

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-K**

- ☒ Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2004 or
- ☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

**Commission File No. 001-09249**

**Graco Inc.**

(Exact name of Registrant as specified in its charter)

Minnesota  
(State or other jurisdiction of incorporation or organization)

41-0285640  
(I.R.S. Employer Identification No.)

**88 –11th Avenue Northeast  
Minneapolis, MN 55413**  
(Address of principal executive offices) (Zip Code)

**(612) 623-6000**  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:  
Common Stock, par value \$1.00 per share  
Preferred Share Purchase Rights  
Shares registered on the New York Stock Exchange.

Securities registered pursuant to Section 12(g) of the Act:  
None

As of February 22, 2005, 69,032,904 shares of Common Stock were outstanding.

Indicate by a 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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ☒

The aggregate market value of approximately 68,867,984 shares held by non-affiliates of the registrant was approximately \$2.0 billion on June 25, 2004.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on April 22, 2005, are incorporated by reference into Part III, as specifically set forth in said Part III.

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### ACCESS TO REPORTS

Investors may obtain access free of charge to the Graco Inc. annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports by visiting the Graco website at [www.graco.com](http://www.graco.com). These reports will be available as soon as reasonably practicable following electronic filing with or furnishing to the Securities and Exchange Commission.

## PART I

### Item 1. Business

#### General Information

Graco Inc. ("Graco" or "the Company") supplies systems and equipment for the management of fluids in industrial, commercial and vehicle lubrication applications. The Company's products help customers solve difficult manufacturing problems, increase productivity, improve quality, conserve energy, save expensive material, control environmental emissions and reduce labor costs. Graco Inc. is the successor to Gray Company, Inc., which was incorporated in 1926 as a manufacturer of automobile lubrication equipment, and became a public company in 1969.

Headquartered in Minneapolis, Minnesota, Graco serves customers around the world in the manufacturing, process, construction and maintenance, and vehicle lubrication industries. It designs, manufactures and markets systems and equipment to move, measure, mix, proportion, control, dispense and spray a wide variety of fluids and viscous materials.

Graco's strategic objectives include: increasing the proportion of sales outside North America, expanding its distribution network, penetrating new markets and actively pursuing focused acquisitions where the Company can add significant value. The Company's long term financial targets include: growing revenue by 10 percent and net earnings by 12 percent per year; achieving returns on sales exceeding 10 percent, on assets of at least 15 percent and on equity of at least 20 percent; generating at least 30 percent of each year's sales from products introduced in the last three years; and generating at least 5 percent of each year's sales from markets entered in the last three years. Initiatives for 2005 include the establishment of regional manufacturing, expansion of global sourcing and investment in emerging markets.

#### Operating Segment Information; Geographic Information

Graco's businesses are classified by management into three operating segments: Industrial/Automotive Equipment, Contractor Equipment and Lubrication Equipment. Financial information concerning these operating segments is set forth in Part II, Item 7, at page 14, and in Note B to the Consolidated Financial Statements. Financial information about geographic areas is set forth in Note B to the Consolidated Financial Statements.

#### Industrial/Automotive Equipment

Graco's Industrial/Automotive Equipment segment designs, markets and sells equipment for the following applications: sealants and adhesives, process, finishing (including automotive refinishing), and protective coatings. The markets served include firms that manufacture, assemble, repair, and refinish a wide variety of equipment, including: automobiles and components, wood products, railcars, ships and other marine equipment, aircraft and other aerospace equipment, farm and construction equipment, and trucks, buses and recreational vehicles.

Products offered by the Industrial/Automotive Equipment segment include air, electric and hydraulic-powered pumps that pressurize and transfer single and plural component paints, stains, chemicals, foams, protective coatings, sealants, adhesives, food, and other viscous materials through various application devices, including airless, air-assisted airless, electrostatic, HVLP (high volume-low pressure), and air spray guns. Fluid pressures ranging from 5 to more than 7,250 pounds per square inch and flow rates from .02 ounces to 275 gallons per minute are available. Sealant and adhesive, paint circulating and plural component packages and modules, and a complete line of parts and accessories, including advanced controllers and single and plural component precision dispense valves, are also offered.

Industrial/Automotive equipment is sold worldwide direct to end users and through general and specialized distributors, integrators, warehouse distributors, jobbers, manufacturer representatives and original equipment manufacturers. Distributors promote and sell the equipment, provide product application expertise, and offer on-site service, technical support and integration capabilities. Integrators implement large individual installations in manufacturing plants where products and services from a number of different vendors are aggregated into a single system.

Warehouse distributors and jobbers are prevalent in the automobile refinishing market. Original equipment manufacturers incorporate individual Graco products into their general equipment offerings to their customers.

Products marketed by the Industrial/Automotive Equipment segment are manufactured in Minneapolis, Minnesota and Sioux Falls, South Dakota. Assembly of certain products for the European market is performed in Maasmechelen, Belgium.

Important drivers of product development in the Industrial/Automotive Equipment segment are the desire by customers to improve quality and increase productivity by using new materials and/or upgrading or automating production processes, the desire to manage costs by controlling and reducing the amount of material used and/or waste generated, and the need to modify processes in order to meet environmental and other governmental regulations.

Graco is developing new products for the global marketplace and expanding its distribution throughout the world in order to achieve optimum market coverage.

**Recent Developments.** In the spring of 2004, the Company relocated the manufacturing of Sharpe® products from Santa Fe Springs, California to the Company's facility in Sioux Falls, South Dakota, to take full advantage of the manufacturing capability in the Sioux Falls plant and realize cost reductions from the elimination of duplicate facilities. The marketing and sale of Sharpe spray guns, Infratech™ paint curing systems and air supply accessories are now managed within the finishing product application category, based in Minneapolis, Minnesota.

The Company introduced the Finex™ air spray gun line, with HVLP, mini-HVLP and conventional gravity feed models in the spring of 2004. These guns are lightweight, well-balanced and designed for the budget-minded painter who demands a high-quality tool.

Graco released the Xtreme Mix™ 185 portable plural component sprayer in the spring of 2004. This sprayer, rated at 4,700 pounds per square inch (500 bar), is designed for easy movement around the jobsite in the shipbuilding, bridge and tank coating industries. The sprayer has auto shutdown and alarm features which prevent off-ratio spraying, and a data reporting capability to verify correct proportioning. A recirculation system keeps material in suspension and allows preheating before spraying.

In May 2004, the Company released the ProMix Easy™ and the ProMix II™ which, along with the PrecisionMix®, provide a full line of electronic plural component proportioning systems. The ProMix Easy offers a complete line of entry-level electronic proportioning systems that mix most two-component solventborne and waterborne epoxies, polyurethanes and acid-catalyzed varnishes for the general metal, wood and furniture, farm and construction, truck and bus, aerospace and electronics industries. User-friendly controls allow easy operation in both pump (airless, air-assisted airless and air spray) and metered applications, and an intrinsically-safe controller permits use in hazardous environments. The ProMix II, the next generation of ProMix technology, offers precise and reliable electronic proportioning for multi-color applications. With user-friendly controls, an intrinsically-safe controller, programmable flushing and filling, and advanced potlife controls, this meter-based system offers cost and material savings to those operators still using hand mixing or a mechanical proportioner.

The Company qualified for inclusion in the Ford Motor Company's Q1 2002 program in May 2004. Eligibility for this program requires a supplier to have both an ISO 9001 certification and an ISO 14001 environmental certification, a quality operating system, meet or exceed a base level of quality and receive employee endorsements from the supplier's Ford customers. The Ford Q1 program provides Ford suppliers with the benefit of preferred status for new sourcing, recognition, publicity and advertising privileges, and eligibility for the Ford World Excellence Award.

In early July 2004, a new automated warehouse system was installed in the Minneapolis distribution center.

Throughout the year additional application devices were introduced to extend the capabilities of the Fusion™ plural component spray gun and Reactor™ proportioning system into new niche markets. The Fusion solvent-purge spray gun is designed to apply two component materials to fiberglass enclosures, the Fusion pour gun dispenses foam insulation into the cavities of refrigerators and similar equipment, and the Fusion automatic spray gun can be used with robots and other automatic spraying systems.

In September 2004, Graco introduced the Delta Spray® XT series of spray guns, in manual air spray, HVLP and compliant models. The XT HVLP model satisfies strict US environmental regulations and the XT Compliant model meets European environmental requirements. These guns, which will accept pressure, siphon or gravity feeds, have four universal nozzle sizes for easy adaptation to different paint coatings, improved balance, a detachable fluid housing for fast and easy cleanup and a more consistent finish. In the spring of 2004, Graco and the Automotive Aftermarket Division of the 3M Company formed an alliance to offer similar spray guns in a private label version to the automotive aftermarket as a complement to 3M's Paint Preparation System.

In the late fall of 2004, Graco introduced the XTR-7™ Airless Spray Gun, with a maximum fluid pressure of 7,250 pounds per square inch (500 bar). The gun offers an insulated handle for use with heated fluids, an EasyGlide™ swivel for maneuverability and an easily removable filter. The XTR-7 is designed to handle the high pressure output needed to spray the high solids coatings and epoxies used in the shipbuilding, railcar and structural steel, tank and pipe coating industries.

Late in 2004, Graco introduced a series of quick-set proportioners designed to handle hybrid materials with cure rates between one and fifteen minutes, including hybrid polyurethanes, epoxies and plural-component materials. These coatings are used to coat water containment surfaces, including surfaces in wastewater treatment plants, sewers, secondary containment areas, and pipes and tanks. The Xtreme Mix proportioner is portable and provides on-demand selectable ratio proportioning from 1:1 to 10:1 and data reporting capabilities. The Hydra-Cat® proportioner is stationary and offers mechanical fixed ratio proportioning in 1:1, 2:1, 3:1 and 4:1 configurations. Mixing and atomizing can be achieved through a remote mix manifold, static mixer and airless spray guns.

Effective January 1, 2005, the Company acquired Liquid Control Corporation of North Canton, Ohio, and its affiliated companies, Profill Corporation, Decker Industries and Liquid Control Ltd. of Wellingborough, U.K. Liquid Control designs, manufactures and sells single and plural component resin dispensing equipment and systems, including general and electronic assembly, fabrication, composite manufacturing and polyurethane molding.

Effective February 4, 2005, the Company acquired Gusmer Corporation of Lakewood, New Jersey and its affiliate, Gusmer Europe S.L. of Vilanova, Spain. Gusmer designs, develops, manufactures and sells specialized two-component dispense equipment systems for polyesters, polyurethanes, polyureas and epoxies employed in the construction, transportation and marine industries for insulation and protective coating and for the manufacture of a wide variety of products.

## **Contractor Equipment**

Graco's Contractor Equipment segment designs and markets sprayers for the application of paint and other architectural coatings, and the high-pressure cleaning of equipment and structures. The segment offers its equipment to distributors who sell to contractors in the painting, roofing, texture, corrosion control and line striping markets. The segment offers equipment that gives contractors and do-it-yourself users the opportunity to produce a high quality finish at high production rates with sprayers that are durable and easy to use.

The segment's primary product lines are airless paint sprayers and associated parts and accessories, such as hose, spray guns, filters, valves and tips. Also offered are pressure washers and specialized spraying equipment for the application of roofing materials, texture coatings and traffic paint. HVLP (high volume-low pressure) equipment provides the ability to spray a fine finish with reduced overspray. Fluid pressures ranging from 5 to more than 4,000 pounds per square inch, and flow rates up to 4 gallons per minute, are available. Pumps powered by electricity, air, hydraulics, and gasoline engines are available. Replacement and maintenance parts, such as packings and seals, which must be replaced periodically in order to maintain efficiency and prevent loss of material, are also offered for sale.

The equipment is sold primarily through retail stores that sell paint and other coatings, and secondarily through general equipment distributors. In 2004, sales to The Sherwin-Williams Company, a paint manufacturer and retailer, were 10 percent of the Company's consolidated sales. Graco markets a limited line of sprayers through the home center channel. In 2004, sales to The Home Depot, a home center retailer, totaled 10 percent of the Company's consolidated sales. With the addition of a texture pump to the Home Depot product offering, Graco equipment is now offered through the Rental, Paint and Decor, and Building Supplies departments of Home Depot.

Graco sales personnel sell Graco-branded and private label equipment to the paint store, home center and rental agency channels. The ASM® product line of airless paint sprayers and spray guns, pressure washers and parts and accessories is promoted to these same channels largely through independent sales representatives.

Products for the contractor equipment markets are manufactured in Rogers and Minneapolis, Minnesota and Sioux Falls, South Dakota.

**Recent Developments.** In January 2004, Graco introduced the Ultra® 595 electric airless sprayer, an extension of the Ultra line. This sprayer supports tip sizes up to .026 inch and flow rates of up to 0.6 gallons per minute.

During the first half of 2004, Graco released the Ultra Max II line of airless sprayers. Ultra Max II sprayers contain a new totally-enclosed DC electric motor with more horsepower capacity and a lifetime motor warranty, a SmartControl™ pressure control with no moving parts, and a new AutoClean<sub>2</sub>™ system with new thread-on design and automatic shut-off with flush timer.

The TexSpray™ RTX 1500 was introduced in March 2004. This high-production texture sprayer has a RotoFlex™ HD pump with a "flow-through" design for the smooth delivery of both heavy and aggregated materials, a material operating pressure of 100 pounds per square inch, an automatic pressure unloader and a large 15 gallon hopper. This sprayer is distributed with the new TexSpray RTX 1500 Air Spray gun with oversized fluid passages for pumping heavy mud and larger aggregate.

In May 2004, the T-Max™ 405 was released. This texture machine was specifically designed to handle the larger aggregate sizes favored by European plasterers without the need in most instances for an air compressor. It is lightweight and easy to disassemble for cleaning. The T-Max 405 applies the texture material in an even layer without requiring substantial additional labor to smooth and finish.

In September 2004, the Company introduced the GH™ 230 and GH 300 airless sprayers. The units, powered by a hydraulic motor and capable of supporting .052 and .057 inch tips respectively, extend the performance capability of the segment's gas-hydraulic platform.

The FieldLazer™ was introduced in December 2004. The unit, an extension of the Company's LineLazer™ family of line striping equipment, works easily on grass and is designed to mark stripes on athletic fields.

The Graco 390™ electric airless sprayer was also launched in December 2004. It is a professional entry-level airless sprayer, that will support a .20 inch tip and provide a maximum flow rate of .4 gallons per minute.

During 2004, Home Depot introduced an In-Store-Service Initiative that removed the responsibility for the installation and maintenance of in-store product displays from product suppliers and assigned this responsibility to Home Depot or its designated contractors.

## Lubrication Equipment

Graco's Lubrication Equipment segment designs and markets products for the lubrication and maintenance of vehicles and other equipment. The markets for the segment's products include fast oil change facilities, service garages, fleet service centers, automobile dealerships, and industrial lubrication. The purchase of vehicle lubrication equipment is often funded by major oil companies for their customers as a marketing tool.

The Lubrication Equipment segment offers a full line of lubrication pumps (air and hydraulic-powered), hose reels, meters and dispense valves, fluid management systems, equipment for handling used oil, automatic lubrication equipment, and parts and accessories.

Products are distributed primarily through independent distributors worldwide, that are serviced by a network of independent sales representatives and direct sales generalists in foreign markets.

Products for the Lubrication Equipment markets are manufactured in Minneapolis, Minnesota.

**Recent Developments.** The Coolant King™, a used anti-freeze receiver, was introduced in May 2004. This unit is designed for draining anti-freeze in high volume service shops. Its distinctive green color allows users to differentiate it from the Oil King™ and avoid co-mingling different waste streams.

In August 2004, Graco launched the Mini-Fire-Ball® 225, a 3:1 air-operated piston oil pump. This pump is designed for low to medium volume use with bulk tanks and drums.

Sales of the Matrix™ Total Fluid Management System, first introduced in late 2002, were suspended in July 2003 because of field performance issues. The Company expects to reintroduce this product during the first half of 2005. The Matrix System provides wireless automated tracking and monitoring of vehicle fluids for car dealerships, fleet servicing centers, fast oil change centers and general vehicle servicing.

## Marketing and Distribution

Graco sells its full line of products in each of the following major geographic markets: the Americas (North and South America), Europe (including the Middle East and Africa), and Asia Pacific. Graco provides worldwide marketing, product design and application assistance to each of these geographic markets. Graco-employed sales personnel provide sales assistance in all geographic markets.

Graco sells its equipment worldwide principally through independent distributors. Manufacturers' representatives are also used. In Japan, Korea and Europe, Graco equipment is sold to distributors through sales subsidiaries. In the People's Republic of China, in addition to sales to independent distributors, a limited line of contractor equipment and some industrial/automotive equipment is sold to domestic distributors by a local subsidiary.

In 2004, Graco's net sales in the Americas were \$401.0 million, or approximately 66 percent of the Company's consolidated net sales; in Europe, net sales were \$124.5, million or approximately 21 percent; and in the Asia Pacific region, net sales were \$79.5 million, or approximately 13 percent.

## Research, Product Development and Technical Services

Graco's research, development and engineering activities are organized by operating segment. The engineering group in each segment focuses on new product design, product improvements, applied engineering and strategic technologies for its specific customer base. During 2004, the Industrial/Automotive segment expanded its product development capabilities with increases in engineering, design and technical staff. The Company's goal of generating at least 30 percent of each year's sales from products introduced in the prior three years was exceeded in 2002 and 2003 and nearly achieved in 2004 with 29 percent coming from new products. All major research and development activities are conducted in facilities located in Minneapolis and Rogers, Minnesota. Total research and development expenditures were \$22 million, \$18 million and \$18 million for 2004, 2003 and 2002, respectively.

