of

the meeting for lack of a quorum of the Common shareholders shall not prevent the election at that meeting of the directors whom the Cumulative Preferred shareholders are entitled to elect if there is a quorum of the Cumulative preferred shareholders.

If at any time the holders of Cumulative Preferred Shares shall become entitled to elect two (2) directors or a majority of the Board of Directors as aforesaid, the terms of all incumbent directors shall expire whenever such two (2) directors or such majority have been duly elected and qualified.

Whenever the Cumulative Preferred Shares shall be divested of voting power with respect to the election of directors the terms of all then incumbent directors shall expire upon the election of a new board by the holders of Common Shares at the next annual or special meeting for the election of directors.

If a vacancy or vacancies in the Board of Directors shall exist with respect to a director or directors elected by the Cumulative Preferred shareholders, the remaining director or directors elected by the Cumulative Preferred shareholders may, by the vote of such remaining director if there be but one, or by the vote of a majority of such remaining directors if there be more than one, elect a successor or successors to hold office for the unexpired term. Likewise, a vacancy or vacancies existing with respect to directors elected by the Common shareholders may be filled by the remaining director or directors elected by the Common shareholders.

ARTICLE 5

5.1 Whether or not a vote of shareholders is otherwise required, the affirmative vote of the holders of not less than two-thirds of the outstanding shares of "Voting Stock" (as hereafter defined) of the corporation shall be required for the approval or authorization of any "Business Combination" (as hereafter defined) with any Related Person (as hereafter defined) involving the corporation or the approval or authorization by the corporation in its capacity as a shareholder of any Business Combination involving a "Subsidiary" (as hereafter defined) which requires the approval or authorization of the shareholders of the Subsidiary; provided, however, that the two-thirds voting requirement shall not be applicable if:

(a) The "Continuing Directors" (as hereafter defined) by a majority vote have expressly approved the Business Combination; or

(b) The Business Combination is a merger, consolidation, exchange of shares or sale of all or substantially all of the assets of the corporation and the cash or fair market value (determined as of the effective date of such Business Combination or, in the case of a sale of assets as of the date of the distribution of the proceeds of the sale to the shareholders of the corporation) of the property, securities or other consideration to be received per share by holders of common stock of the corporation other than the Related Person is not less than the

highest per share price (with appropriate adjustments for recapitalizations, stock splits, stock dividends and like distributions), paid by the Related Person in acquiring any of its holdings of the corporation's common stock during the two-year period prior to the effective date of the Business Combination or the distribution of the proceeds of a sale of assets.

5.2 For the purposes of this Article 5:

(a) The term "Business Combination" shall mean

(i) any merger or consolidation of the corporation or a Subsidiary with or into a Related Person,

(ii) any exchange of shares of the corporation or a Subsidiary for shares of a Related Person which, in the absence of this Article, would have required the affirmative vote of at least a majority of the voting power of the outstanding shares of the corporation entitled to vote or the affirmative vote of the corporation, in its capacity as a shareholder of the Subsidiary,

(iii) any sale, lease, exchange, transfer or other disposition (in one transaction or a series of transactions), including, without limitation, a mortgage or any other security device, of all or any "Substantial Part" (as hereinafter defined) of the assets either of the corporation (including, without limitation, any voting securities of a Subsidiary) or of a Subsidiary, to or with a Related Person,

(iv) any sale, lease, exchange, transfer or other disposition (in one transaction or a series of transactions) of all or any Substantial Part of the assets of a Related Person to or with the corporation or a Subsidiary,

(v) the issuance of any securities to a Related Person (except pursuant to stock dividends, stock splits or similar transactions which would not have the effect of increasing the proportionate voting power of a Related Person) of the corporation, or of a Subsidiary (except pursuant to a pro rata distribution to all holders of common stock of the corporation),

(vi) any recapitalization or reclassification that would have the effect of increasing the voting power of a Related Person, and

(vii) any agreement, contract or other arrangement providing for any of the transactions described in this definition of Business Combination.

(b) The term "Related Person" shall mean and include any individual, corporation, partnership or other person or entity which, together with its

"Affiliates" and "Associates" (as defined on February 24, 1984 by Rule 12b-2 under the Securities Exchange Act of 1934), "Beneficially Owns" (as defined on February 24, 1984 by Rule 13d-3 under the Securities Exchange Act of 1934) in the aggregate 15 percent or more of the outstanding Voting Stock of the corporation, and any Affiliate or Associate (other than the corporation or a wholly-owned subsidiary of the corporation) of any such individual, corporation, partnership or other person or entity.

(c) The term "Substantial Part" shall mean more than 30 percent of the fair market value of the total assets of the corporation in question, as of the end of its most recent fiscal year ending prior to the time the determination is being made.

(d) Without limitation, any shares of common stock of the corporation that any Related Person has the right to acquire pursuant to any agreement, or upon exercise of conversion rights, warrants or options, or otherwise, shall be deemed beneficially owned by the Related Person.

(e) The term "Subsidiary" shall mean any corporation, a majority of the equity securities of any class of which are owned by the corporation, by another Subsidiary, or in the aggregate by the corporation and one or more of its Subsidiaries.

(f) The term "Voting Stock" shall mean all outstanding shares of capital stock of the corporation entitled to vote generally in the election of directors and each reference to a proportion of shares of Voting Stock shall refer to such proportion of the votes entitled to be cast by such shares.

(g) The term "Continuing Director" shall mean (i) a director who was a member of the Board of Directors of the corporation either on February 24, 1984 or immediately prior to the time that any Related Person involved in the Business Combination in question became a Related Person and (ii) any person becoming a director whose election, or nomination for election by the corporation's shareholders, was approved by a vote of a majority of the Continuing Directors; provided, however, that in no event shall a Related Person involved in the Business Combination in question be deemed to be a Continuing Director.

5.3 For the purposes of this Article 5 the Continuing Directors by a majority vote shall have the power to make a good faith determination, on the basis of information known to them, of: (i) the number of shares of Voting Stock of the corporation that any person or entity Beneficially Owns, (ii) whether a person or entity is an Affiliate or Associate of another, (iii) whether the assets subject to any Business Combination constitute a Substantial Part, (iv) whether any business transaction is one in which a Related Person has an interest, (v) whether the cash or fair market value of the property, securities or other consideration to be received per share by holders of capital stock of the corporation other than the Related Person in a Business Combination is an amount at least equal to the highest per share price paid by the

Related Person and (vi) such other matters with respect to which a determination is required under this Article 5.

5.4 The provisions set forth in this Article 5 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of Voting Stock of the corporation.

ARTICLE 6

6.1 The number of directors shall initially be ten and, thereafter, shall be fixed from time to time by the Board of Directors or by the affirmative vote of the holders of two-thirds of the voting power of the outstanding capital stock of the corporation, voting together as a single class. The directors shall be divided into three classes, as nearly equal in number as reasonably possible, with the term of office of the first class to expire at the 1988 annual meeting of shareholders, the term of office of the second class to expire at the 1989 annual meeting of shareholders and the term of office of the third class to expire at the 1990 annual meeting of shareholders. At each annual meeting of shareholders following such initial classification and election, directors elected to succeed those directors whose terms expire shall be elected for a term of office to expire at the third succeeding annual meeting of shareholders after their election.

6.2 Subject to the rights of the holders of any series of Preferred Stock then outstanding, newly created directorships resulting from any increase in the authorized number of directors or any vacancies in the Board of Directors resulting from death, resignation, retirement, disqualification, removal from office or other cause may be filled by a majority vote of the directors then in office though less than a quorum, and directors so chosen shall hold office for a term expiring at the next annual meeting of shareholders. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

6.3 Any directors, or the entire Board of Directors, may be removed from office at any time, but only for cause and only by the affirmative vote of the holders of the proportion or number of the voting power of the shares of the classes or series the director represents sufficient to elect them.

6.4 The provisions of this Article 6 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of the capital stock of the corporation entitled to vote generally in the election of directors, voting together as a single class.

ARTICLE 7

7. No director of the corporation shall be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty by

such director as a director; provided, however, that this Article 7 shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 302A.559 of the Minnesota Business Corporation Act or Section 80A.23 of the Minnesota Securities Law, or (iv) for any transaction from which the director derived an improper personal benefit. No amendment to or repeal of this Article 7 shall apply to or have any effect on the liability or alleged liability of any director of the corporation for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

ARTICLE 8

8. The Board of Directors of the corporation (the "Board"), when evaluating any offer of another party, (a) to make a tender or exchange offer for any Voting Stock (as defined in Article 5) of the corporation or (b) to effect a Business Combination (as defined in Article 5), shall, in connection with the exercise of its judgment in determining what is in the best interests of the corporation as a whole, be authorized to give due consideration to such factors as the Board determines to be relevant, including, without limitation:

- (i) the interests of the corporation's shareholders;
- (ii) the social, legal and economic effects upon employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its business;
- (iii) whether the proposed transaction might violate federal or state laws; and
- (iv) not only the consideration being offered in the proposed transaction, in relation to the then current market price for the outstanding capital stock of the corporation, but also the market price for the capital stock of the corporation over a period of years, the estimated price that might be achieved in a negotiated sale of the corporation as a whole or in part of through orderly liquidation, the premiums over market price for the securities of other corporations in similar transactions, current political, economic or other factors bearing on securities prices and the corporation's financial condition and future prospects.