## Raw Materials

The primary materials used in the manufacturing process are: various alloys, sizes and hardness of steel, specialty stainless steel and aluminum bar stock, tubing and castings; electric motors; injection molded plastics; and electronic components. In general, the raw materials and components used are adequately available through multiple sources of supply. The Company continues to increase its global sourcing of materials and components.

The automated equipment used in many of the Company's production processes requires special grades and sizes of bar stock and tubing to achieve maximum efficiency and productivity. During 2004, the Company experienced upward pressure on the price and decreased availability of steel, specialty stainless steel, aluminum and other metals. The Company is managing the price and availability fluctuations of various metals through more precise forecasts and long-term agreements. No work stoppages or price increases of the Company's products are attributable to the shortage of raw material. Price and availability pressures in the steel market are expected to ease in 2005 as mills and foundries around the world respond to the sharp increase in demand experienced during 2004.

## Intellectual Property

Graco owns a number of patents and has patent applications pending both in the United States and in other countries, licenses its patents to others, and is licensed under patents owned by others. In the opinion of the Company, its business is not materially dependent upon any one or more of these patents or licenses. The Company also owns a number of trademarks in the United States and foreign countries, including the registered trademarks for "GRACO," several forms of a capital "G" and various product trademarks which are material to the business of the Company, inasmuch as they identify Graco and its products to its customers.

## Competition

Graco faces substantial competition in all of its markets. The nature and extent of this competition varies in different markets due to the depth and breadth of the Company's product lines. Product quality, reliability, design, customer support and service, specialized engineering and pricing are the major competitive factors in Graco's markets. Although no competitor duplicates all of Graco's products, some competitors are larger than the Company, both in terms of sales of directly competing products and in terms of total sales and financial resources. The Company also faces competitors with different cost structures and expectations of profitability and these companies offer competitive products at lower prices. Graco believes it is one of the world's leading producers of high-quality specialized fluid management equipment. It is not possible to determine its relative market position because of the absence of reliable industry-wide third-party data.

## Environmental Protection

The Company's compliance with federal, state and local environmental laws and regulations did not have a material effect upon the capital expenditures, earnings or competitive position of the Company during the fiscal year ending December 31, 2004.

## Employees

As of December 31, 2004, the Company employed approximately 1,700 persons on a full-time basis. Of this total, approximately 250 were employees based outside the United States, and 750 were hourly factory workers in the United States. None of the Company's U.S. employees is covered by a collective bargaining agreement. Various national industry-wide labor agreements apply to certain employees in Europe. Compliance with such agreements has no material effect on the Company or its operations. The acquisition of Liquid Control Corporation and Gusmer Corporation and their affiliated companies added approximately 400 employees, approximately 100 of whom are based outside the United States.

## Item 2. Properties

As of December 31, 2004, the Company's principal operations that occupy more than 10,000 square feet were conducted in the following facilities:

| <u>Type of Facility</u>   | <u>Location</u>        | <u>Gross Square Footage</u> |
|---|------------------------|-----------------------------|
| <u>Owned</u>  |                        |                             |
| Manufacturing/Warehouse/Office                                    | Minneapolis, Minnesota | 405,000                     |
| Office  | Minneapolis, Minnesota | 42,000                      |
| Manufacturing/Warehouse/Office/<br>Contractor Product Development | Rogers, Minnesota      | 333,000                     |

|                                    |                                   |         |
|------------------------------------|-----------------------------------|---------|
| and Marketing                      |                                   |         |
| Corporate Headquarters/Lubrication | Minneapolis, Minnesota            | 139,000 |
| and Industrial/Automotive Product  |                                   |         |
| Development and Marketing          |                                   |         |
| Manufacturing/Office               | Sioux Falls, South Dakota         | 127,000 |
| European Headquarters/Warehouse    | Maasmechelen, Belgium             | 75,000  |
| <b><u>Leased</u></b>               |                                   |         |
| Office                             | Yokohama, Japan                   | 18,500  |
| Office/Warehouse                   | Gwangju-Gun, Korea (2 facilities) | 14,500  |

The Company leases space for liaison offices and a warehouse in the People's Republic of China.

Operations in the leased facility in Santa Fe Springs, California, ceased during the second quarter of 2004. Graco's sublease on this facility terminated on August 31, 2004.

The facilities listed above are in satisfactory condition, suitable for their respective uses and are generally adequate to meet current needs. Manufacturing capacity generally met business demand in 2004, but there were periods when the Company had difficulty meeting expected delivery service levels. Demand for several newly introduced products substantially exceeded forecast. Foreign sourcing of components and materials has lengthened lead times and made the Company more dependent upon efficient and responsive transportation systems. Shortages of certain commodities like steel, stainless steel and aluminum, together with rising costs, have affected both the Company and its customers. Production requirements in the immediate future are expected to be met through existing production capabilities, the installation of new automatic and semi-automatic machine tools, efficiency and productivity improvements, and the use of available subcontract services.

In July 2004, the Company announced its intention to open a manufacturing facility in Suzhou, China in late 2005. The 50,000 square foot factory will be built to Graco specifications and is expected to produce lower technology products for worldwide distribution.

Effective January 1, 2005, Graco acquired the stock of Liquid Control Corporation ("Liquid Control"). Liquid Control owns a 73,250 square foot manufacturing and office facility in North Canton, Ohio. Decker Industries and Liquid Control Limited, wholly-owned subsidiaries of Liquid Control, lease manufacturing and office space of 23,000 square feet in Palm City, Florida and own a manufacturing and office facility of 12,500 square feet in Wellingborough, United Kingdom, respectively. Effective February 4, 2005, Graco acquired the stock of Gusmer Corporation and Gusmer Europe S.L. Gusmer Corporation leases facilities in Lakewood, New Jersey consisting of 23,000 square feet of office space and 59,000 square feet of manufacturing/ warehouse space. Gusmer Europe, S.L. leases 29,000 square feet of office, manufacturing and warehouse space in Vilanova, Spain.

### Item 3. Legal Proceedings

The Company is engaged in routine litigation incident to its business, which management believes will not have a material adverse effect upon its operations or consolidated financial position. The Company has also been named as a defendant in a number of lawsuits alleging bodily injury as a result of exposure to asbestos, and a number of lawsuits alleging bodily injury as a result of exposure to silica. All of these lawsuits have multiple (most in excess of 100) defendants, and several have multiple plaintiffs. None of the suits make any allegations specifically regarding the Company or any of its products. A portion of the cost and potential liability for these claims is covered by insurance, although the exact extent of insurance coverage cannot be determined at this time because the cases are in the early stages of the litigation process and the allegations are so indefinite. Management does not expect that resolution of these matters will have a material adverse effect on the Company, although the ultimate outcome cannot be determined based on available information.

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

No issues were submitted to a vote of security holders during the fourth quarter of 2004.

### Executive Officers of the Company

The following are all the executive officers of Graco Inc. as of February 22, 2005.

**David A. Roberts, 57**, President and Chief Executive Officer. He has held this position since June 25, 2001. Prior to joining Graco, from 1996 to June 2001, he was Group Vice President of the Marmon Group, where he had responsibility for a group of manufacturing companies with products including grocery store refrigeration, retail store fixtures and fast food restaurant equipment. Mr. Roberts has been a director of Graco since June 2001.

**Karen Park Gallivan, 48**, Vice President, Human Resources since January 6, 2003. Prior to joining Graco, she was Vice President of Human Resources & Communications at Syngenta Seeds Inc. from January 1999 through December 2002.

**James A. Graner, 60**, Vice President and Controller since February 1994. He was Treasurer from May 1993 to February 1994. Prior to becoming Treasurer, he held various managerial positions in the treasury, accounting and information systems departments. He joined the Company in 1974.

**Dale D. Johnson, 50**, became Vice President and General Manager, Contractor Equipment Division on March 19, 2001. From January 14, 2000, to March 2001, he served as President and Chief Operating Officer. From December 1996 to January 2000, he was Vice President, Contractor Equipment Division. Prior to becoming the Director of Marketing, Contractor Equipment Division, in June 1996, he held various marketing and sales positions in the Contractor Equipment Division and the Industrial Equipment Division. He joined the Company in 1976.

**D. Christian Koch, 40**, became Vice President, Asia Pacific, effective June 16, 2003. From February 2000 until June 2003, he was Vice President, Lubrication Equipment Division. From August 1999 to February 2000, he was the Director, Industrial Global Sales and Marketing. From December 1998 to August 1999, he was Director, Lubrication Marketing. Mr. Koch joined the Company in December 1998.

**David M. Lowe, 49**, was elected Vice President and General Manager, Industrial Products Division, on February 18, 2005. He was Vice President and General Manager, European Operations, from September 1999 to February 2005. He was Vice President, Lubrication Equipment Division, from December 1996 to September 1999. From February 1995 to December 1996, he was Treasurer. Mr. Lowe joined the Company in 1995.

**Robert M. Mattison, 57**, became Vice President, General Counsel and Secretary, in January 1992, a position which he holds today. He joined the Company in 1992.

**Patrick J. McHale, 43**, Vice President and General Manager, Lubrication Equipment Division. He has held this position since June 16, 2003. He was Vice President of Manufacturing from March 2001 until June 2003. From February 2000 to March 2001, he served as Vice President, Contractor Equipment Division. Mr. McHale was also Vice President, Lubrication Equipment Division, from September 1999 to February 2000. Prior to becoming Contractor Equipment Manufacturing – Distribution Operations Manager in February 1998, he held various manufacturing management positions in Plymouth, Michigan and Sioux Falls, South Dakota. Mr. McHale joined the Company in 1989.

**Charles L. Rescorla, 53**, became Vice President of Manufacturing/Distribution Operations and Information Systems, effective June 16, 2003. From March 2001 until June 2003, he was Vice President of the Industrial/Automotive Equipment Division. Prior to becoming Vice President, Manufacturing and Distribution Operations in January 1995, he held various positions in manufacturing and engineering management. Mr. Rescorla joined the Company in 1988.

**Mark W. Sheahan, 40**, became Vice President and Treasurer on December 11, 1998. Effective December 17, 1996, he became Treasurer. Prior to becoming Treasurer, he was Manager of Treasury Services where he was responsible for strategic and financial activities. He joined the Company in 1995.

**Fred A. Sutter, 44**, was elected Vice President and General Manager, Applied Fluid Technologies Division, on February 18, 2005. He was Vice President and General Manager, Industrial/Automotive Equipment Division, from June 2003 to February 2005. He was Vice President, Asia Pacific and Latin America, from March 1999 to June 2003. From March 1995 to February 1999, he was Director of Industrial Marketing. He joined the Company in 1995.

The Board of Directors elected Ms. Gallivan, Mr. Graner, Mr. Johnson, Mr. Koch, Mr. Mattison, Mr. McHale, Mr. Rescorla, Mr. Roberts and Mr. Sheahan to their respective offices on April 23, 2004, all to hold office for the next year, or until their successors are elected and qualify.

## PART II

### Item 5. Market for the Company's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

#### Graco Common Stock

Graco common stock is traded on the New York Stock Exchange under the ticker symbol “GGG.” As of February 22, 2005, the share price was \$37.51 and there were 69,032,904 shares outstanding and 2,480 common shareholders of record, which includes nominees or broker dealers holding stock on behalf of an estimated 28,000 beneficial owners.

#### Quarterly Financial Information (Unaudited)

(In thousands, except per share amounts)

| 2004                          | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|-------------------------------|------------------|-------------------|------------------|-------------------|
| Net sales                     | \$134,982        | \$160,165         | \$149,066        | \$160,819         |
| Gross profit                  | 73,404           | 85,142            | 82,120           | 87,744            |
| Net earnings                  | 22,327           | 29,979            | 28,817           | 27,558            |
| Per common share              |                  |                   |                  |                   |
| Basic net earnings            | .32              | .43               | .42              | .40               |
| Diluted net earnings          | .32              | .43               | .41              | .39               |
| Dividends declared            | .09              | .09               | .09              | .13               |
| Stock price (per share)       |                  |                   |                  |                   |
| High                          | \$ 29.11         | \$ 31.05          | \$ 33.66         | \$ 37.70          |
| Low                           | 26.43            | 27.12             | 29.96            | 33.76             |
| Close <sup>1</sup>            | 29.11            | 31.05             | 33.50            | 37.35             |
| Volume (# of shares)          | 12,095           | 13,801            | 15,972           | 16,348            |
| 2003                          | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
| Net sales                     | \$119,660        | \$143,364         | \$133,788        | \$135,826         |
| Gross profit                  | 63,003           | 75,932            | 71,403           | 72,464            |
| Net earnings                  | 18,194           | 24,463            | 22,711           | 21,345            |
| Per common share <sup>2</sup> |                  |                   |                  |                   |
| Basic net earnings            | .26              | .36               | .33              | .31               |
| Diluted net earnings          | .25              | .35               | .32              | .30               |
| Dividends declared            | .06              | .06               | .06              | 1.59              |
| Stock price (per share)       |                  |                   |                  |                   |
| High                          | \$ 19.87         | \$ 21.33          | \$ 26.73         | \$ 26.99          |
| Low                           | 17.12            | 18.85             | 21.95            | 24.01             |
| Close <sup>1</sup>            | 18.73            | 21.33             | 25.03            | 26.73             |
| Volume (# of shares)          | 10,686           | 13,149            | 18,660           | 12,206            |

<sup>1</sup> As of the last trading day of the calendar quarter.

<sup>2</sup> All share and per share data has been restated for the three-for-two stock split declared on February 20, 2004, and distributed on March 30, 2004.

## Issuer Purchases of Equity Securities<sup>1</sup>

On February 22, 2002, the Board of Directors authorized a plan for the Company to purchase up to a total of 2,700,000 shares of its outstanding common stock, primarily through open-market transactions. This plan effectively expired upon approval of a new plan on February 20, 2004, authorizing the purchase of up to 3,000,000 shares and expiring on February 28, 2006.

In addition to shares purchased under the plan, 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 stock option exercises.

Information on issuer purchases of equity securities follows:

| Period                      | (a)<br>Total Number of<br>Shares Purchased | (b)<br>Average Price<br>Paid per<br>Share | (c)<br>Total Number<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | (d)<br>Maximum Number<br>of Shares that May<br>Yet Be Purchased<br>Under the Plans or<br>Programs (at end of<br>period) |
|-----------------------------|--|---|--|---|
| Sep 25, 2004 - Oct 29, 2004 | 17,500                                     | \$34.51                                   | 17,500   | 2,169,100   |
| Oct 30, 2004 - Nov 26, 2004 | 125,730                                    | \$36.91                                   | 124,800  | 2,044,300   |
| Nov 27, 2004 - Dec 31, 2004 | 74,900                                     | \$37.05                                   | 74,900   | 1,969,400   |

<sup>1</sup> All share and per share data reflects the three-for-two stock splits distributed on June 6, 2002 and March 30, 2004.

## Item 6. Selected Financial Data

| Graco Inc. & Subsidiaries<br>(In thousands, except per share amounts) | 2004      | 2003      | 2002      | 2001      | 2000      |
|---|-----------|-----------|-----------|-----------|-----------|
| Net sales   | \$605,032 | \$535,098 | \$487,048 | \$472,819 | \$494,373 |
| Net earnings  | 108,681   | 86,713    | 75,625    | 65,266    | 70,108    |
| Per common share <sup>1</sup>   |           |           |           |           |           |
| Basic net earnings  | \$ 1.57   | \$ 1.25   | \$ 1.06   | \$ .94    | \$ 1.03   |
| Diluted net earnings  | 1.55      | 1.23      | 1.05      | .92       | 1.01      |
| Total assets  | \$371,714 | \$397,390 | \$355,850 | \$276,113 | \$238,544 |
| Long-term debt (including current portion)                            | --        | --        | --        | 550       | 19,360    |
| Cash dividends declared<br>per common share <sup>1,2</sup>            | .41       | 1.76      | 0.20      | 0.18      | 0.17      |

<sup>1</sup> All share and per share data has been restated for the three-for-two stock splits distributed in 2004 and 2002.

<sup>2</sup> 2003 includes a special dividend of \$1.50 per share declared on December 12, 2003, paid on March 25, 2004, to shareholders of record as of March 11, 2004.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Results of Operations

The following discussion of the Company's financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements and other financial information included elsewhere in this report.

### 2004 Compared to 2003

#### Overview:

The Company achieved record sales and net earnings in 2004. All three business segments and regions posted strong sales gains that resulted in even higher net earnings. For the year, Industrial/Automotive Equipment sales were up 18.5 percent, Contractor Equipment sales were up 8.7 percent and Lubrication Equipment sales were up 10.3 percent. Geographically, in the Americas sales were up 9.0 percent and sales in Europe and Asia Pacific were up 22.8 and 20.8 percent, respectively. These sales gains were generally characterized by strong demand for the Company's products in most of its main product categories throughout the entire year. Management believes that improved demand was the result of many factors including an overall improvement in global demand for capital goods. Net earnings in 2004 were a record \$108.7 million, up 25.3 percent from 2003. In addition to the strong revenue gains, the effects of currency translation increased 2004 net earnings by approximately \$6.5 million. Diluted net earnings per share of \$1.55 were also the combined result of the aforementioned higher sales, favorable currency translations and share repurchases. Operating expenses were higher in all categories, but declined by 1.2 percentage points as a percentage of net sales. Higher operating expenses included additional spending for product development (up \$3.7 million) across all three divisions. The Company made a decision to increase its product development spending in 2004 to drive future incremental revenue growth. Operating expenses were also higher in



other areas including warehousing costs (up \$1.4 million), information systems spending (up \$2.1 million), additional contributions made to the Company's charitable foundation (up \$2.0 million) and the impact of currency translations (up approximately \$3 million).

Higher net earnings led to \$13.1 million of increased cash flow from operations in 2004. Total cash flow from operations of \$122.9 million plus cash on hand were used for dividends (\$129.9 million), share repurchases (\$40.8 million), and property, plant, equipment and software additions (\$19.3 million). By the end of the year, the Company had \$60.6 million of cash on hand after beginning the year with \$112.1 million. The Company also announced a 39 percent increase in its regular common stock dividend to be paid in 2005 (up approximately \$10 million versus 2004). Subsequent to year-end, the Company purchased Liquid Control Corporation, Inc., Gusmer Corporation and Gusmer Europe S.A. for cash totaling approximately \$100 million. These acquisitions were funded with cash on hand and borrowings under available lines of credit. In addition to funding ongoing operations, the Company's priorities for cash include acquisitions, share repurchases and dividends. Management believes that it has adequate liquidity to fund these items in 2005.

#### Sales:

| (In millions)            | 2004    | 2003    | % Increase (Decrease) |
|--------------------------|---------|---------|-----------------------|
| <b>Segment Sales:</b>    |         |         |                       |
| Industrial/Automotive    | \$274.6 | \$231.8 | 18.5                  |
| Contractor               | 278.7   | 256.4   | 8.7                   |
| Lubrication              | 51.7    | 46.9    | 10.3                  |
| Consolidated             | \$605.0 | \$535.1 | 13.1                  |
| <b>Geographic Sales:</b> |         |         |                       |
| Americas <sup>1</sup>    | \$401.0 | \$367.8 | 9.0                   |
| Europe <sup>2</sup>      | 124.5   | 101.5   | 22.8                  |
| Asia Pacific             | 79.5    | 65.8    | 20.8                  |
| Consolidated             | \$605.0 | \$535.1 | 13.1                  |

<sup>1</sup> North and South America, including the United States. Sales in the United States were \$363.4 in 2004 and \$336.6 in 2003.

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

#### Components of Net Sales Change

|                | Americas | Europe | 2004<br>Asia | Consolidated |
|----------------|----------|--------|--------------|--------------|
| Volume & price | 7.9%     | 12.6%  | 18.1%        | 10.1%        |
| Acquisitions   | 0.6%     | 0.0%   | 0.0%         | 0.4%         |
| Currency       | 0.5%     | 10.2%  | 2.7%         | 2.6%         |
| Total          | 9.0%     | 22.8%  | 20.8%        | 13.1%        |

|                | Industrial/Automotive | Contractor | 2004<br>Lubrication | Consolidated |
|----------------|-----------------------|------------|---------------------|--------------|
| Volume & price | 13.5%                 | 7.2%       | 8.9%                | 10.1%        |
| Acquisitions   | 0.9%                  | 0.0%       | 0.0%                | 0.4%         |
| Currency       | 4.1%                  | 1.5%       | 1.4%                | 2.6%         |
| Total          | 18.5%                 | 8.7%       | 10.3%               | 13.1%        |

Worldwide net sales in 2004 totaled \$605.0 million, compared with \$535.1 million in 2003, a 13.1 percent increase. Sales in 2004 include an extra week when compared to 2003 as a result of the Company's 52/53 week year-end convention. In 2004, volume (which includes price increases) increased 10.1 percent, acquisitions increased net sales by 0.4 percent, and changes in the value of the U.S. dollar increased worldwide net sales by 2.6 percent. In the Americas, net sales for 2004 increased 9.0 percent to \$401.0 million, with volume up 7.9 percent, acquisitions contributing 0.6 percent and currency translations adding 0.5 percent. Volume growth in the Americas (excluding acquisitions and currency translations) came from all three segments, with Industrial/Automotive Equipment up 14.6 percent, Contractor Equipment up 5.4 percent and Lubrication Equipment up 7.7 percent. This growth was primarily due to successful new product introductions in the Contractor Equipment and Industrial/Automotive Equipment segments, strong underlying economic growth for both Industrial/Automotive Equipment and Lubrication Equipment and the continued strength of the housing market in the Americas. The Company experienced sales increases in the Americas throughout the year in each of its segments including a 15 percent increase in the fourth quarter. In Europe, sales for 2004 totaled \$124.5 million (up 22.8 percent in U.S. dollars), with volume and price (excluding acquisitions and currency translations) contributing 12.6 percent. The volume increase in Europe was primarily the result of growth in both the Industrial/Automotive and Contractor segments. Europe's Industrial/Automotive sales volume was up 12.2 percent, driven by the successful launch of new products, increased large projects (defined as projects valued at more than \$100,000), ongoing growth in Eastern Europe and the Middle East and added distribution. Contractor Equipment sales volume in Europe was up 14.0 percent, primarily as the result of successful new products, increased distribution outlets, and strong business in the Middle East, Africa, and Southern and Eastern Europe. In Asia Pacific, 2004 sales were \$79.5 million, (up 20.8 percent in U.S. dollars), with volume and price contributing 18.1 percent. The volume growth in Asia Pacific was the result of higher sales in all three segments, with Industrial/Automotive Equipment up 17.1 percent, Contractor Equipment up 18.1 percent and Lubrication Equipment sales up 42.2 percent. This growth was primarily due to new product introductions, adding distribution and robust economic conditions resulting in significant capital investments being made throughout the region.

**Costs:**

|                                     | As a Percentage of Net Sales |              |
|-------------------------------------|------------------------------|--------------|
|                                     | 2004                         | 2003         |
| <b>Net Sales</b>                    | <b>100.0</b>                 | <b>100.0</b> |
| Cost of products sold               | 45.7                         | 47.1         |
| Gross profit                        | 54.3                         | 52.9         |
| Product development                 | 3.6                          | 3.4          |
| Selling, marketing and distribution | 17.3                         | 18.6         |
| General and administrative          | 6.7                          | 6.8          |
| Operating earnings                  | 26.7                         | 24.1         |
| Interest expense                    | 0.1                          | 0.1          |
| Other expense, net                  | 0.0                          | 0.1          |
| Earnings before income taxes        | 26.6                         | 23.9         |
| Income taxes                        | 8.6                          | 7.7          |
| <b>Net Earnings</b>                 | <b>18.0</b>                  | <b>16.2</b>  |

Gross profit margin, expressed as a percentage of sales, was 54.3 percent versus 52.9 percent last year. Factors contributing to the higher gross margin include higher volume (\$3 million favorable), manufacturing process improvements and the higher proportion of Industrial/Automotive products versus last year. These factors more than offset higher material costs (\$2 million net unfavorable), promotions and discounting.

Product development expenses for 2004 were 3.6 percent of net sales, up 2/10ths of one percentage point from 2003. Product development spending totaled \$21.8 million in 2004, up 20.4 percent from 2003. The increase was the result of additional headcount and increased projects in all three business segments.

Selling, marketing and distribution (SM&D) expenses for 2004 were 17.3 percent of net sales, down 1.3 percentage points from 2003. SM&D spending totaled \$104.4 million in 2004, up 5 percent from 2003. The increase in SM&D costs was the result of several factors including currency translation effects (approximately \$2 million), costs associated with the automated warehousing system (approximately \$1 million), higher sales incentives and the Home Depot In Store Service Initiative (ISSI) program (approximately \$1 million). Under the ISSI program, Home Depot will utilize third party organizations to assist with training associates and stocking products throughout their stores.

General and administrative (G&A) expenses for 2004 were 6.7 percent of net sales, down 1/10th of one percentage point from 2003. G&A spending totaled \$40.7 million in 2004, up 11.7 percent from 2003. The increase in G&A costs was the result of several factors. Some of the more significant increases were higher contributions to the Company's charitable foundation (up \$2.0 million) and higher information systems spending (up \$2.1 million).

The Company recorded pension income of \$0.9 million in 2004 versus pension expense of \$2.6 million in 2003. Improved investment returns on plan assets combined with a \$20 million voluntary contribution made in the fourth quarter if 2003 were the primary reasons for the change. Pension expense/income is recorded in cost of products sold and operating expense based on salaries and wages, approximately 45 percent to cost of products sold and 55 percent to operating expenses.

**Operating earnings:**

Operating earnings are used by management to measure performance of its business segments and the Company as a whole. Operating earnings exclude interest expense, interest income and the provision for income taxes. Consolidated operating earnings in 2004 were 26.7 percent of net sales, compared with 24.1 percent in 2003. Higher sales and an improved gross margin (both discussed previously) more than offset higher spending and were primarily responsible for the increased operating earnings. Operating results by segment were as follows:

| (In Millions)                 | 2004    | 2003    | % Increase (Decrease) |
|-------------------------------|---------|---------|-----------------------|
| <b>Segment Sales:</b>         |         |         |                       |
| Industrial/Automotive         | \$274.6 | \$231.8 | 18.5                  |
| Contractor                    | 278.7   | 256.4   | 8.7                   |
| Lubrication                   | 51.7    | 46.9    | 10.3                  |
| Consolidated                  | \$605.0 | \$535.1 | 13.1                  |
| <b>Operating Earnings:</b>    |         |         |                       |
| Industrial/Automotive         | \$ 88.2 | \$ 65.9 | 33.9                  |
| Contractor                    | 68.47   | 59.4    | 15.1                  |
| Lubrication                   | 11.8    | 9.9     | 19.8                  |
| Unallocated Corporate Expense | (6.9)   | (6.4)   | 8.5                   |
| Consolidated                  | \$161.5 | \$128.8 | 25.4                  |

**Industrial/Automotive.** Management looks at economic and financial indicators to gauge the business environment for its Industrial/Automotive Equipment segment. Since sales in this segment are significant in each geographic region, Americas (\$131.6 million, or 47.9 percent of segment sales), Europe (\$83.4 million, or 30.4 percent of segment sales), and Asia Pacific (\$59.6 million, or 21.7 percent of segment sales) management looks at economic and financial indicators in each region. The indicators used by management include gross domestic product, industrial production, capital investment rates and the level of the U.S. dollar versus the euro, Japanese yen, South Korean won and the Canadian dollar. Operating earnings in the Industrial/Automotive Equipment segment were 33.9 percent higher than last year. The increase was primarily due to

higher net sales, which were up 18.5 percent. For the year, the Industrial/Automotive segment experienced volume growth (excluding currency translations and acquisitions) of 13.5 percent, with favorable currency translations and acquisitions adding 4.1 and 0.9 percentage points of sales growth, respectively. Growth was experienced in each of the five major product application categories (sealant and adhesives, automobile refinishing, protective coatings, process equipment and finishing). In the Americas, reported sales were up 15.4 percent with volume (excluding currency translations and acquisitions) up 12.8 percent, acquisitions contributing 1.8 percent and currency translations adding 0.8 percent. Volume growth in the Americas was the result of successful new product introductions and robust underlying economic growth. Growth was experienced in each quarter throughout 2004 and management believes that conditions will remain strong for at least the first half of 2005. In Asia, reported sales were up 19.9 percent with volume growth of 17.1 percent, primarily due to new product introductions and robust economic conditions resulting from significant capital investments being made throughout the region. In Europe, reported sales were up 22.5 percent with volume up 12.2 percent, primarily as the result of increased large project activity, growth in Eastern Europe and the Middle East, the successful launch of new products and new distribution. In addition to the higher net sales, an improved gross margin (up 1.2 percentage points), primarily due to favorable currency translations, helped offset higher spending to contribute to the double-digit growth in operating earnings.

**Contractor.** Management looks at economic and financial indicators to gauge the business environment for its Contractor Equipment segment. Since the Americas represent the vast majority of sales (\$223.5 million, or 80.2 percent of segment sales), indicators in that region are the most important. The indicators used by management include levels of residential, commercial and institutional building and remodeling activity, interest rates and the value of the U.S dollar versus the euro and the Canadian dollar. Operating earnings in the Contractor Equipment segment increased 15.1 percent versus last year. The increase in operating earnings was primarily due to higher net sales, which were up 8.7 percent. Overall, sales volume (excluding currency translations) was up 7.2 percent with favorable currency translations adding 1.5 percentage points of sales growth for the year. In the Americas, reported sales were up 5.6 percent with volume (excluding currency translations) up 5.4 percent. This growth was primarily driven by higher sales in the paint store channel, which were up 7.5 percent. Sales in the home center channel were up 0.7 percent. Management believes that new product introductions, new distribution outlets and a strong housing market drove paint store revenue gains in the Americas. In Europe, reported sales were up 24.2 percent with volume growth of 14.0 percent, primarily due to successful new product introductions, incremental distribution and strong business in Southern Europe, Middle East/Africa and Eastern Europe. In Asia, reported sales were up 20.5 percent with volume growth of 18.1 percent, primarily from increased market penetration in developing countries like China, successful new product introductions and new distribution in Australia. In addition to the higher net sales, an improved gross margin (up 1.0 percentage point), primarily due to product cost improvements and the favorable impact of currency translations, helped offset higher spending to contribute to the double-digit increase in operating earnings.

**Lubrication.** Management looks at economic and financial indicators to gauge the business environment for its Lubrication Equipment segment. Since the Americas represent the vast majority of sales (\$45.9 million, or 88.6% of sales), indicators in that region are the most important. The indicators used by management include levels of capital investment, industrial production and gross domestic product. Operating earnings in the Lubrication Equipment segment were up 19.8 percent on a 10.3 percent increase in net sales. Sales were higher in all three geographic regions but the primary driver of the reported increase was growth of 8.6 percent in the Americas. Sales were strong across all of the major product categories, which are pumps, meters and hose reels. In addition to the increase in net sales, an improved gross margin (up 3.6 percentage points), primarily due to enhanced pricing and product cost reductions helped offset higher spending in product development, selling and warranty to contribute to the growth in operating earnings.

#### Unallocated corporate expense:

Unallocated corporate expense includes items such as bad debt expense, contributions to the Graco Foundation, amortization and certain other expenses driven by corporate decisions. In 2004, unallocated corporate expense was \$6.9 million versus \$6.4 million in 2003. The primary reason for the increase was higher contributions to the Company's charitable foundation (up \$2.0 million), which offset lower corporate spending for moves and facility closures.

#### Provision for income taxes:

The Company's net effective tax rate of 32 percent in 2004 was virtually unchanged from 2003 and both periods are lower than the U.S. federal statutory rate of 35 percent, due primarily to earnings from sales outside the U.S. being taxed at rates lower than the federal statutory rate.

#### Backlog:

Total backlog at the end of 2004 was \$18 million up from \$13 million at the end of 2003. The Company's backlog is typically small and is not a good indicator of future business levels.

#### 2003 Compared to 2002

#### Overview:

Net income totaled \$86.7 million, or \$1.23 per diluted share, compared with \$75.6 million, or \$1.05 per diluted share, in 2002. The effects of currency translation increased net earnings by approximately \$8 million in 2003, primarily due to the strength of the euro versus the U.S. dollar. The remaining portion of the increase in net earnings was the result of higher sales. Diluted earnings per share were affected by share repurchases in 2003 (repurchased 3.3 million shares, or approximately 4.6 percent of basic shares outstanding). Higher sales were reported in all three business segments in 2003 with Industrial/Automotive Equipment sales up 13.5 percent, Contractor Equipment sales up 7.7 percent and Lubrication Equipment sales up 4.7 percent. Operating expenses were higher in most categories except product development. Overall operating expenses were up \$16.7 million in 2003 with some of the major items being warranty and extended service (up approximately \$4 million), wages, benefit and severance expenses (up approximately \$6 million), the addition of Sharpe expenses (approximately \$2 million) and the impact of currency translations (approximately \$4 million).

Cash flow from operations was \$109.8 million in 2003 versus \$95.7 million in 2002. The significant uses of cash in 2003 included share repurchases (\$55.5 million), a pension contribution (\$20 million), property, plant and equipment additions (\$15.5 million), dividends (\$15.3 million), acquisitions (\$13.5 million), and retirement of debt (\$9.6 million). By the end of the year the Company had \$112.1 million of cash after beginning the year with \$103.3 million.

#### Sales:

| (In millions)         | 2003    | 2002    | % Increase (Decrease) |
|-----------------------|---------|---------|-----------------------|
| <b>Segment Sales:</b> |         |         |                       |
| Industrial/Automotive | \$231.8 | \$204.2 | 13.5                  |

|                          |         |         |      |
|--------------------------|---------|---------|------|
| Contractor               | 256.4   | 238.0   | 7.7  |
| Lubrication              | 46.9    | 44.8    | 4.7  |
| Consolidated             | \$535.1 | \$487.0 | 9.9  |
| <b>Geographic Sales:</b> |         |         |      |
| Americas <sup>1</sup>    | \$367.8 | \$345.7 | 6.4  |
| Europe <sup>2</sup>      | 101.5   | 88.3    | 14.9 |
| Asia Pacific             | 65.8    | 53.0    | 24.1 |
| Consolidated             | \$535.1 | \$487.0 | 9.9  |

<sup>1</sup> North and South America, including the United States. Sales in the United States were \$336.6 in 2003 and \$315.9 in 2002.