In connection with any such evaluation, the Board is authorized to conduct such investigations and to engage in such legal proceedings as the Board may determine.

Wachovia Bank, N.A.
301 South College Street
Charlotte NC 28288

Exhibit 4.1



WACHOVIA SECURITIES

May 23, 2007

Graco Inc.
88 11th Avenue Northwest
Minneapolis, Minnesota 55413

Attention: Janel W. French

RE: Promissory Note from Graco Inc. ("**Borrower**") to Wachovia Bank, National Association ("**Wachovia**") in the original principal amount of \$25,000,000.00 dated April 1, 2006, including any amendments (the "**Note**").

Obligor # 000004151380481

Obligation # 000000000000265

Dear Janel:

Wachovia has agreed to extend the term of the Note, which will mature or has matured on May 31, 2007. Accordingly, this letter shall constitute Wachovia's agreement and formal notice to you, as follows:

Extension. Wachovia hereby extends, on the same terms and conditions as presently in effect, the maturity of the Note to July 31, 2007, at which time the outstanding principal balance, accrued interest and all other amounts due under the Note shall become due and payable. All periodic payments required under the Note shall be made during this extension period.

No Other Changes. Extension on the maturity date as stated herein is the only change to the Note. Except as extended by this letter, the Note and all other Loan Documents (as defined in the Note) shall continue in full force and effect. Should you have any questions, do not hesitate to call.

Very truly yours,

Wachovia Bank, National Association

By: 

G. Jeffrey Seaton
Managing Director

**FOURTH AMENDMENT
OF
GRACO INC.
DEFERRED COMPENSATION PLAN
(1992 RESTATEMENT)**

The Graco Inc. Deferred Compensation Plan Restated ("Plan"), which was adopted and approved by the Board of Directors of Graco Inc. effective December 1, 1992, as amended by the First Amendment effective September 1, 1996, the Second Amendment effective as of May 27, 2000, and a Third Amendment adopted as of December 19, 2002 and as ratified on February 21, 2003 (the Plan as so amended is hereafter referred to as the "Plan Statement"), which was frozen as to new participants and contributions by the Management Organization and Compensation Committee ("MOCC") of the Board of Directors of Graco Inc. on December 9, 2004, is hereby amended as follows:

1. INVESTMENT. Effective August 1, 2007, Section 4.5 of the Plan Statement is amended such that (i) the heading for Section 4.5 is changed to "Investment", (ii) a new Section 4.5.1 is created, (iii) the heading for Subsection 4.5.1 is "Interest Crediting", (iv) the text of Section 4.5 is moved to the new Section 4.5.1, and (v) two new sentences are added at the start of the text for Section 4.5.1 that reads as follows: "This Section shall apply through the end of the day on July 31, 2007. No interest shall be credited to a Participant's account based on this Section 4.5.1 after July 31, 2007; rather, Section 4.5.2 shall apply."

2. MEASURING INVESTMENTS. Effective for valuation to Participant Accounts beginning on and after August 1, 2007, a new Section 4.5.2 is added to the Plan Statement that reads as follows:

4.5.2. Measuring Investments. Effective for valuation to Participant Accounts beginning on and after August 1, 2007, the value of a Participant's Account shall be determined based on the value of the Participant's Account as of the end of the day on July 31, 2007, plus the earnings or losses since that date based on the measuring investments in which the assets are invested pursuant to this section. This Section shall not apply to Participant Accounts prior to August 1, 2007.

- (a) **Designation of Measuring Investments.** Measuring investments are specified solely as a device for computing the amount of benefits to be paid by the Employer under the Plan, and the Employer is not required to purchase such investments. The measuring investments shall be the same as the measuring investments under the Graco Deferred Compensation Plan (2005 Statement). The default investment shall be the same as the default investment under the Graco Deferred Compensation Plan (2005 Statement).
- (b) **Operational Rules for Measuring Investments.** The Chief Administrative Officer (or similar position in charge of Human Resources) shall adopt rules specifying the circumstances under which a particular measuring investment may be elected, or shall be automatically utilized, the minimum or maximum amount or percentage of an Account which may be allocated to a measuring investment, the procedures for making or changing measuring investment elections, the extent (if any) to which Beneficiaries of deceased Participants may make measuring investment elections, the effect of a Participant's or Beneficiary's failure to make an effective measuring investment election with respect to all or any portion of an Account, and investment of a Participant's or Beneficiary's Account in the default investment.
- (c) **Investment Direction of Participants.**

- (i) **Rights of Participants.** A Participant shall direct the Chief Administrative Officer (or similar position in charge of Human Resources) as to the measuring investments which shall be the standard by which the value of the Participant's Account shall be measured.
- (ii) **Transmission of Investment Directions.** Through a voice response system (or other written or electronic means) approved by the Chief Administrative Officer (or similar position in charge of Human Resources), each Participant shall designate the measuring investments that shall be used to determine the value of such Participant's Account (until changed as provided herein).
- (d) **Losses Under the Plan.** The cash value of the Participant's Account shall depend on the investment return experience of the Participant's elected measuring investments. No officer, director or employee of the Employer shall be accountable or liable for any investment losses to a Participant's Account incurred by virtue of implementing the directions of the Participant with respect to the measuring investments of the Account, with respect to losses due to the Participant's Account being invested in the default investment in the absence of direction from the Participant, or due to any reasonable administrative delay in implementing such directions.

3. **SAVINGS CLAUSE.** This amendment is enacted with the understanding that the change in the Plan's rate of return does not constitute a material modification for purposes of section 409A of the Internal Revenue Code (Treas. Reg. § 1.409A-6(a)(4)(iv)). If the amendment is found to be a material modification for purposes of section 409A of the Internal Revenue Code, the amendment shall be considered null and void. Save and except as herein above expressly amended, the Plan shall continue in full force and effect.

**NONEMPLOYEE DIRECTOR
AMENDED AND RESTATED STOCK INCENTIVE PLAN (2006)**

**STOCK OPTION AGREEMENT
(NSO)**

THIS AGREEMENT, made this ____ day of _____, 20____ by _____ and _____ between Graco Inc., a Minnesota corporation (the “Company”) and «NAME» (the “Nonemployee Director”).

WITNESSETH THAT:

WHEREAS, the Company pursuant to the Graco Inc. Amended and Restated Stock Incentive Plan (2006) (the “Plan”) wishes to grant this stock option to Nonemployee Director.

NOW THEREFORE, in consideration of the premises and of the mutual covenants herein contained, the parties agree as follows:

1. Grant of Option

The Company grants to Nonemployee Director the right and option (the “Option”) to purchase all or any part of an aggregate of «Shares» shares of Common Stock of the Company, par value \$1.00 per share, at the price of «Price» per share on the terms and conditions set forth herein. This is a nonstatutory stock Option which does not qualify for special tax treatment under Sections 421 or 422 of the Internal Revenue Code. The date of grant is _____ (the “Date of Grant”)

2. Duration and Exercisability

- A. No portion of this Option may be exercised by Nonemployee Director until the first anniversary of the Date of Grant, and then only in accordance with the Vesting Schedule set forth below. In no event shall this Option or any portion of this Option be exercisable following the tenth anniversary of the Date of Grant.

Vesting Schedule

| <u>Date</u> | <u>Portion of Option Exercisable</u> |
|-------------------------------------|--|
| First Anniversary of Date of Grant | 25% |
| Second Anniversary of Date of Grant | 50% |
| Third Anniversary of Date of Grant | 75% |
| Fourth Anniversary of Date of Grant | 100% |

If Nonemployee Director does not purchase in any one year the full number of shares of Common Stock of the Company to which he/she is entitled under this Option, he/she may, subject to the terms and conditions of Section 3 hereof, purchase such shares of Common Stock in any subsequent year during the term of this Option. The Option shall expire as of the close of trading at the national securities exchange on which the Common Stock is traded ("Exchange") on the tenth anniversary of the Date of Grant, or if the Exchange is closed on the anniversary date, or the Common Stock of the Company is not trading on said anniversary date, such earlier business day on which the Common Stock is trading on the Exchange.

- B. During the lifetime of Nonemployee Director, the Option shall be exercisable only by him/her and shall not be assignable or transferable by him/her otherwise than by will or the laws of descent and distribution.
- C. Under no circumstances may the Option granted by this Agreement be exercised after the term of the Option expires.