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

## Components of Net Sales Change

|                | Americas | Europe | 2003<br>Asia | Consolidated |
|----------------|----------|--------|--------------|--------------|
| Volume & price | 3.7%     | (1.3)% | 20.7%        | 4.5%         |
| Acquisitions   | 2.0%     | 0.0%   | 0.0%         | 1.4%         |
| Currency       | 0.7%     | 16.2%  | 3.4%         | 4.0%         |
| Total          | 6.4%     | 14.9%  | 24.1%        | 9.9%         |

|                | Industrial/Automotive | Contractor | 2003<br>Lubrication | Consolidated |
|----------------|-----------------------|------------|---------------------|--------------|
| Volume & price | 3.5%                  | 5.5%       | 2.7%                | 4.5%         |
| Acquisitions   | 3.4%                  | 0.0%       | 0.0%                | 1.4%         |
| Currency       | 6.6%                  | 2.2%       | 2.0%                | 4.0%         |
| Total          | 13.5%                 | 7.7%       | 4.7%                | 9.9%         |

Worldwide net sales in 2003 totaled \$535.1 million, compared with \$487.0 million in 2002, a 9.9 percent increase. In 2003, volume (which includes price increases) increased 4.5 percent, acquisitions increased net sales by 1.4 percent, and changes in the value of the U.S. dollar increased worldwide net sales by 4.0 percent. In the Americas, net sales for 2003 increased 6.4 percent to \$367.8 million, with volume up 3.7 percent, acquisitions contributing 2.0 percent and currency translations adding 0.7 percent. Volume growth in the Americas (excluding acquisitions and currency translations) came from all three segments, with Industrial/Automotive Equipment up 2.4 percent, Contractor Equipment up 4.5 percent and Lubrication Equipment up 2.3 percent. This growth was primarily due to successful new product introductions in the Contractor Equipment and Industrial/Automotive Equipment segments, modest underlying economic growth for both Industrial/Automotive Equipment and Lubrication Equipment, the continued robust housing market in the Americas and the addition of distribution outlets having a favorable impact on demand for Contractor Equipment products. The Company did experience a significant increase (up 14 percent) in Industrial/Automotive Equipment sales (excluding acquisitions and currency translations) in the Americas during the fourth quarter of 2003. Management believes that this increase was the result of improved economic conditions in the United States. In Europe, sales for 2003 totaled \$101.5 million (up 14.9 percent in U.S. dollars), with volume (excluding acquisitions and currency translations) down 1.3 percent. The volume decline in Europe was the result of weak industrial production in large portions of the region with Industrial/Automotive sales down 4.1 percent and Lubrication Equipment sales down 4.9 percent. Contractor Equipment sales volume in Europe was up 5.8 percent, primarily as the result of successful new products and increased market share from adding distribution outlets. In Asia Pacific, 2003 sales were \$65.8 million, (up 24.1 percent in U.S. dollars), with volume up 20.7 percent. The volume growth in Asia Pacific was the result of higher sales in all three segments, with Industrial/Automotive Equipment up 20.2 percent, Contractor Equipment up 21.8 percent and Lubrication Equipment sales up 25.4 percent. This growth was primarily due to new product introductions, adding distribution and robust economic conditions resulting from significant capital investments being made throughout the region, except for Japan, which remained weak.

## Costs:

|                                     | As a Percentage of Net Sales<br>2003 | 2002         |
|-------------------------------------|--------------------------------------|--------------|
| <b>Net Sales</b>                    | <b>100.0</b>                         | <b>100.0</b> |
| Cost of products sold               | 47.1                                 | 48.6         |
| Gross profit                        | 52.9                                 | 51.4         |
| Product development                 | 3.4                                  | 3.7          |
| Selling, marketing and distribution | 18.6                                 | 17.8         |
| General and administrative          | 6.8                                  | 6.7          |
| Operating earnings                  | 24.1                                 | 23.2         |
| Interest expense                    | 0.1                                  | 0.2          |

|                              |             |             |
|------------------------------|-------------|-------------|
| Other expense, net           | 0.1         | 0.1         |
| Earnings before income taxes | 23.9        | 22.9        |
| Income taxes                 | 7.7         | 7.4         |
| <b>Net Earnings</b>          | <b>16.2</b> | <b>15.5</b> |

Gross profit margin, expressed as a percentage of sales, was 52.9 percent versus 51.4 percent last year. Without the favorable impact of currency translations, the 2003 gross profit margin would have been unchanged from 2002 as normal production-related cost increases were offset by improved productivity, reduced material costs and selected price increases.

Product development expenses for 2003 were 3.4 percent of net sales, down 3/10ths of one percentage point from 2002. Product development spending totaled \$18.1 million in 2003, virtually flat with 2002. The Company anticipates increasing its product development spending in 2004 to drive incremental sales growth.

Selling, marketing and distribution (SM&D) expenses for 2003 were 18.6 percent of net sales, up 8/10ths of one percentage point from 2002. SM&D spending totaled \$99.4 million in 2003, up 15 percent from 2002. The increase in SM&D costs was the result of several factors including currency translation effects (\$3 million), warranty and extended service expenses (up \$4.4 million), severance payments (up \$2 million), payroll benefits (up \$1 million) and the addition of Sharpe expenses (\$1.5 million).

General and administrative (G&A) expenses for 2003 were 6.8 percent of net sales, up 1/10th of one percentage point from 2002. G&A spending totaled \$36.5 million in 2003, up 11 percent from 2002. The increase in G&A costs was the result of several factors including currency translation effects (\$1 million), employee bonus and incentives (up \$1 million), payroll benefits (up \$0.5 million) and the addition of Sharpe expenses (\$0.5 million). General and administrative expenses for 2003 and 2002 include contributions to the Graco Foundation totaling \$1.7 million and \$1.5 million, respectively.

The Company recorded pension expense of \$2.6 million in 2003 versus pension income of \$0.3 million in 2002. The primary reason for the increased pension expense in 2003 was lower investment performance of plan assets. Pension expense/income is recorded in cost of products sold and operating expense based on salaries and wages.

#### **Operating earnings:**

Operating earnings are used by management to measure performance of its business segments and the Company as a whole. Operating earnings excludes interest expense, interest income and the provision for income taxes. Consolidated operating earnings in 2003 were 24.1 percent of net sales, compared with 23.2 percent in 2002. Higher sales and an improved gross margin (both discussed previously) more than offset higher spending and were primarily responsible for the increased operating earnings. Operating results by segment were as follows:

| (In Millions)                 | 2003    | 2004    | % Increase (Decrease) |
|-------------------------------|---------|---------|-----------------------|
| <b>Segment Sales:</b>         |         |         |                       |
| Industrial/Automotive         | \$231.8 | \$204.2 | 13.5                  |
| Contractor                    | 256.4   | 238.0   | 7.7                   |
| Lubrication                   | 46.9    | 44.8    | 4.7                   |
| Consolidated                  | \$535.1 | \$487.0 | 9.9                   |
| <b>Operating Earnings:</b>    |         |         |                       |
| Industrial/Automotive         | \$65.9  | \$54.2  | 21.5                  |
| Contractor                    | 59.4    | 53.7    | 10.6                  |
| Lubrication                   | 9.9     | 9.6     | 2.8                   |
| Unallocated Corporate Expense | (6.4)   | (4.7)   | 34.6                  |
| Consolidated                  | \$128.8 | \$112.8 | 14.2                  |

**Industrial/Automotive.** Management looks at economic and financial indicators to gauge the business environment for its Industrial/Automotive Equipment segment. Since sales in this segment are significant in each geographic region, Americas (\$114.0 million, or 49.2 percent of segment sales), Europe (\$68.1 million, or 29.4 percent of segment sales), and Asia Pacific (\$49.7 million, or 21.4 percent of segment sales) management looks at economic and financial indicators in each region. The indicators used by management include gross domestic product, industrial production, capital investment rates and the level of the U.S. dollar versus the euro, Japanese yen, South Korean won and the Canadian dollar. Operating earnings in the Industrial/Automotive Equipment segment were 21.5 percent higher than last year. The increase was primarily due to higher net sales, which were up 13.5 percent. For the year, the Industrial/Automotive segment experienced volume growth (excluding currency translations and acquisitions) of 3.5 percent, with favorable currency translations and acquisitions adding 6.6 and 3.4 percentage points of sales growth, respectively. Growth was experienced in four of the five major product application categories (automobile refinishing, protective coatings, process equipment and finishing) while demand for sealant and adhesive equipment declined slightly. In the Americas, reported sales were up 10.5 percent with volume (excluding currency translations and acquisitions) up 2.4 percent, acquisitions contributing 6.8 percent and currency translations adding 1.3 percent. Volume growth in the Americas was the result of successful new product introductions and modest underlying economic growth. In the fourth quarter of 2003, volume growth (excluding currency translations and acquisitions) in the Americas was 14 percent and management believes that this increase was the result of improved economic conditions in the United States. In Asia, reported sales were up 23.8 percent with volume growth of 20.2 percent, primarily due to new product introductions and robust economic conditions resulting from significant capital investments being made throughout the region, except for Japan. In Europe, reported sales were up 11.8 percent with volume down 4.1 percent, primarily as the result of weak industrial production in large portions of the region. In addition to the higher net sales, an improved gross margin (up 1.5 percentage points), primarily due to favorable currency translations, helped offset higher spending to contribute to the double-digit growth in operating earnings.

**Contractor.** Management looks at economic and financial indicators to gauge the business environment for its Contractor Equipment segment. Since the Americas represent the vast majority of sales (\$211.6 million, or 82.5 percent of segment sales), indicators in that region are the most

important. The indicators used by management include levels of residential, commercial and institutional building and remodeling activity, interest rates and the value of the U.S dollar versus the euro and the Canadian dollar. Operating earnings in the Contractor Equipment segment increased 10.6 percent versus last year. The increase in operating earnings was primarily due to higher net sales, which were up 7.7 percent. Overall, sales volume (excluding currency translations) was up 5.5 percent with favorable currency translations adding 2.2 percentage points of sales growth for the year. In the Americas, reported sales were up 4.9 percent with volume (excluding currency translations) up 4.5 percent. Sales increased in both major customer channels in the Americas (paint store channel up 2.9 percent and home center channel up 10.1 percent), driven by new product introductions, new distribution outlets and a robust housing market. In Europe, reported sales were up 22.8 percent with volume growth of 5.8 percent, primarily due to successful new product introductions and increased market share from adding distribution outlets. In Asia, reported sales were up 25.0 percent with volume growth of 21.8 percent, primarily from increased market penetration in developing countries like China and a new distribution arrangement in Australia. In addition to the higher net sales, an improved gross margin (up 1.3 percentage points), primarily due to product cost improvements, helped offset higher spending to contribute to the double-digit increase in operating earnings.

**Lubrication.** Management looks at economic and financial indicators to gauge the business environment for its Lubrication Equipment segment. Since the Americas represent the vast majority of sales (\$42.2 million, or 90.1% of sales), indicators in that region are the most important. The indicators used by management include levels of capital investment, industrial production and gross domestic product. Operating earnings in the Lubrication Equipment segment were up 2.8 percent on a 4.7 percent increase in net sales. The primary reason for the deterioration in profitability was due to higher warranty and rework expenses (approximately \$1 million) associated with the Matrix™ product line. Sales were higher in all three geographic regions but the primary driver of the reported increase was growth of 3.5 percent in the Americas. In addition to the increase in net sales, an improved gross margin (up 1.5 percentage points), primarily due to enhanced pricing and product cost reductions helped offset higher spending to contribute to the growth in operating earnings.

#### ***Unallocated corporate expense:***

Unallocated corporate expense includes items such as bad debt expense, contributions to the Graco Foundation, amortization and certain other expenses driven by corporate decisions. In 2003, unallocated corporate expense was \$6.4 million versus \$4.7 million in 2002. The primary reason for the increase was higher corporate spending for move and facility closures.

#### ***Provision for income taxes:***

The Company's net effective tax rate of 32 percent in 2003 was virtually unchanged from 2002 and both periods are lower than the U.S. federal statutory rate of 35 percent, due primarily to earnings from sales outside the U.S. being taxed at rates lower than the federal statutory rate.

#### ***Backlog:***

Total backlog at the end of 2003 was \$13 million virtually unchanged from 2002. The Company's backlog is typically small and is not a good indicator of future business levels.

#### **Liquidity and Capital Resources**

The following table highlights several key measures of asset performance.

| (In thousands)                           | 2004      | 2003      |
|--|-----------|-----------|
| Cash and cash equivalents                | \$ 60,554 | \$112,118 |
| Working capital                          | \$130,453 | \$ 68,159 |
| Current ratio                            | 2.3       | 1.4       |
| Days of sales in receivables outstanding | 66        | 67        |
| Inventory turnover (LIFO)                | 6.7       | 8.7       |

**Financial Condition.** At December 31, 2004, the Company's capital structure included \$6.0 million of current debt, no long-term debt and \$230.8 million of shareholders' equity. Total debt outstanding increased \$1.8 million for the year.

At December 31, 2004, the Company had various lines of credit totaling \$91 million, of which \$89 million was unused. Cash balances of \$60.6 million at December 31, 2004, internally generated funds and unused financing sources provide the Company with the financial flexibility to meet its liquidity needs, including its capital expenditure plan of approximately \$25 million, acquisitions of approximately \$100 million and planned dividends of an estimated \$36 million.

In December of 2004, the Company's Board of Directors increased the Company's regular common dividend from an annual rate of \$0.373 per share to \$0.52 per share, a 39.3 percent increase. In 2005, the increase in the regular common dividend will result in payments to shareholders totaling approximately \$36.0 million. On February 20, 2004, the Company's Board of Directors authorized a plan for the Company to repurchase up to 3 million shares of its outstanding common stock. This authorization will expire on February 28, 2006. The Company has approximately 2.0 million shares remaining under this authorization.

Cash decreased \$51.6 million in 2004 to \$60.6 million. This decrease was primarily due to dividend payments (\$129.9 million) and share repurchases (\$40.8 million) made throughout the year. Included in 2004 dividend payments was a special dividend of approximately \$104 million that was paid on March 25, 2004.

Accounts receivable increased \$10.2 million in 2004 to \$109.1 million. The 10.3 percent increase in accounts receivable was primarily due to higher net sales (up 13.1 percent) versus 2003.

Inventories increased \$11.2 million in 2004 to \$40.2 million. The increase in inventory was primarily due to higher sales and initiatives to support the Company's customer service goals for in-stock inventory.

Dividends payable decreased \$101.3 million to \$9.0 million. The principal reason for the decrease was due to the payment of a special dividend on March 25, 2004.

Shareholders' equity increased \$61.0 million in 2004 to \$230.8 million. The key components of changes in shareholders' equity include current year earnings of \$108.7 million, common stock issued of \$15.1 million, \$6.8 million of tax benefits related to stock option exercises, reduced by \$28.6 million of dividends declared and \$40.8 million of shares repurchased.

**Contractual Obligations.** As of December 31, 2004, the Company is obligated to make cash payments in connection with its long-term debt, capital leases, operating leases and purchase obligations in the amounts listed below. The Company has no significant off-balance sheet debt or other unrecorded obligations other than the items noted in the following table. In addition to the commitments noted in the following table, the Company could be obligated to perform under standby letters of credit totaling \$2.5 million at December 31, 2004. The Company has also guaranteed the debt of its subsidiaries for up to \$22.2 million. All debt of subsidiaries is reflected in the consolidated balance sheets.

| (In thousands)                    | Payments due by period |                     |              |              |                      |
|-----------------------------------|------------------------|---------------------|--------------|--------------|----------------------|
|                                   | Total                  | Less than<br>1 year | 1-3<br>years | 3-5<br>years | More than<br>5 years |
| Long-term debt                    | \$ --                  | \$ --               | \$ --        | \$--         | \$--                 |
| Capital lease obligations         | --                     | --                  | --           | --           | --                   |
| Operating leases                  | 3,409                  | 1,824               | 1,576        | 9            | --                   |
| Purchase obligations <sup>1</sup> | 23,000                 | 23,000              | --           | --           | --                   |
| Total                             | \$26,409               | \$24,824            | \$1,576      | \$9          | \$--                 |

<sup>1</sup> The Company is committed to pay suppliers under the terms of open purchase orders issued in the normal course of business. The Company also has commitments with certain suppliers to purchase minimum quantities, and under the terms of certain agreements, the Company is committed for certain portions of the supplier's inventory. The Company does not purchase, or commit to purchase, quantities in excess of normal usage or amounts that cannot be used within one year.

**Cash Flows.** During 2004, \$122.9 million was generated from operating activities, compared to \$109.8 million in 2003 and \$95.7 million in 2002. The increase in 2004 was primarily due to higher net earnings and lower contributions to pension plans. These amounts were somewhat offset by higher inventories and accounts receivable, primarily as a result of increased sales activity. The increase in 2003 was primarily due to higher net earnings and increased changes in inventories, accounts receivable, deferred income taxes and accrued liabilities, offset somewhat by the impact of the \$20 million contribution made to the Company's U.S. defined benefit pension plan.