3. Effect of Termination of Membership on the Board

- A. In the event Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in Section 3B below, Nonemployee Director shall have the right to exercise the Option as follows:
 - (1) If Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, the portion of the Option not yet exercisable shall become immediately exercisable upon the date Nonemployee Director ceases being a director. Nonemployee Director may exercise all or any portion of the Option not yet exercised for a period beginning on the day after the date of Nonemployee Director's ceasing to be a director and ending at the close of trading on the Exchange on the tenth anniversary of the Date of Grant, provided that if Nonemployee Director dies during the period between the date of Nonemployee Director ceasing to be a director and the expiration of the Option, =the executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of

distribution and descent may exercise the unexercised portion of the Option at any time during a period beginning the day after the date of Nonemployee Director's death and ending at the close of trading on the Exchange = on the anniversary of death one (1) year later. In no event shall the Option be exercisable following the tenth anniversary of the Date of Grant..

- (2) If Nonemployee Director was a member of the Board of Directors of the Company for less than five (5) years, Nonemployee Director may exercise that portion of the Option exercisable upon the date Nonemployee Director ceases being a director at any time within the period beginning on the day after Nonemployee Director ceases being a director and ending at the close of trading on the Exchange thirty (30) days later. If Nonemployee Director dies within the thirty (30) day period and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining portion of the Option at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.
 - (3) If Nonemployee Director dies while a member of the Board of Directors of the Company, the Option, to the extent exercisable by Nonemployee Director at the date of death, may be exercised by the executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.
 - (4) In the event the Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased Nonemployee Director, the Company shall be under no obligation to issue stock thereunder unless and until the Company is satisfied that the person(s) exercising the Option is the duly appointed legal representative of Nonemployee Director's estate or the proper legatee or distributee thereof.
- B. If Nonemployee Director ceases being a director of the Company by reason of Nonemployee Director's gross and willful misconduct, including but not limited to, (i) fraud or intentional misrepresentation; (ii) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any affiliate of the Company; (iii) breach of fiduciary duty, or (iv) any other gross or willful misconduct, as determined by the Board, in its sole and conclusive discretion, the unexercised portion of the Option granted to such Nonemployee Director shall

immediately be forfeited as of the time of the misconduct. If the Board determines subsequent to the time Nonemployee Director ceases being a director of the Company for whatever reason, that Nonemployee Director engaged in conduct while a member of the Board of Directors of the Company that would constitute gross and willful misconduct, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Board thereafter determines that Nonemployee Director engaged in gross and willful misconduct while a member of the Board of Directors of the Company at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise.

4. Manner of Exercise

- A. Nonemployee Director or other proper party may exercise the Option only by delivering within the term of the Option written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the Option is being exercised and, except as provided in Sections 4B(2) and 4C, accompanied by payment in full of one hundred percent (100%) of the Option price.
- B. The Nonemployee Director may, at his/her election, pay the Option price as follows:
 - (1) by cash or check (bank check, certified check, or personal check),
 - (2) by delivery of shares of Common Stock to the Company, which shall have been owned for at least six (6) months and have a fair market value per share on the date of surrender equal to the exercise price.

For purposes of Section 4B(2), the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the Exchange on the day immediately preceding the date of exercise. If there is not a quotation available for such day, then the closing price on the next preceding day for which such a quotation exists shall be determinative of fair market value. If the shares are not then traded on an exchange, the fair market value shall be the average of the closing bid and asked prices of the Common Stock as reported by the National Association of Securities Dealers Automated Quotation System. If the Common Stock is not then traded on NASDAQ or on an exchange, then the fair market value shall be determined in such manner as the Company shall deem reasonable.

- C. The Nonemployee Director may, with the consent of the Company, pay the Option price by delivery to the Company of a properly executed exercise notice, together with irrevocable instructions to a broker to promptly deliver to the Company from sale or loan proceeds the amount required to pay the exercise price.

5. Change of Control

- A. Notwithstanding Section 2A hereof, the entire Option shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:

- (1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
 - (a) the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or
 - (b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

provided, however, that the following acquisitions will not result in a Change of Control:

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of

this Section 5, a Trust Person shall not be deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

- (v) an acquisition by the Nonemployee Director or any group that includes the Nonemployee Director, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of Section 5A(4); and

provided, further, that if any Person's beneficial ownership of the Outstanding Company Common Stock or Outstanding Company Voting Securities is 25% or more as a result of a transaction described in clause (i) or (ii) above, and such Person subsequently acquires beneficial ownership of additional Outstanding Company Common Stock or Outstanding Company Voting Securities as a result of a transaction other than that described in clause (i) or (ii) above, such subsequent acquisition will be treated as an acquisition that causes such Person to own 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities and be deemed a Change of Control; and provided further, that in the event any acquisition or other transaction occurs which results in the beneficial ownership of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities by any Trust Person, the Incumbent Board may by majority vote increase the threshold beneficial ownership percentage to a percentage above 32% for any Trust Person; or