Cash generated by operations in 2004 combined with cash on the balance sheet was used to fund \$19.3 million of capital expenditures, \$129.9 million of cash dividends and \$40.8 million of share repurchases. Cash was invested in highly liquid investments (mainly money market funds) with maturities of three months or less. Total cash at the end of 2004 was \$60.6 million. Significant uses of cash in 2003 included \$15.5 million of capital expenditures, \$13.5 million for acquisitions, \$9.6 million for retirement of debt, \$15.3 million of cash dividends and \$55.5 million of share repurchases.

### Critical Accounting Estimates

The Company prepares its consolidated financial statements in conformity with generally accepted accounting principles in the United States of America ("U.S. GAAP"). This requires management to make estimates and judgments that affect reported amounts and related disclosures. Actual amounts will differ from those estimates. The Company considers the following policies to involve the most judgment in the preparation of the Company's consolidated financial statements.

**Sales Returns.** An allowance is established for possible return of products. The amount of the allowance is an estimate, which is based on historical ratios of returns to sales, the historical average length of time between the sale and the return and other factors. Also, the Company's written agreements with distributors typically limit the amount that may be returned. Though management considers these balances adequate and proper, changes in customers' behavior versus historical experience or changes in the Company's return policies are among the factors that would result in materially different amounts for this item.

**Product Warranty.** A liability is established for estimated warranty and service claims to be paid in the future that relate to current and prior period sales. The Company estimates these costs based on historical claim experience and other factors, including evaluating specific customer warranty issues. The establishment of reserves requires the use of judgment and assumptions regarding the potential for losses relating to warranty issues. Though management considers these balances adequate and proper, changes in the Company's warranty policy or a significant change in product defects versus historical averages are among the factors that would result in materially different amounts for this item.

**Excess and Discontinued Inventory.** The Company's inventories are valued at the lower of cost or market. Reserves for excess and discontinued product are estimated. The amount of the reserve is determined based on projected sales information, plans for discontinued products and other factors. Though management considers these balances adequate and proper, changes in sales volumes due to unexpected economic or competitive conditions are among the factors that would result in materially different amounts for this item.

**Self-Insurance.** The Company is self-insured for most claims related to products liability, workers compensation and employee medical benefits. Third party insurance is carried for what is believed to be the major portion of potential exposures that would exceed the Company's self-insured retentions. The Company has established liabilities for potential uninsured claims, including estimated costs and legal fees. The Company employs actuaries to assist in evaluating its potential ultimate exposure for uninsured claims and then considers factors such as known outstanding claims, historical experience, sales trends and other relevant factors in setting the liabilities. Though management considers these balances adequate and proper, a substantial change in the number and/or severity of claims would result in materially different amounts for this item.

**Income Taxes.** In the preparation of the Company's consolidated financial statements, management calculates income taxes. This includes estimating current tax liability as well as assessing temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income. A valuation allowance is established to the extent that management believes that recovery is not likely. Reserves are also established for potential and ongoing

audits of federal, state and international issues. The Company routinely monitors the potential impact of such situations and believes that it is properly reserved. Valuations related to amounts owed and tax rates could be impacted by changes to tax codes, changes in statutory tax rates, the Company's future taxable income levels and the results of tax audits.

**Retirement Obligations.** The measurement of the Company's pension and post-retirement medical obligation is dependent on a number of assumptions including estimates of the present value of projected future payments, taking into consideration future events such as salary increases and demographic experience. These assumptions may have an impact on the amount and timing of future contributions.

The assumptions used in developing the required estimates include discount rates, inflation, salary increases, retirement rates, expected return on plan assets and mortality rates.

The Company determines its discount rate assumption at year-end based on the prevailing interest rate on long-term corporate bonds rated AA as quoted by Moody's Investor Services, an established credit rating agency. The Company bases its inflation assumption on an evaluation of external market indicators. The salary assumptions are based on actual historical experience, the near-term outlook and assumed inflation. Retirement rates are based on actual experience. The investment return assumption is based on the expected long-term performance of plan assets. In setting this number, the Company considers the input of actuaries and investment advisors, long-term historical returns, the allocation of plan assets, and projected returns on plan assets. Mortality rates are based on a common group mortality table for males and females.

Pension income in 2004 was \$0.9 million and was allocated to cost of products sold and operating expenses based on salaries and wages. At December 31, 2004, a one-half percent decrease in the indicated assumptions would have the following effects (in thousands):

| Assumption                | Funded Status | Expense |
|---------------------------|---------------|---------|
| Discount rate             | \$(12,400)    | \$300   |
| Expected return on assets | \$ --         | \$800   |

## New Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004), "Share-Based Payment" that requires compensation costs related to share-based payment transactions to be recognized in the financial statements. This standard will be effective for the Company starting with the third quarter of 2005. Future compensation cost, net of tax effects, related to unvested stock compensation as of December 31, 2004 is approximately \$2.7 million in 2005, \$1.8 million in 2006 and \$1.3 million in 2007 (as valued and calculated under SFAS 123 for pro forma disclosures.) The Company has not yet determined how it will value future grants or whether it will elect to adjust prior periods upon adoption of SFAS No. 123 (Revised 2004).

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4." This standard clarifies the accounting for abnormal inventory costs and requires the allocation of fixed production overheads to inventory to be based on the normal capacity of the production facilities. The new standard is effective for the Company starting in 2006 and is expected to have no significant impact on operating results or financial condition.

In December 2004, the FASB issued Staff Position (FSP) No. 109-1, "Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004" and FSP No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision Within the American Jobs Creation Act of 2004." The Company expects the benefits from the provisions of the American Jobs Creation Act of 2004 addressed by these FSP's to be similar to the Extra Territorial Income Exclusion rules in place for 2004.

## Item 7a. Quantitative and Qualitative Disclosures About Market Risk

The Company sells and purchases products and services in currencies other than the U.S. dollar. Consequently, the Company is subject to profitability risk arising from exchange rate movements.

The Company manages foreign currency market risk, from time to time, through the use of a variety of financial and derivative instruments. The Company does not enter into any of these instruments for trading purposes to generate revenue. Rather, the Company's objective in managing these risks is to reduce fluctuations in earnings and cash flows associated with changes in foreign currency exchange rates. The Company uses forward exchange contracts, options and other hedging activities to hedge the U.S. dollar value resulting from anticipated currency transactions and net monetary asset and liability positions. At December 31, 2004, the foreign currencies to which the Company had the most significant balance sheet exchange rate exposure were the euro, Canadian dollar, Japanese yen, British pound, and Korean won.

It is not possible to determine the true impact of foreign currency translation changes; however, the direct effect on net sales and net earnings can be estimated. When compared to 2003 results, the weaker U.S. dollar versus foreign currencies helped to increase sales and net earnings. For the year ended December 31, 2004, the impact of foreign currency translation resulted in an overall increase in net sales and net earnings of approximately \$14 million and \$6.5 million, respectively. For the year ended December 26, 2003, the impact of foreign currency translation resulted in an overall increase in net sales and net earnings of approximately \$18 million and \$8 million, respectively.

When appropriate, the Company utilizes interest rate swaps to manage its exposure to fluctuations in earnings due to changes in interest rates on its variable rate debt. There was no such debt at December 31, 2004.

## Long-Term Outlook

The Company does not provide analysts or shareholders with specific targets for net sales or net earnings growth. Rather, management is committed to achieving its stated financial objectives over a long-term time horizon. The Company's financial objectives are:

- Net sales growth exceeding 10 percent annually
- Net earnings growth exceeding 12 percent annually
- Return on sales exceeding 10 percent
- Return on assets exceeding 15 percent
- Return on equity exceeding 20 percent



## 2005 Outlook

The Company is expecting higher net sales and net earnings in 2005. This expectation is based on management's belief that most of the Company's major markets will continue to experience favorable economic conditions in 2005. It is important to note that management's vision regarding future sales activity is limited due to the small backlog that the Company carries. In addition to economic growth, the improved sales outlook is dependent upon many factors, including the successful launch of new products, expanding distribution coverage, price increases, the successful management and integration of acquisitions and stable or favorable exchange rates versus 2004. The earnings outlook assumes higher sales, continued improvements in manufacturing (which minimize cost increases including purchased commodities), the continued disciplined management of operating expenses, the successful management and integration of acquisitions and a relatively stable effective income tax rate.

## Forward-Looking Statements

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, as well as in press or earnings releases, analyst briefings, conference calls and the Company's Annual Report to shareholders 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 Exhibit 99 to the Company's Annual Report on Form 10-K for fiscal year 2004 for a more comprehensive discussion of these and other risk factors.

Investors should realize that factors other than those identified above and in 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 8. Financial Statements and Supplementary Data

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## Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. The internal control system was designed to provide reasonable assurance to management and the board of directors regarding the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework.

Based on our assessment and those criteria, management believes the Company's internal control over financial reporting is effective as of December 31, 2004.

The Company's independent auditors have issued an attestation report on management's assessment of the Company's internal control over financial reporting. That report appears herein.

## Reports of Independent Registered Public Accounting Firm

### *Internal Control Over Financial Reporting*

Shareholders and Board of Directors  
Graco Inc.  
Minneapolis, Minnesota

We have audited management's assessment, included in the accompanying Management Report on Internal Control Over Financial Reporting, that Graco Inc. and Subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended December 31, 2004, of the Company and our report dated February 25, 2005, expressed an unqualified opinion on those financial statements and financial statement schedule.

Deloitte & Touche LLP  
Minneapolis, Minnesota  
February 25, 2005

**Consolidated Financial Statements**

Shareholders and Board of Directors  
Graco Inc.  
Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheets of Graco Inc. and Subsidiaries (the "Company") as of December 31, 2004 and December 26, 2003, and the related consolidated statements of earnings, shareholders' equity, comprehensive income, and cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Graco Inc. and Subsidiaries as of December 31, 2004, and December 26, 2003, and the results of their operations and cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 25, 2005 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP  
Minneapolis, Minnesota  
February 25, 2005

**CONSOLIDATED STATEMENTS OF EARNINGS**

**Graco Inc. and Subsidiaries**

|  | Years Ended       |                   |                   |
|--|-------------------|-------------------|-------------------|
| (In thousands, except per share amounts) | December 31, 2004 | December 26, 2006 | December 27, 2002 |
| Net Sales                                | \$605,032         | \$535,098         | \$487,048         |
| Cost of products sold                    | 276,622           | 252,296           | 236,890           |

|  |           |           |           |
|--|-----------|-----------|-----------|
| <b>Gross Profit</b>                          | 328,410   | 282,802   | 250,158   |
| Product development                          | 21,783    | 18,087    | 18,172    |
| Selling, marketing and distribution          | 104,372   | 99,426    | 86,409    |
| General and administrative                   | 40,724    | 36,456    | 32,731    |
| <b>Operating Earnings</b>                    | 161,531   | 128,833   | 112,846   |
| Interest expense                             | 498       | 483       | 614       |
| Other expense, net                           | 252       | 437       | 507       |
| <b>Earnings before Income Taxes</b>          | 160,781   | 127,913   | 111,725   |
| Income taxes                                 | 52,100    | 41,200    | 36,100    |
| <b>Net Earnings</b>                          | \$108,681 | \$ 86,713 | \$ 75,625 |
| <b>Basic Net Earnings per Common Share</b>   | \$ 1.57   | \$ 1.25   | \$ 1.06   |
| <b>Diluted Net Earnings per Common Share</b> | \$ 1.55   | \$ 1.23   | \$ 1.05   |
| <b>Dividends Declared per Common Share</b>   | \$ .41    | \$ 1.76   | \$ .20    |

See Notes to Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEETS

## Graco Inc. and Subsidiaries

(In thousands, except share and per share amounts)

December 31, 2004

December 26, 2003

### Assets

#### Current Assets

|   |           |            |
|---|-----------|------------|
| Cash and cash equivalents                                   | \$ 60,554 | \$ 112,118 |
| Accounts receivable, less allowances of \$5,600 and \$5,700 | 109,080   | 98,853     |
| Inventories   | 40,219    | 29,018     |
| Deferred income taxes                                       | 15,631    | 14,909     |
| Other current assets  | 1,742     | 1,208      |

|  |         |         |
|--|---------|---------|
| Total current assets                       | 227,226 | 256,106 |
| <b>Property, Plant and Equipment</b> , net | 94,510  | 94,317  |
| <b>Prepaid Pension</b>                     | 27,556  | 25,444  |
| <b>Goodwill</b>                            | 9,199   | 9,199   |
| <b>Other Intangible Assets</b> , net       | 8,959   | 10,622  |
| <b>Other Assets</b>                        | 4,264   | 1,702   |

|                     |                   |                   |
|---------------------|-------------------|-------------------|
| <b>Total Assets</b> | <b>\$ 371,714</b> | <b>\$ 397,390</b> |
|---------------------|-------------------|-------------------|

### LIABILITIES AND SHAREHOLDERS' EQUITY

#### Current Liabilities

|                                 |          |          |
|---------------------------------|----------|----------|
| Notes payable to banks          | \$ 6,021 | \$ 4,189 |
| Trade accounts payable          | 18,599   | 15,752   |
| Salaries, wages and commissions | 19,804   | 16,384   |
| Dividends payable               | 8,990    | 110,304  |
| Other current liabilities       | 43,359   | 41,318   |

|                           |        |         |
|---------------------------|--------|---------|
| Total current liabilities | 96,773 | 187,947 |
|---------------------------|--------|---------|

|  |        |        |
|--|--------|--------|
| <b>Retirement Benefits and Deferred Compensation</b> | 33,092 | 30,567 |
|--|--------|--------|

|                              |        |       |
|------------------------------|--------|-------|
| <b>Deferred Income Taxes</b> | 11,012 | 9,066 |
|------------------------------|--------|-------|

#### Commitments and Contingencies (Note K)

#### Shareholders' Equity

|   |         |        |
|---|---------|--------|
| Common stock, \$1 par value; 97,000,000 shares authorized;<br>68,979,219 and 46,040,134 shares outstanding in 2004 and 2003 | 68,979  | 46,040 |
| Additional paid-in capital  | 100,180 | 81,405 |
| Retained earnings   | 62,773  | 43,295 |
| Accumulated comprehensive income (loss) and other   | (1,095) | (930)  |

|                            |         |         |
|----------------------------|---------|---------|
| Total shareholders' equity | 230,837 | 169,810 |
|----------------------------|---------|---------|

|   |                   |                   |
|---|-------------------|-------------------|
| <b>Total Liabilities and Shareholders' Equity</b> | <b>\$ 371,714</b> | <b>\$ 397,390</b> |
|---|-------------------|-------------------|

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

## Graco Inc. and Subsidiaries

Years Ended

(In thousands)

December 31, 2004

December 26, 2003

December 27, 2002

**Cash Flows From Operating Activities**

|   |                |                |               |
|---|----------------|----------------|---------------|
| Net earnings  | \$ 108,681     | \$ 86,713      | \$ 75,625     |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                |                |               |
| Depreciation and amortization   | 17,808         | 18,747         | 18,080        |
| Deferred income taxes   | 1,403          | 4,721          | 274           |
| Tax benefit related to stock options exercised                                      | 6,782          | 3,673          | 4,312         |
| Change in:  |                |                |               |
| Accounts receivable   | (7,290)        | 563            | (5,053)       |
| Inventories   | (11,031)       | 4,694          | 452           |
| Trade accounts payable  | 2,790          | 1,231          | 2,215         |
| Salaries, wages and commissions   | 3,020          | 1,402          | 3,565         |
| Retirement benefits and deferred compensation                                       | (1,067)        | (17,394)       | (566)         |
| Other accrued liabilities   | 1,539          | 4,808          | (4,192)       |
| Other   | 273            | 649            | 961           |
| <b>Net cash provided by operating activities</b>                                    | <b>122,908</b> | <b>109,807</b> | <b>95,673</b> |

**Cash Flows from Investing Activities**

|   |                 |                 |                 |
|---|-----------------|-----------------|-----------------|
| Property, plant and equipment additions             | (16,893)        | (15,515)        | (12,253)        |
| Proceeds from sale of property, plant and equipment | 175             | 257             | 295             |
| Capitalized software additions                      | (2,446)         | --              | --              |
| Acquisition of business, net of cash acquired       | --              | (13,514)        | --              |
| <b>Net cash used in investing activities</b>        | <b>(19,164)</b> | <b>(28,772)</b> | <b>(11,958)</b> |

**Cash Flows from Financing Activities**

|   |                  |                   |                   |
|---|------------------|-------------------|-------------------|
| Borrowings on notes payable and lines of credit | 25,399           | 14,675            | 21,198            |
| Payments on notes payable and lines of credit   | (23,647)         | (24,283)          | (18,200)          |
| Payments on long-term debt                      | --               | --                | (550)             |
| Common stock issued                             | 15,117           | 10,514            | 12,867            |
| Common stock retired                            | (40,792)         | (55,496)          | (7,088)           |
| Cash dividends paid                             | (129,910)        | (15,253)          | (13,887)          |
| <b>Net cash used in financing activities</b>    | <b>(153,833)</b> | <b>(69,843)</b>   | <b>(5,660)</b>    |
| Effect of exchange rate changes on cash         | (1,475)          | (2,407)           | (1,253)           |
| Net increase in cash and cash equivalents       | (51,564)         | 8,785             | 76,802            |
| Cash and cash equivalents                       |                  |                   |                   |
| Beginning of year                               | 112,118          | 103,333           | 26,531            |
| <b>End of year</b>                              | <b>\$ 60,554</b> | <b>\$ 112,118</b> | <b>\$ 103,333</b> |

See Notes to Consolidated Financial Statements.