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or

- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
 - (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of Common Stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets, either directly or through one or more subsidiaries), in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,
 - (b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of Common Stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and
 - (c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

- (5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.
- B. A Change of Control shall not be deemed to have occurred with respect to a Nonemployee Director if:
 - (1) the acquisition of the 25% or greater interest referred to in Section 5A(1) is by a group, acting in concert, that includes the Nonemployee Director or
 - (2) if at least 25% of the then outstanding Common Stock or combined voting power of the then outstanding Company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in Sections 5A(4) or 5A(5) by a group, acting in concert, that includes that Nonemployee Director.

6. Adjustments and Changes in the Stock

If there shall be any change in the number or character of the Common Stock of the Company through merger, consolidation, reorganization, recapitalization, dividend in the form of stock (of whatever amount), stock split or other change in the corporate structure of the Company, and all or any portion of the Option shall then be unexercised and not yet expired, appropriate adjustments in the outstanding Option shall be made by the Company, in order to prevent dilution or enlargement of Nonemployee Director's Option rights. Such adjustments shall include, where appropriate, changes in the number of shares of Common Stock and the price per share subject to the outstanding Option.

7. Miscellaneous

- A. This Option is issued pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. Neither the Plan nor any action taken hereunder shall be construed as giving Nonemployee Director any right to be retained in the service of the Company.
- C. Neither Nonemployee Director, Nonemployee Director's legal representative, nor the executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.

- D. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- E. The internal law, and not the law of conflicts, of the State of Minnesota, U.S.A., shall govern all questions concerning the validity, construction and effect of this Agreement, the Plan and any rules and regulations relating to the Plan or this Option.

IN WITNESS WHEREOF, the parties have caused this Agreement to be executed on the day and year first above written.

GRACO INC.

By _____
Its Vice President, General Counsel
and Secretary

NONEMPLOYEE DIRECTOR

«NAME»

GRACO INC.

**NONEMPLOYEE DIRECTOR RETAINER/MEETING FEES
CASH/STOCK/DEFERRED STOCK**

ELECTION/CHANGE IN ELECTION FORM

| | |
|-------------------|---|
| SUBMIT TO: | Secretary to the Board, Legal Department, Graco Inc., P.O. Box 1441, Mpls, MN. 55440-1441 |
| NAME: | <div style="border-bottom: 1px solid black; height: 1.2em; margin-bottom: 5px;"></div> Stock may be registered in director's name and name of one other person. Print name(s) exactly as you wish them to appear in stock register. |

EFFECTIVE DATE: This Form must be completed and delivered to the Secretary to the Board before the beginning of the taxable year in which the services are to be performed. Your election will remain in effect for, and may not be changed during, the entire taxable year. In the event that a Change in Election Form is not received prior to the beginning of any taxable year, the election currently in effect will remain in effect for the next taxable year. For an individual who becomes a nonemployee director during a taxable year, the individual must complete and deliver his Initial Election Form to the Secretary no later than 30 days after the date that the individual first becomes a nonemployee director and will be applicable only to services performed after the election.

Check One:

- ☐ **Initial Election.** Allocate my annual retainer and meeting fees according to the percentages indicated below.
- ☐ **Change in Election.** I elect to change my election for the taxable year following the current taxable year and all taxable years subsequent thereto, unless I submit a Change in Election Form prior to the commencement of the applicable taxable year. Allocate my annual retainer and meeting fees according to the percentages indicated below.

Fill in Blanks:

Retainer: [Select one: 0%, 25%, 50%, 75%, 100%]

Percentage of Retainer paid in cash: _____ %

Percentage of Retainer paid in Graco stock: _____ %

Percentage of Retainer credited to Deferred Stock Account: _____ %

TOTAL** _____ %

Meeting Fees (Board and Committee): [Select one: 0%, 25%, 50%, 75%, 100%]

Percentage of Meeting Fees paid in cash: _____ %

Percentage of Meeting Fees paid in Graco stock: _____ %

Percentage of Meeting Fees credited to Deferred Stock Account: _____ %

TOTAL** _____ %

** Total cannot exceed 100%

PAYMENT ELECTION:

If you have made a Deferred Stock Account Election, select one of the payment options below. **NOTE: If you are changing your payment election from a payment election previously made, the new payment election will apply only to deferrals made with respect to services performed in taxable years subsequent to the current taxable year. Previous payment elections are irrevocable with respect to services performed in the taxable years to which they apply.**

I elect to receive payment from my Deferred Stock Account by the method checked below.

- ☐ **Lump sum.** Credits to a Deferred Stock Account will be paid in full by the issuance of shares of Graco Common Stock plus cash in lieu of any fractional share on January 10 of the year following my separation from service, as defined by regulations and rulings issued under Section 409A of the Internal Revenue Code, as amended (the "IRC"), or the first business day after January 10, or such other date as elected by me. Alternative date: _____.(month/date/year)
- ☐ **Installments.** Number of installments elected (from 2 to 15): _____. Credits to a Deferred Stock Account will be paid in annual installments by the issuance of shares of Graco Common Stock, plus cash in lieu of any fractional share, on January 10 of each year following my separation from service on the Board as defined by regulations and rulings issued under Section 409A of the IRC, or the first business day after January 10. The number of annual installments may range from 2 to 15. The amount of each payment will be computed by multiplying the number of shares credited to my Deferred Stock Account as of January 10 of each year by a fraction, the numerator of which is one and the denominator of which is the total number of installments elected (not to exceed fifteen) minus the number of installments previously paid. Amounts paid prior to the final installment payment will be rounded to the nearest whole number of shares. The final installment payment will be for the whole number of shares remaining credited to my Deferred Stock Account, plus cash in lieu of any fractional share.

BENEFICIARY

In order to permit the payment of your Deferred Stock Account to a beneficiary in the event of your death prior to the complete payout of your Deferred Stock Account, provide the information indicated below:

Primary Beneficiary(ies)*

Name _____

Address _____

Name _____

Address _____

*Your Primary Beneficiaries will share equally unless any beneficiary dies before you or unless you specify otherwise above.

Secondary Beneficiary(ies)*

(If no primary beneficiary survives you)

Name _____

Address _____

Name _____

Address _____

*Your Secondary Beneficiaries will share equally unless any beneficiary dies before you or unless you specify otherwise above.

I have made the elections indicated above and on the reverse side and have received and read the Terms applicable to this Stock/Deferred Stock Program which are set forth in the document attached hereto entitled Graco Inc. Nonemployee Director Stock and Deferred Stock Program Terms and hereby agree to such Terms..

Date

Signature

GRACO INC.

**NONEMPLOYEE DIRECTOR RETAINER/MEETING FEES
CASH/STOCK/DEFERRED STOCK**

ELECTION/CHANGE IN ELECTION FORM

| | |
|-------------------|---|
| SUBMIT TO: | Secretary to the Board, Legal Department, Graco Inc., P.O. Box 1441, Mpls, MN. 55440-1441 |
| NAME: | <div style="border-bottom: 1px solid black; height: 1.2em; margin-bottom: 5px;"></div> Stock may be registered in director's name and name of one other person. Print name(s) exactly as you wish them to appear in stock register. |

EFFECTIVE DATE: This Form must be completed and delivered to the Secretary to the Board before the beginning of the taxable year in which the services are to be performed. Your election will remain in effect for, and may not be changed during, the entire taxable year. In the event that a Change in Election Form is not received prior to the beginning of any taxable year, the election currently in effect will remain in effect for the next taxable year. For an individual who becomes a nonemployee director during a taxable year, the individual must complete and deliver his Initial Election Form to the Secretary no later than 30 days after the date that the individual first becomes a nonemployee director and will be applicable only to services performed after the election.

Check One:

- ☐ **Initial Election.** Allocate my annual retainer and meeting fees according to the percentages indicated below.
- ☐ **Change in Election.** I elect to change my election for the taxable year following the current taxable year and all taxable years subsequent thereto, unless I submit a Change in Election Form prior to the commencement of the applicable taxable year. Allocate my annual retainer and meeting fees according to the percentages indicated below.