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY****Graco Inc. and Subsidiaries**

| (In thousands)                                 | Years Ended       |                   |                   |
|--|-------------------|-------------------|-------------------|
|  | December 31, 2004 | December 26, 2003 | December 27, 2002 |
| <b>Common Stock</b>                            |                   |                   |                   |
| Balance, beginning of year                     | \$ 46,040         | \$ 47,533         | \$ 31,113         |
| Stock split                                    | 23,081            | --                | 15,875            |
| Shares issued                                  | 1,038             | 734               | 798               |
| Shares repurchased                             | (1,180)           | (2,227)           | (253)             |
| Balance, end of year                           | 68,979            | 46,040            | 47,533            |
| <b>Additional Paid-In Capital</b>              |                   |                   |                   |
| Balance, beginning of year                     | 81,405            | 71,277            | 54,269            |
| Shares issued                                  | 14,079            | 9,816             | 13,138            |
| Tax benefit related to stock options exercised | 6,782             | 3,673             | 4,312             |
| Shares repurchased                             | (2,086)           | (3,361)           | (442)             |
| Balance, end of year                           | 100,180           | 81,405            | 71,277            |
| <b>Retained Earnings</b>                       |                   |                   |                   |
| Balance, beginning of year                     | 43,295            | 128,125           | 89,155            |
| Net income                                     | 108,681           | 86,713            | 75,625            |
| Dividends declared                             | (28,596)          | (121,635)         | (14,387)          |
| Stock split                                    | (23,081)          | --                | (15,875)          |
| Shares repurchased                             | (37,526)          | (49,908)          | (6,393)           |

|  |                   |                   |                   |
|--|-------------------|-------------------|-------------------|
| Balance, end of year                                 | 62,773            | 43,295            | 128,125           |
| <b>Accumulated Other Comprehensive Income (Loss)</b> |                   |                   |                   |
| Balance, beginning of year                           | (474)             | (702)             | (720)             |
| Current period change                                | (505)             | 228               | 18                |
| Balance, end of year                                 | (979)             | (474)             | (702)             |
| <b>Unearned Compensation</b>                         |                   |                   |                   |
| Balance, beginning of year                           | (456)             | (827)             | (77)              |
| Restricted stock issued                              | --                | (36)              | (1,069)           |
| Charged to operations                                | 340               | 407               | 319               |
| Balance, end of year                                 | (116)             | (456)             | (827)             |
| <b>Total Shareholders' Equity</b>                    | <b>\$ 230,837</b> | <b>\$ 169,810</b> | <b>\$ 245,406</b> |

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

## Graco Inc. and Subsidiaries

| (In thousands)                          | Years Ended       |                   |                   |
|---|-------------------|-------------------|-------------------|
|   | December 31, 2004 | December 26, 2003 | December 27, 2002 |
| <b>Net Earnings</b>                     | \$ 108,681        | \$86,713          | \$75,625          |
| Other comprehensive income, net of tax: |                   |                   |                   |
| Minimum pension liability adjustment    | (505)             | 228               | 18                |
| <b>Comprehensive Income</b>             | <b>\$ 108,176</b> | <b>\$86,941</b>   | <b>\$75,643</b>   |

See Notes to Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Graco Inc. and Subsidiaries

Years Ended December 31, 2004, December 26, 2003, and December 27, 2002

### A. Summary of Significant Accounting Policies

**Fiscal Year.** The fiscal year of Graco Inc. and Subsidiaries (the Company) is 52 or 53 weeks, ending on the last Friday in December. The year ended December 31, 2004, was a 53-week year. Years ended December 26, 2003, and December 27, 2002, were 52-week years.

**Basis of Statement Presentation.** The consolidated financial statements include the accounts of the parent company and its subsidiaries after elimination of all significant intercompany balances and transactions. As of December 31, 2004, all subsidiaries are 100 percent owned. Certain prior year amounts have been reclassified to conform with 2004 presentation, but had no effect on previously reported net earnings or shareholders' equity.

**Foreign Currency Translation.** The U.S. dollar is the functional currency for all foreign subsidiaries. Accordingly, gains and losses from the translation of foreign currency balances and transactions of foreign subsidiaries are included in other expense, net.

**Accounting Estimates.** The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Such estimates and assumptions also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash Equivalents.** All highly liquid investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents.

**Inventory Valuation.** Inventories are stated at the lower of cost or market. The last-in, first-out (LIFO) cost method is used for valuing most U.S. inventories. Inventories of foreign subsidiaries are valued using the first-in, first-out (FIFO) cost method.

**Property, Plant and Equipment.** For financial reporting purposes, plant and equipment are depreciated over their estimated useful lives, primarily by using the straight-line method as follows:

|  |  |
|--|--|
| Buildings and improvements                 | 10 to 30 years                           |
| Leasehold improvements                     | lesser of 5 to 10 years or life of lease |
| Manufacturing equipment                    | 5 to 10 years                            |
| Office, warehouse and automotive equipment | 3 to 10 years                            |

**Intangible Assets.** Goodwill has been assigned to reporting units, which have been determined to be the Company's operating segments, as follows:

| (In thousands)          | 2004    | 2003    |
|-------------------------|---------|---------|
| Industrial / Automotive | \$1,260 | \$1,260 |
| Contractor              | 7,939   | 7,939   |

The Company reviews goodwill for impairment annually in the fourth quarter. Results of testing indicated no impairment in 2004 and 2003.

Components of other intangible assets were:

|  | December 31, 2004      |               |              |            | December 26, 2003 |              |            |
|--|------------------------|---------------|--------------|------------|-------------------|--------------|------------|
| (Dollars in thousands)                             | Estimated Life (Years) | Original Cost | Amortization | Book Value | Original Cost     | Amortization | Book Value |
| <b>Subject to Amortization</b>                     |                        |               |              |            |                   |              |            |
| Customer lists and distribution network            | 5                      | \$ 3,765      | \$1,543      | \$2,222    | \$ 8,336          | \$4,980      | \$ 3,356   |
| Trademarks, trade names and non-compete agreements | 2 - 10                 | 1,494         | 667          | 827        | 2,803             | 1,622        | 1,181      |
| Patents and other                                  | 3 - 15                 | 1,241         | 611          | 630        | 1,241             | 436          | 805        |
|  |                        | 6,500         | 2,821        | 3,679      | 12,380            | 7,038        | 5,342      |
| <b>Not Subject to Amortization</b>                 |                        |               |              |            |                   |              |            |
| Brand Name   |                        | 5,280         | --           | 5,280      | 5,280             | --           | 5,280      |
|  |                        | \$11,780      | \$2,821      | \$8,959    | \$17,660          | \$7,038      | \$10,622   |

Amortization of intangibles was \$1.7 million in 2004 and \$2.2 million in 2003. Estimated future annual amortization is as follows: \$1.1 million in 2005, \$0.9 million in 2006, \$0.9 million in 2007, \$0.4 million in 2008, \$0.2 million in 2009 and \$0.2 million thereafter. The Company tests other intangible assets not subject to amortization for impairment annually in the fourth quarter. Results of testing indicated no impairment in 2004 and 2003.

**Capitalized Software.** The Company capitalizes certain external application development and purchased software costs. Capitalized software is included in Other Assets and is amortized over its estimated useful life (generally 2 to 5 years) beginning at date of implementation.

**Impairment of Long-Lived Assets.** Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate the carrying value of the assets may not be recoverable. There have been no write-downs of any long-lived assets in the periods presented.

**Other Current Liabilities.** Components of other current liabilities were:

| (In thousands)                           | 2004     | 2003     |
|--|----------|----------|
| Accrued insurance liabilities            | \$ 9,139 | \$ 9,939 |
| Accrued warranty and service liabilities | 9,409    | 9,227    |
| Accrued trade promotions                 | 6,574    | 3,090    |
| Payable for employee stock purchases     | 4,913    | 4,250    |
| Income taxes payable                     | 2,188    | 5,981    |
| Other                                    | 11,136   | 8,831    |
| Total                                    | \$43,359 | \$41,318 |

**Self-Insurance.** The Company is self-insured for certain losses and costs relating to product liability, workers' compensation and employee medical benefits claims. The Company has purchased stop-loss coverage in order to limit its exposure to significant claims. Accrued insurance liabilities are based on claims filed and estimates of claims incurred but not reported.

**Product Warranties.** 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 customer warranty issues. Following is a summary of activity in accrued warranty and service liabilities:

| (In thousands)                 | 2004     | 2003     |
|--------------------------------|----------|----------|
| Balance, beginning of year     | \$ 9,227 | \$ 9,939 |
| Charged to expense             | 8,066    | 9,490    |
| Margin on parts sales reversed | 2,516    | 4,697    |
| Reductions for claims settled  | (10,400) | (11,254) |
| Balance, end of year           | \$ 9,409 | \$ 9,227 |

**Revenue Recognition.** Sales are recognized when revenue is realized or realizable and has been earned. The Company's policy is to recognize revenue when risk and title passes to the customer. This is generally on the date of shipment, however certain sales are shipped FOB destination and revenue is recognized when received by the customer. Where there are multiple deliverables, the transactions are separated and a portion of the sale deferred until earned. The Company records provisions for anticipated returns and warranty claims at the time revenue is recognized. Historically, sales returns have been between 2 and 3 percent of sales. Provisions for sales returns are recorded as a reduction of net sales, and provisions for warranty claims are recorded in selling, marketing and distribution expenses.

Trade promotions are offered to distributors and end users through various programs, generally with terms of one year or less. Such promotions include cooperative advertising arrangements, rebates based on annual purchases, and coupons. Under cooperative advertising arrangements,

the Company reimburses the distributor for a portion of its advertising costs related to the Company's products. Estimated costs are accrued at the time of sale and classified as selling, marketing and distribution expense. Rebates are accrued based on the program rates and progress toward the estimated annual sales amount, and are recorded as a reduction of sales. The estimated costs related to coupon programs are accrued at the time of sale and classified as selling, marketing and distribution expense, unless such promotion is considered a transaction with multiple deliverables.

**Earnings Per Common Share.** Basic net earnings per share is computed by dividing earnings available to common shareholders by the weighted average number of shares outstanding during the year. Diluted net earnings per share is computed after giving effect to the exercise of all dilutive outstanding option grants.

**Comprehensive Income.** Comprehensive income is a measure of all changes in shareholders' equity except those resulting from investments by and distributions to owners, and includes such items as net earnings, certain foreign currency translation items, minimum pension liability adjustments and changes in the value of available-for-sale securities.

**Stock-Based Compensation.** The Company accounts for its stock option and purchase plans using the intrinsic value method and has adopted the "disclosure only" provisions of Statement of Financial Accounting Standards (SFAS) No. 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." No compensation cost has been recognized for the Employee Stock Purchase Plan and stock options granted under the various stock incentive plans.

Had compensation cost for these stock plans been determined based upon fair value at the grant date for awards under these plans, the Company's net earnings and earnings per share would have been reduced as follows:

| (In thousands, except per share amounts)             | 2004      | 2003     | 2002     |
|--|-----------|----------|----------|
| Net earnings   |           |          |          |
| As reported  | \$108,681 | \$86,713 | \$75,625 |
| Stock-based compensation, net of related tax effects | (3,637)   | (4,108)  | (4,233)  |
| Pro forma  | \$105,044 | \$82,605 | \$71,392 |
| Net earnings per common share                        |           |          |          |
| Basic as reported                                    | \$ 1.57   | \$ 1.25  | \$ 1.06  |
| Diluted as reported                                  | 1.55      | 1.23     | 1.05     |
| Pro forma basic                                      | 1.52      | 1.19     | 1.00     |
| Pro forma diluted                                    | 1.50      | 1.17     | .99      |

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:

|  | 2004   | 2003   | 2002   |
|--|--------|--------|--------|
| Expected life in years                                   | 6.0    | 6.5    | 6.5    |
| Interest rate  | 4.2%   | 3.9%   | 5.0%   |
| Volatility   | 21.5%  | 25.1%  | 31.3%  |
| Dividend yield   | 1.3%   | 1.2%   | 1.1%   |
| Reduction for non-transferability                        | 10.0%  | 10.0%  | 10.0%  |
| Weighted average fair value per share of options granted | \$6.79 | \$4.65 | \$6.18 |

The fair value of the employees' purchase rights under the Employee Stock Purchase 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:

|  | 2004   | 2003   | 2002   |
|--|--------|--------|--------|
| Expected life in years                                   | 1.0    | 1.0    | 1.0    |
| Interest rate  | 4.2%   | 4.0%   | 4.9%   |
| Volatility   | 22.3%  | 25.2%  | 32.1%  |
| Dividend yield   | 1.5%   | 1.2%   | 1.1%   |
| Reduction for non-transferability                        | 10.0%  | 10.0%  | 10.0%  |
| Weighted average fair value per share of options granted | \$6.47 | \$4.19 | \$4.64 |

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004), "Share-Based Payment" that requires compensation costs related to share-based payment transactions to be recognized in the financial statements. This standard will be effective for the Company starting with the third quarter of 2005. Future compensation cost, net of tax effects, related to unvested stock compensation as of December 31, 2004 is approximately \$2.7 million in 2005, \$1.8 million in 2006 and \$1.3 million in 2007 (as valued and calculated under SFAS 123 for pro forma disclosures.) The Company has not yet determined how it will value future grants or whether it will elect to adjust prior periods upon adoption of SFAS No. 123 (Revised 2004).

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

As part of its risk management program, the Company uses currency hedges and interest rate swaps to hedge known market exposures. Terms of derivative instruments are structured to match the terms of the risk being hedged and are generally held to maturity. The Company does not hold or issue derivative financial instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also

meet the requirements of, and have been designated as, normal purchases or sales. The Company's policy is to not enter into contracts with terms that cannot be designated as normal purchases or sales.

The Company periodically evaluates its monetary asset and liability positions denominated in foreign currencies. The Company enters into forward contracts or options, or borrows in various currencies, in order to hedge its net monetary positions. These hedges and net monetary positions are recorded at current market values and the gains and losses are included in other expense, net. The Company believes it uses strong financial counterparts in these transactions and that the resulting credit risk under these hedging strategies is not significant.

The Company may periodically hedge anticipated transactions, generally with forward exchange contracts, which are designated as cash flow hedges. Gains and losses representing effective hedges are initially recorded as a component of other comprehensive income and are subsequently reclassified into earnings when the hedged exposure affects earnings. Gains and losses on such transactions were not significant in 2004, 2003 and 2002, and there were no such transactions outstanding as of December 31, 2004, and December 26, 2003.

**Recent Accounting Pronouncements.** In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4." This standard clarifies the accounting for abnormal inventory costs and requires the allocation of fixed production overheads to inventory to be based on the normal capacity of the production facilities. The new standard is effective for the Company starting in 2006 and is expected to have no significant impact on operating results or financial condition.

In December 2004, the FASB issued Staff Position (FSP) No. 109-1, "Application of FASB Statement No. 109, *Accounting for Income Taxes*, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004" and FSP No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision Within the American Jobs Creation Act of 2004." The Company expects the benefits from the provisions of the American Jobs Creation Act of 2004 addressed by these FSP's to be similar to the Extra Territorial Income Exclusion rules in place for 2004.

## B. Segment Information

The Company has three reportable segments: Industrial/Automotive, Contractor and Lubrication. The Industrial/Automotive segment markets equipment and pre-engineered packages for moving and applying paints, coatings, sealants, adhesives and other fluids. Markets served include automotive and truck assembly and components plants, wood products, rail, marine, aerospace, farm, construction, bus, recreational vehicles, and various other industries. The Contractor segment markets sprayers for architectural coatings for painting, roofing, texture, corrosion control and line striping and also high-pressure washers. The Lubrication segment markets products to move and dispense lubricants for fast oil change facilities, service garages, fleet service centers, automobile dealerships, the mining industry and industrial lubrication. All segments market parts and accessories for their products.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The cost of manufacturing for each segment is based on product cost, and expenses are based on actual costs incurred along with cost allocations of shared and centralized functions based on activities performed, sales or space utilization. Certain products are sold across segments, in which case the segment marketing the product is credited with the sale. Assets of the Company are not tracked along reportable segment lines. Depreciation expense is charged to the manufacturing or operating cost center that utilizes the asset, and is then allocated to segments on the same basis as other expenses within that cost center.

Reportable segments are defined by product and type of customer. Segments are responsible for the sales, marketing and development of their products and market channel. This allows for focused marketing and efficient product development. The segments share common purchasing, manufacturing, distribution and administration functions.