Fill in Blanks:

Retainer: [Select one: 0%, 25%, 50%, 75%, 100%]

Percentage of Retainer paid in cash: _____ %

Percentage of Retainer paid in Graco stock: _____ %

Percentage of Retainer credited to Deferred Stock Account: _____ %

TOTAL** _____ %

Meeting Fees (Board and Committee): [Select one: 0%, 25%, 50%, 75%, 100%]

Percentage of Meeting Fees paid in cash: _____ %

Percentage of Meeting Fees paid in Graco stock: _____ %

Percentage of Meeting Fees credited to Deferred Stock Account: _____ %

TOTAL** _____ %

** Total cannot exceed 100%

PAYMENT ELECTION:

If you have made a Deferred Stock Account Election, select one of the payment options below. NOTE: If you are changing your payment election from a payment election previously made, the new payment election will apply only to deferrals made with respect to services performed in taxable years subsequent to the current taxable year. Previous payment elections are irrevocable with respect to services performed in the taxable years to which they apply.

I elect to receive payment from my Deferred Stock Account by the method checked below.

- ☐ **Lump sum.** Credits to a Deferred Stock Account will be paid in full by the issuance of shares of Graco Common Stock plus cash in lieu of any fractional share on January 10, or the first business day after January 10, of the year following my separation from service, as defined by regulations and rulings issued under Section 409A of the Internal Revenue Code, as amended (the "IRC"), or such other date as elected by me. Alternative date: _____.(month/date/year)
- ☐ **Installments.** Number of installments elected (from 2 to 15): _____. Credits to a Deferred Stock Account will be paid in annual installments by the issuance of shares of Graco Common Stock, plus cash in lieu of any fractional share, on January 10, or the first business day after January 10, of each year following my separation from service on the Board as defined by regulations and rulings issued under Section 409A of the IRC. The number of annual installments may range from 2 to 15. The amount of each payment will be computed by multiplying the number of shares credited to my Deferred Stock Account as of January 10 of each year by a fraction, the numerator of which is one and the denominator of which is the total number of installments elected (not to exceed fifteen) minus the number of installments previously paid. Amounts paid prior to the final installment payment will be rounded to the nearest whole number of shares. The final installment payment will be for the whole number of shares remaining credited to my Deferred Stock Account, plus cash in lieu of any fractional share.

BENEFICIARY

In order to permit the payment of your Deferred Stock Account to a beneficiary in the event of your death prior to the complete payout of your Deferred Stock Account, provide the information indicated below:

Primary Beneficiary(ies)*

Name _____

Address _____

Name _____

Address _____

*Your Primary Beneficiaries will share equally unless any beneficiary dies before you or unless you specify otherwise above.

Secondary Beneficiary(ies)*

(If no primary beneficiary survives you)

Name _____

Address _____

Name _____

Address _____

*Your Secondary Beneficiaries will share equally unless any beneficiary dies before you or unless you specify otherwise above.

I have made the elections indicated above and on the reverse side and have received and read the Terms applicable to this Stock/Deferred Stock Program which are set forth in the document attached hereto entitled Graco Inc. Nonemployee Director Stock and Deferred Stock Program Terms and hereby agree to such Terms..

Date

Signature

CERTIFICATION

I, James A. Graner, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

July 25, 2007

James A. Graner
James A. Graner
Chief Financial Officer and Treasurer

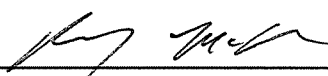
CERTIFICATION

I, Patrick J. McHale, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

7/25/07

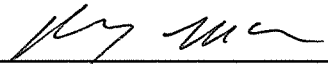

Patrick J. McHale

President and Chief Executive Officer

CERTIFICATION UNDER SECTION 1350

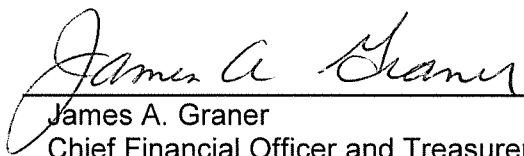
Pursuant to Section 1350 of Title 18 of the United States Code, each of the undersigned certifies that this periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in this periodic report fairly presents, in all material respects, the financial condition and results of operations of Graco Inc.

Date: 7/25/07



Patrick J. McHale
President and Chief Executive Officer

Date: July 25, 2007



James A. Graner
Chief Financial Officer and Treasurer



July 25, 2007

Electronically Filed

Securities and Exchange Commission
Judiciary Plaza
450 Fifth Street NW
Washington, DC 20549

Re: Graco Inc.
Second Quarter Report on Form 10-Q
File No. 001-9249
CIK No. 0000042888

Gentlemen/Ladies:

Enclosed for filing is the Graco Inc. Quarterly Report on Form 10-Q for the quarter ended June 29, 2007.

Sincerely,

A handwritten signature in dark ink, appearing to read 'K. Gallivan', is written over a horizontal line.

Karen P. Gallivan
Vice President, General Counsel and Secretary

Enclosure

KPG/nas