(In thousands)

| Reportable Segments            | 2004       | 2003       | 2002       |
|--------------------------------|------------|------------|------------|
| Sales                          |            |            |            |
| Industrial / Automotive        | \$ 274,574 | \$ 231,743 | \$ 204,206 |
| Contractor                     | 278,713    | 256,441    | 238,027    |
| Lubrication                    | 51,745     | 46,914     | 44,815     |
| Total                          | \$ 605,032 | \$ 535,098 | \$ 487,048 |
| Segment operating earnings     |            |            |            |
| Industrial / Automotive        | \$ 88,271  | \$ 65,931  | \$ 54,247  |
| Contractor                     | 68,381     | 59,433     | 53,756     |
| Lubrication                    | 11,807     | 9,855      | 9,587      |
| Unallocated corporate expenses | (6,928)    | (6,386)    | (4,744)    |
| Total                          | \$ 161,531 | \$ 128,833 | \$ 112,846 |

Unallocated corporate expenses are not included in management's measurement of segment performance and include such items as bad debt expense, amortization of intangibles, charitable contributions and certain other expenses driven by corporate decisions.

(In thousands)

| Geographic Information             | 2004      | 2003      | 2002      |
|------------------------------------|-----------|-----------|-----------|
| Sales (based on customer location) |           |           |           |
| United States                      | \$363,417 | \$336,575 | \$315,858 |
| Other countries                    | 241,615   | 198,523   | 171,190   |
| Total                              | \$605,032 | \$535,098 | \$487,048 |
| Long-lived assets                  |           |           |           |
| United States                      | \$137,243 | \$133,794 | \$106,382 |
| Belgium                            | 4,855     | 6,124     | 7,496     |



|                 |           |           |           |
|-----------------|-----------|-----------|-----------|
| Other countries | 2,390     | 1,366     | 1,448     |
| Total           | \$144,488 | \$141,284 | \$115,326 |

## Sales to Major Customers

In 2004, sales to a home center retailer totaled 10 percent of consolidated sales, and sales to a paint retailer totaled 10 percent of consolidated sales. In 2003 and 2002, sales to a home center retailer totaled 11 percent of consolidated sales, and sales to a paint retailer totaled 10 percent of consolidated sales.

## C. Inventories

Major components of inventories were as follows:

|   |           |           |
|---|-----------|-----------|
| (In thousands)  | 2004      | 2003      |
| Finished products and components                        | \$ 29,263 | \$ 25,548 |
| Products and components in various stages of completion | 18,656    | 16,464    |
| Raw materials and purchased components                  | 19,929    | 15,408    |
|   | 67,848    | 57,420    |
| Reduction to LIFO cost                                  | (27,629)  | (28,402)  |
| Total   | \$ 40,219 | \$ 29,018 |

Inventories valued under the LIFO method were \$28.4 million for 2004 and \$15.6 million for 2003. All other inventory was valued on the FIFO method.

In 2003 certain inventory quantities were reduced, resulting in liquidation of LIFO inventory quantities carried at lower costs from prior years. The effect on net earnings was not significant.

## D. Property, Plant and Equipment

Property, plant and equipment were as follows:

|  |           |           |
|--|-----------|-----------|
| (In thousands)                             | 2004      | 2003      |
| Land and improvements                      | \$ 6,139  | \$ 5,771  |
| Buildings and improvements                 | 66,067    | 61,627    |
| Manufacturing equipment                    | 132,099   | 123,181   |
| Office, warehouse and automotive equipment | 25,804    | 24,535    |
| Additions in progress                      | 1,710     | 6,119     |
| Total property, plant and equipment        | 231,819   | 221,233   |
| Accumulated depreciation                   | (137,309) | (126,916) |
| Net property, plant and equipment          | \$ 94,510 | \$ 94,317 |

Depreciation expense was \$15.9 million in 2004, \$16.5 million in 2003 and \$15.7 million in 2002.

## E. Income Taxes

Earnings before income tax expense consist of:

|                |           |           |           |
|----------------|-----------|-----------|-----------|
| (In thousands) | 2004      | 2003      | 2002      |
| Domestic       | \$144,603 | \$110,631 | \$ 94,214 |
| Foreign        | 16,178    | 17,282    | 17,511    |
| Total          | \$160,781 | \$127,913 | \$111,725 |

Income tax expense consists of:

|                 |           |           |           |
|-----------------|-----------|-----------|-----------|
| (In thousands)  | 2004      | 2003      | 2002      |
| Current:        |           |           |           |
| Domestic:       |           |           |           |
| Federal         | \$ 45,738 | \$ 31,025 | \$ 29,571 |
| State and local | 2,200     | 3,100     | 2,600     |
| Foreign         | 2,938     | 2,548     | 4,350     |
|                 | 50,876    | 36,673    | 36,521    |

Deferred:

|          |           |           |           |
|----------|-----------|-----------|-----------|
| Domestic | 1,449     | 4,363     | (1,025)   |
| Foreign  | (225)     | 164       | 604       |
|          | 1,224     | 4,527     | (421)     |
| Total    | \$ 52,100 | \$ 41,200 | \$ 36,100 |

Income taxes paid were \$48.4 million, \$32.6 million and \$32.6 million in 2004, 2003 and 2002.

A reconciliation between the U.S. federal statutory tax rate and the effective tax rate is as follows:

|   | 2004 | 2003 | 2002 |
|---|------|------|------|
| Statutory tax rate                              | 35%  | 35%  | 35%  |
| Earnings from non-U.S. sales at lower tax rates | (2)  | (3)  | (3)  |
| State taxes, net of federal effect              | 1    | 1    | 2    |
| U.S. general business tax credits               | (1)  | (1)  | (2)  |
| Other   | (1)  | --   | --   |
| Effective tax rate                              | 32%  | 32%  | 32%  |

Deferred income taxes are provided for all temporary differences between the financial reporting and the tax basis of assets and liabilities. The deferred tax assets (liabilities) resulting from these differences are as follows:

| (In thousands)   | 2004     | 2003     |
|--|----------|----------|
| Inventory valuations                                     | \$ 4,845 | \$ 3,957 |
| Insurance accruals                                       | 2,826    | 3,091    |
| Warranty reserves  | 3,118    | 3,094    |
| Vacation accruals  | 1,386    | 1,412    |
| Bad debt reserves  | 1,570    | 1,554    |
| Other  | 1,886    | 1,801    |
| Current  | 15,631   | 14,909   |
| Unremitted earnings of consolidated foreign subsidiaries | (2,000)  | (2,100)  |
| Excess of tax over book depreciation                     | (9,806)  | (9,120)  |
| Postretirement benefits                                  | 6,469    | 6,142    |
| Pension and deferred compensation                        | (6,544)  | (5,032)  |
| Other  | 869      | 1,044    |
| Non-current  | (11,012) | (9,066)  |
| Net deferred tax assets                                  | \$ 4,619 | \$ 5,843 |

Total deferred tax assets were \$24.5 million and \$23.4 million, and total deferred tax liabilities were \$19.9 million and \$17.5 million on December 31, 2004, and December 26, 2003.

## F. Debt

Interest paid on debt during 2004, 2003 and 2002 was \$0.5 million, \$0.5 million and \$0.7 million.

On December 31, 2004, the Company entered into a credit agreement with Wachovia Bank, National Association providing credit up to \$50 million, expiring on December 30, 2005. Outstanding balances bear interest at the London Interbank Offered Rate plus a spread of up to 0.8 percent. This spread changes as the ratio of total debt to earnings before interest, taxes and depreciation and amortization declines. The agreement requires the Company to maintain certain financial ratios as to cash flow leverage and fixed charge coverage.

On December 31, 2004, the Company had lines of credit with U.S. and foreign banks of \$91 million, including the \$50 million Wachovia credit facility. The unused portion of these credit lines was \$89 million at December 31, 2004. Borrowing rates under these credit lines vary with the prime rate, rates on domestic certificates of deposit and the London Interbank market. The weighted average short-term borrowing rates were 2.5 percent, 2.1 percent, and 1.8 percent for the years ended December 31, 2004, December 26, 2003, and December 27, 2002. The Company pays commitment fees of up to 0.2 percent per annum on the daily average unused amounts on certain of these lines. No compensating balances are required.

The Company is in compliance with the financial covenants of its debt agreements.

## G. Shareholders' Equity

In March 2003, the Company repurchased 2.2 million shares of its common stock for \$54.8 million from David A. Koch, a former Chairman and Chief Executive Officer of the Company, his wife, a family trust and a family foundation. The per share purchase price represented a discount of 5.5 percent from the ten-day average closing price of the Company's stock immediately prior to the date of the transaction. The Company used available cash balances to fund the repurchase.

On December 12, 2003, the Company's Board of Directors approved a special dividend of \$1.50 per common share payable on March 25, 2004 to shareholders of record as of March 11, 2004. Dividends payable at December 26, 2003 include the special dividend and the regular quarterly dividend declared on December 12, 2003, payable on February 4, 2004.

Three-for-two stock splits were distributed in March 2004 and in June 2002. All stock option, share and per share data reflect these splits.

At December 31, 2004, the Company had 22,549 authorized, but not issued, cumulative preferred shares, \$100 par value. The Company also has authorized, but not issued, a separate class of 3 million shares of preferred stock, \$1 par value.

The Company maintains a plan in which one preferred share purchase right (Right) exists for each common share of the Company. Each Right will entitle its holder to purchase one four-hundredth of a share of a new series of junior participating preferred stock at an exercise price of \$180, subject to adjustment. The Rights are exercisable only if a person or group acquires beneficial ownership of 15 percent or more of the Company's outstanding common stock. The Rights expire in March 2010 and may be redeemed earlier by the Board of Directors for \$.001 per Right.

## H. Stock Option and Purchase Plans

**Stock Option and Award Plans.** The Company has various stock incentive plans under which it grants stock options and restricted share awards to officers and other employees. Option price is the market price on the date of grant. Options become exercisable at such time and in such installments as set by the Company, and expire ten years from the date of grant. Restricted share awards have been made to certain key employees under the plans, including 1,800 common shares with a grant-date value of \$36,000 in 2003 and 55,125 shares with a grant-date value of \$1,069,000 in 2002. The market value of restricted stock at the date of grant is recorded as unearned compensation, a component of shareholders' equity, and is charged to operations over the vesting period. Compensation cost charged to operations for restricted share awards was \$340,000 in 2004, \$407,000 in 2003 and \$319,000 in 2002.

Options on common shares granted and outstanding, as well as the weighted average exercise price, are shown below:

|                                | Options     | Weighted Average<br>Exercise Price | Options<br>Exercisable | Weighted Average<br>Exercise Price |
|--------------------------------|-------------|------------------------------------|------------------------|------------------------------------|
| Outstanding, December 28, 2001 | 4,477,182   | \$ 8.58                            | 1,355,101              | \$ 5.72                            |
| Granted                        | 853,875     | 18.43                              |                        |                                    |
| Exercised                      | (1,196,834) | 7.00                               |                        |                                    |
| Canceled                       | (150,986)   | 11.33                              |                        |                                    |
| Outstanding, December 27, 2002 | 3,983,237   | \$11.06                            | 1,533,686              | \$ 7.21                            |
| Granted                        | 374,925     | 17.61                              |                        |                                    |
| Exercised                      | (786,605)   | 7.23                               |                        |                                    |
| Canceled                       | (80,511)    | 15.16                              |                        |                                    |
| Outstanding, December 26, 2003 | 3,491,046   | \$12.51                            | 1,460,930              | \$ 9.60                            |
| Granted                        | 1,127,667   | 29.66                              |                        |                                    |
| Exercised                      | (930,305)   | 10.24                              |                        |                                    |
| Canceled                       | (66,064)    | 21.26                              |                        |                                    |
| Outstanding, December 31, 2004 | 3,622,344   | \$18.28                            | 1,804,328              | \$11.87                            |

The following table summarizes information for options outstanding and exercisable at December 31, 2004:

| Range of<br>Prices | Options<br>Outstanding | Options<br>Outstanding<br>Weighted Avg.<br>Remaining Life | Options<br>Outstanding<br>Weighted Avg.<br>Exercise Price | Options<br>Exercisable | Options<br>Exercisable<br>Weighted Avg.<br>Exercise Price |
|--------------------|------------------------|---|---|------------------------|---|
| \$ 3-11            | 832,178                | 4   | \$ 8.14   | 815,303                | \$ 8.12   |
| 11-21              | 1,687,591              | 7   | 15.83   | 971,025                | 14.69   |
| 27-35              | 1,102,575              | 9   | 29.68   | 18,000                 | 29.59   |
| \$ 3-35            | 3,622,344              | 7   | \$18.28   | 1,804,328              | \$11.87   |

**Stock Purchase Plans.** Under the Company's Employee Stock Purchase Plan, the purchase price of the shares is the lesser of 85 percent of the fair market value on the first day or the last day of the plan year. The Company issued 343,913 shares under this Plan in 2004, 297,758 shares in 2003 and 427,490 shares in 2002.

Individual nonemployee directors of the Company may elect to receive all or part of their annual retainer, and/or payment for attendance at Board or Committee meetings, in the form of shares of the Company's common stock instead of cash. The Company issued 11,577 shares under this arrangement in 2004, 14,548 shares in 2003, and 14,521 shares in 2002. Such shares were issued under the Stock Incentive Plan in 2004. In 2003 and 2002, the shares were issued under the Nonemployee Director Stock Plan, which expired on December 31, 2003. The expense related to this arrangement is not significant.

**Authorized Shares.** Shares authorized for issuance under the various stock option and purchase plans are shown below:

|                               | Total Shares<br>Authorized | Available for Future<br>Issuance as of<br>December 31, 2004 |
|-------------------------------|----------------------------|---|
| Employee Stock Incentive Plan | 3,375,000                  | 1,589,079   |
| Stock Incentive Plan          | 3,375,000                  | 1,340,257   |

|                              |            |           |
|------------------------------|------------|-----------|
| Employee Stock Purchase Plan | 19,743,750 | 1,000,142 |
| Total                        | 26,493,750 | 3,929,478 |

Amounts available for future issuance exclude outstanding options. Options outstanding as of December 31, 2004, include options granted under two plans that were replaced by the Stock Incentive Plan in 2001. No shares are available for future grants under those two plans.

## I. Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share:

| (In thousands, except per share amounts)  | 2004      | 2003     | 2002     |
|---|-----------|----------|----------|
| Numerator   |           |          |          |
| Net earnings available to common shareholders   | \$108,681 | \$86,713 | \$75,625 |
| Denominators  |           |          |          |
| Weighted average shares outstanding for basic earnings per share  | 69,142    | 69,284   | 71,136   |
| Dilutive effect of stock options computed based on the treasury stock method using the average market price | 1,109     | 1,131    | 1,172    |
| Denominator for diluted earnings per share  | 70,251    | 70,415   | 72,308   |
| Basic earnings per share  | \$ 1.57   | \$ 1.25  | \$ 1.06  |
| Diluted earnings per share  | \$ 1.55   | \$ 1.23  | \$ 1.05  |

Stock options to purchase 786,000 common shares were not included in the 2002 calculation of diluted earnings per share because they would have been anti-dilutive.

## J. Retirement Benefits

The Company has a defined contribution plan, under Section 401(k) of the Internal Revenue Code, which provides retirement benefits to all U.S. employees who elect to participate. The Company matches employee contributions at a 100 percent rate, up to 3 percent of the employee's compensation. Employer contributions were \$2.4 million in 2004 and \$2.2 million each year for 2003 and 2002.

The Company's postretirement medical plan provides certain medical benefits for retired U.S. employees. Employees are eligible for these benefits upon retirement and fulfillment of other eligibility requirements as specified by the plan.

The Company has both funded and unfunded noncontributory defined benefit pension plans that together cover substantially all U.S. employees, certain directors and some of the employees of the Company's non-U.S. subsidiaries. For U.S. plans, benefits are based on years of service and the highest five consecutive years' earnings in the ten years preceding retirement. The Company funds annually in amounts consistent with minimum funding requirements and maximum tax deduction limits. In 2003, the Company made a voluntary \$20 million tax-deductible contribution to the funded defined benefit plan. The plan invests primarily in common stocks and bonds, including the Company's common stock. The market value of the plan's investment in the common stock of the Company was \$13.0 million at December 31, 2004, and \$9.3 million at December 26, 2003.

The Company uses a December 31 measurement date for all of its plans.

For the funded pension plan, asset allocations at year-end were as follows:

|                         | 2004 | 2003 |
|-------------------------|------|------|
| Graco common stock      | 7%   | 6%   |
| Other equity securities | 74%  | 76%  |
| Debt securities         | 13%  | 8%   |
| Real estate             | 5%   | 5%   |
| Cash                    | 1%   | 5%   |
| Total                   | 100% | 100% |

Investment policies and strategies of the funded pension plan are based on a long-term view of economic growth and heavily weighted toward equity securities.

The following provides a reconciliation of the changes in the plans' benefit obligations and fair value of assets over the periods ending December 31, 2004, and December 26, 2003, and a statement of the funded status as of the same dates.

|   | Pension Benefits |            | Postretirement Medical Benefits |           |
|---|------------------|------------|---------------------------------|-----------|
| (In thousands)  | 2004             | 2003       | 2004                            | 2003      |
| <b>Reconciliation of accumulated benefit obligation</b> |                  |            |                                 |           |
| Obligation, beginning of year                           | \$ 147,226       | \$ 130,380 | \$ 25,898                       | \$ 23,223 |
| Service cost  | 4,136            | 3,544      | 771                             | 685       |
| Interest cost   | 8,707            | 8,204      | 1,501                           | 1,483     |

|  |            |            |             |             |
|--|------------|------------|-------------|-------------|
| Assumption changes                                 | 10,731     | 8,726      | 798         | 1,572       |
| Actuarial loss                                     | 2,647      | 1,482      | 235         | 497         |
| Benefit payments                                   | (5,514)    | (5,110)    | (1,790)     | (1,562)     |
| Obligation, end of year                            | \$ 167,933 | \$ 147,226 | \$ 27,413   | \$ 25,898   |
| <b>Reconciliation of fair value of plan assets</b> |            |            |             |             |
| Fair value, beginning of year                      | \$ 156,774 | \$ 109,458 | \$ --       | \$ --       |
| Actual return on assets                            | 24,037     | 31,799     | --          | --          |
| Employer contributions                             | 654        | 20,627     | 1,790       | 1,562       |
| Benefit payments                                   | (5,514)    | (5,110)    | (1,790)     | (1,562)     |
| Fair value, end of year                            | \$ 175,951 | \$ 156,774 | \$ --       | \$ --       |
| <b>Funded status</b>                               |            |            |             |             |
| Funded status over (under), end of year            | \$ 8,018   | \$ 9,548   | \$ (27,413) | \$ (25,898) |
| Unrecognized transition obligation (asset)         | (11)       | (25)       | --          | --          |
| Unrecognized prior service cost                    | 1,070      | 1,214      | --          | --          |
| Unrecognized loss (gain)                           | 5,929      | 3,472      | 8,931       | 8,350       |
| Net  | \$ 15,006  | \$ 14,209  | \$ (18,482) | \$ (17,548) |

The following table provides the amounts included in the consolidated balance sheets as of December 31, 2004, and December 26, 2003.

|                                 | Pension Benefits |           | Postretirement Medical Benefits |             |
|---------------------------------|------------------|-----------|---------------------------------|-------------|
| (In thousands)                  | 2004             | 2003      | 2004                            | 2003        |
| Prepaid benefit, funded plan    | \$ 27,566        | \$ 25,444 | \$ —                            | \$ —        |
| Accrued benefit, unfunded plans | (12,550)         | (11,235)  | (18,482)                        | (17,548)    |
| Net                             | \$ 15,006        | \$ 14,209 | \$ (18,482)                     | \$ (17,548) |

The accumulated benefit obligation for all defined benefit pension plans was \$151 million and \$135 million as of December 31, 2004, and December 26, 2003. Information for plans with an accumulated benefit obligation in excess of plan assets follows:

| (In thousands)                 | 2004     | 2003     |
|--------------------------------|----------|----------|
| Projected benefit obligation   | \$13,668 | \$12,509 |
| Accumulated benefit obligation | 12,275   | 11,267   |
| Fair value of plan assets      | --       | --       |

The components of net periodic benefit cost for the plans for 2004, 2003 and 2002 were as follows:

|  | Pension Benefits |          |          | Postretirement Medical Benefits |          |          |
|--|------------------|----------|----------|---------------------------------|----------|----------|
| (In thousands)   | 2004             | 2003     | 2002     | 2004                            | 2003     | 2002     |
| Service cost - benefits earned during the period                                 | \$ 4,136         | \$ 3,544 | \$ 3,450 | \$ 771                          | \$ 685   | \$ 594   |
| Interest cost on projected benefit obligation                                    | 8,707            | 8,204    | 7,961    | 1,501                           | 1,483    | 1,378    |
| Expected return on assets  | (14,095)         | (9,990)  | (11,445) | --                              | --       | --       |
| Amortization of transition obligation (asset)                                    | (15)             | (15)     | (15)     | --                              | --       | --       |
| Amortization of prior service cost   | 144              | 144      | 149      | --                              | --       | --       |
| Amortization of net loss (gain)  | (69)             | 384      | (565)    | 452                             | 358      | 160      |
| Cost of pension plans which are not significant and have not adopted SFAS No. 87 | 284              | 337      | 218      | N/A                             | N/A      | N/A      |
| Net periodic benefit cost (credit)   | \$ (908)         | \$ 2,608 | \$ (247) | \$ 2,724                        | \$ 2,526 | \$ 2,132 |

Assumptions used to determine the Company's benefit obligations are shown below:

|                               | Pension Benefits |      | Postretirement Medical Benefits |      |
|-------------------------------|------------------|------|---------------------------------|------|
| Weighted average assumptions  | 2004             | 2003 | 2004                            | 2003 |
| Discount rate                 | 5.9%             | 5.9% | 6.0                             | 6.0  |
| Rate of compensation increase | 3.7%             | 3.2% | N/A                             | N/A  |

Assumptions used to determine the Company's net periodic benefit cost are shown below:

|  | Pension Benefits | Postretirement Medical Benefits |
|--|------------------|---------------------------------|
|--|------------------|---------------------------------|

| Weighted average assumptions  | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
|-------------------------------|------|------|------|------|------|------|
| Discount rate                 | 5.9% | 6.4% | 6.9% | 6.0  | 6.5  | 7.0  |
| Expected return on assets     | 9.0% | 9.0% | 9.0% | N/A  | N/A  | N/A  |
| Rate of compensation increase | 3.2% | 3.2% | 3.7% | N/A  | N/A  | N/A  |

Several sources of information are considered in determining the expected rate of return assumption, including the allocation of plan assets, the input of actuaries and professional investment advisors, and historical long-term returns. In setting the return assumption, the Company recognizes that historical returns are not always indicative of future returns and also considers the long-term nature of its pension obligations.

The Company's U.S. retirement medical plan limits the annual cost increase that will be paid by the Company. In measuring the accumulated postretirement benefit obligation (APBO), the annual trend rate for health care costs was assumed to be 9 percent for 2005, decreasing by one percentage point each year to a constant rate of 5 percent in 2009 and thereafter, subject to the plan's 6 percent annual increase limitation.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act) was signed into law. The Company's retirement medical plan is not eligible for the Medicare subsidy under the Act.

At December 31, 2004, a one percent change in assumed health care cost trend rates would have the following effects:

| (In thousands)  | 1% Increase | 1% Decrease |
|---|-------------|-------------|
| Effect on total of service and interest cost components of net periodic postretirement health care benefit cost | \$ 41       | \$ (238)    |
| Effect on the health care component of the accumulated postretirement benefit obligation                        | 354         | (2,369)     |

The Company expects to contribute \$0.5 million to its unfunded pension plans and \$1.4 million to the retirement medical plan in 2005. No contribution to the funded pension plan is expected in 2005. Estimated future benefit payments are as follows:

| (In thousands)    | Pension Benefits | Postretirement Medical Benefits |
|-------------------|------------------|---------------------------------|
| 2005              | \$ 6,000         | \$1,400                         |
| 2006              | 6,500            | 1,500                           |
| 2007              | 7,300            | 1,500                           |
| 2008              | 7,700            | 1,600                           |
| 2009              | 8,400            | 1,600                           |
| Years 2010 - 2014 | 55,200           | 9,500                           |

## K. Commitments and Contingencies

**Lease Commitments.** Aggregate annual rental commitments under operating leases with noncancelable terms of more than one year were \$3.4 million at December 31, 2004, payable as follows:

| (In thousands) | Buildings | Vehicles & Equipment | Total   |
|----------------|-----------|----------------------|---------|
| 2005           | \$ 850    | \$ 974               | \$1,824 |
| 2006           | 465       | 590                  | 1,055   |
| 2007           | 206       | 265                  | 471     |
| 2008           | --        | 50                   | 50      |
| 2009           | --        | 9                    | 9       |
| Thereafter     | --        | --                   | --      |
| Total          | \$1,521   | \$1,888              | \$3,409 |

Total rental expense was \$1.3 million for 2004, \$2.1 million for 2003 and \$1.8 million for 2002.

**Other Commitments.** The Company is committed to pay suppliers under the terms of open purchase orders issued in the normal course of business totaling approximately \$10 million at December 31, 2004. The Company also has commitments with certain suppliers to purchase minimum quantities, and under the terms of certain agreements, the Company is committed for certain portions of the supplier's inventory. The Company does not purchase, or commit to purchase quantities in excess of normal usage or amounts that cannot be used within one year. The Company estimates that the maximum commitment amount under such agreements does not exceed \$13 million. In addition, the Company could be obligated to perform under standby letters of credit totaling \$2.5 million at December 31, 2004. The Company has also guaranteed the debt of its subsidiaries for up to \$22.2 million.

**Contingencies.** The Company has been named as a defendant in a number of lawsuits alleging bodily injury as a result of exposure to asbestos or silica. None of the suits make any allegations specifically regarding the Company or any of its products. Management does not know why the Company was included in the suits along with hundreds of other defendants. The Company is also party to various other legal proceedings arising in the normal course of business. The Company is actively defending these matters and has recorded an estimate of the probable costs. Management does not expect that resolution of these matters will have a material adverse effect on the Company, although the ultimate outcome cannot be determined based on available information.

## L. Acquisition

At the beginning of the second quarter of 2003, the Company purchased certain assets and assumed certain liabilities of Sharpe Manufacturing Company for \$13.5 million cash. Sharpe manufactures spray guns and related parts and accessories for the automotive refinishing market, where the Company had no previous presence. Sharpe had sales of approximately \$11 million in 2002. Results of Sharpe's operations have been included in the Industrial/Automotive segment since the date of acquisition.

The purchase price was allocated as follows (in thousands):

|                                |          |
|--------------------------------|----------|
| Accounts receivable            | \$ 1,300 |
| Inventories                    | 3,000    |
| Property, plant and equipment  | 600      |
| Identifiable intangible assets | 8,900    |
| Goodwill                       | 1,300    |
| <hr/>                          |          |
| Total Purchase Price           | 15,100   |
| Liabilities Assumed            | (1,600)  |
| <hr/>                          |          |
| Net assets acquired            | \$13,500 |
| <hr/>                          |          |

Included in identifiable intangible assets is \$5.3 million assigned to the Sharpe brand name, which has an indefinite useful life. Remaining identifiable intangible assets mainly consist of Sharpe's distribution network, which is being amortized over an estimated useful life of 5 years. Goodwill is expected to be fully deductible for tax purposes.

#### **M. Subsequent Event**

Effective January 1, 2005, the Company purchased the stock of Liquid Control Corporation, Inc. and its affiliated company Profill Corp. for approximately \$35 million cash. The purchase price will be allocated based on a valuation of assets acquired and liabilities assumed. Liquid Control designs and manufactures highly engineered precision resin dispensing equipment and had sales of approximately \$26 million in 2004.

In February 2005, the Company purchased the stock of Gusmer Corporation and Gusmer Europe S.L. for \$65 million cash. The purchase price will be allocated based on a valuation of assets acquired and liabilities assumed. Gusmer designs and manufactures specialized two-component dispense equipment systems and had sales of approximately \$43 million in 2004.

The products, brands, distribution channels and engineering capabilities of Liquid Control and Gusmer will expand and complement the Company's Industrial/Automotive business.

#### **Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

#### **Item 9a. Controls and Procedures**

##### **Evaluation of disclosure controls and procedures**

As of the end of the fiscal year 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; Vice President and Controller; Vice President and Treasurer; and Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

##### **Management's Report on Internal Control Over Financial Reporting**

The information under the heading "Management's Report on Internal Control Over Financial Reporting" in Part II, Item 8, of this 2004 Annual Report on Form 10-K is incorporated herein by reference.

##### **Report of Independent Registered Public Accounting Firm**

The information under the heading "Reports of Independent Registered Public Accounting Firm: Internal Control Over Financial Reporting" in Part II, Item 8, of this 2004 Annual Report on Form 10-K is incorporated herein by reference.

##### **Changes in internal control**

During the fourth 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.

#### **Item 9b. Other Information**

Not applicable.

### **PART III**

#### **Item 10. Directors and Executive Officers of the Company**

The information under the heading "Executive Officers of the Company" in Part I of this 2004 Annual Report on Form 10-K and the information under the headings "Election of Directors, Nominees and Other Directors" and under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" of the Company's Proxy Statement for its 2005 Annual Meeting of Shareholders, to be held on April 22, 2005, (the "Proxy Statement"), are incorporated herein by reference.

## New York Stock Exchange Rule 303A.12

The Company's Annual CEO Certification as required by NYSE Rule 303A.12(a) was filed with the New York Stock Exchange on or about May 13, 2004. The certifications of the Chief Executive Officer, the Controller and the Treasurer under Section 302 of the Sarbanes-Oxley Act of 2002, regarding the quality of the company's disclosure in this Annual Report on Form 10-K, have been filed as exhibits 31.1, 31.2 and 31.3 hereto.

### Audit Committee Members and Audit Committee Financial Expert

The information under the headings "Committees of the Board of Directors" and "Audit Committee Report" of the Company's Proxy Statement are incorporated herein by reference.

### Corporate Governance Guidelines, Committee Charters and Code of Ethics

Graco Inc. has adopted Corporate Governance Guidelines and Charters for the Audit, Governance, and Management Organization and Compensation Committees. Graco Inc. also has in place Conduct of Business Guidelines (Code of Ethics) that apply to the Company's principal executive officer, principal financial officer, principal accounting officer, all officers, directors, and employees of Graco Inc. and all of its subsidiaries and branches worldwide. The Corporate Governance Guidelines, Committee Charters, and Conduct of Business Guidelines, with any amendments or waivers thereto, may be accessed free of charge by visiting the Graco website at [www.graco.com](http://www.graco.com). Copies of these documents are also available in print by written request directed to Secretary, Graco Inc., P.O. Box 1441, Minneapolis, MN 55440-1441.

The Company intends to post on the Graco website any amendment to, or waiver from, a provision of the Conduct of Business Guidelines that applies to its principal executive officer, principal financial officer, principal accounting officer, controller and other persons performing similar functions within five business days following the date of such amendment or waiver.

### Item 11. Executive Compensation

The information contained under the heading "Executive Compensation" of the Proxy Statement is incorporated herein by reference, other than the subsection thereunder entitled "Report of the Management Organization and Compensation Committee" and "Comparative Stock Performance Graph."

### Item 12. Security Ownership of Certain Beneficial Owners and Management

The information contained under the heading "Beneficial Ownership of Shares" and under the heading "Equity Compensation Plan Information" of the Proxy Statement is incorporated herein by reference.

### Item 13. Certain Relationships and Related Transactions

The information under the heading "Certain Business Relationships" of the Proxy Statement is incorporated herein by reference.

### Item 14. Principal Accounting Fees and Services

The information under the heading "Principal Accounting Fees and Services" of the Proxy Statement is incorporated herein by reference.

## PART IV

### Item 15. Exhibits, Financial Statement Schedule

(a) The following documents are filed as part of this report:

- |     |  |                   |
|-----|--|-------------------|
| (1) | Financial Statements<br>See Part II  | <u>Page</u><br>50 |
| (2) | Financial Statement Schedule <ul style="list-style-type: none"><li>Schedule II - Valuation and Qualifying Accounts</li></ul> |                   |

All other schedules are omitted because they are not applicable, or not required, or because the required information is included in the Consolidated Financial Statements or Notes thereto.

- |     |   |    |
|-----|---|----|
| (3) | Management Contract, Compensatory Plan or Arrangement. (See Exhibit Index)<br>Those entries marked by an asterisk are Management Contracts, Compensatory Plans or Arrangements. | 52 |
|-----|---|----|

### Schedule II - Valuation and Qualifying Accounts

Graco Inc. and Subsidiaries

| Description                       | Balance at beginning of year | Additions charged to costs and expenses | Deductions From Reserves | Other <sup>3</sup> Add (Deduct) | Balance at end of year |
|-----------------------------------|------------------------------|---|--------------------------|---------------------------------|------------------------|
| Year ended December 31, 2004      |                              |   |                          |                                 |                        |
| Allowance for doubtful accounts   | \$ 2,600                     | \$ 200                                  | \$ 500 <sup>1</sup>      |                                 | \$ 2,300               |
| Allowance for returns and credits | 3,100                        | 6,400                                   | 6,200 <sup>2</sup>       |                                 | 3,300                  |
|                                   | \$ 5,700                     | \$ 6,600                                | \$ 6,700                 |                                 | \$ 5,600               |
| Year ended December 26, 2003      |                              |   |                          |                                 |                        |
| Allowance for doubtful accounts   | \$ 2,300                     | \$ 700                                  | \$ 600 <sup>1</sup>      | \$ 200                          | \$ 2,600               |
| Allowance for returns and credits | 3,300                        | 5,500                                   | 5,700 <sup>2</sup>       | \$ --                           | 3,100                  |



|                                   | \$ 5,600 | \$ 6,200 | \$ 6,300            | \$ 200 | \$ 5,700 |
|-----------------------------------|----------|----------|---------------------|--------|----------|
| Year ended December 27, 2002      |          |          |                     |        |          |
| Allowance for doubtful accounts   | \$ 2,000 | \$ 700   | \$ 400 <sup>1</sup> |        | \$ 2,300 |
| Allowance for returns and credits | 2,500    | 7,000    | 6,200 <sup>2</sup>  |        | 3,300    |
|                                   | \$ 4,500 | \$ 7,700 | \$ 6,600            |        | \$ 5,600 |

- 1 Accounts determined to be uncollectible and charged against reserve, net of collections on accounts previously charged against reserves.
- 2 Credits issued and returns processed.
- 3 Assumed or established in connection with acquisition.

## Signatures

Pursuant to the requirements of Section 13 or 15(d) 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.

David A. Roberts February 24, 2005  
David A. Roberts  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

David A. Roberts February 24, 2005  
David A. Roberts  
President and Chief Executive Officer  
(Principal Executive Officer)

Mark W. Sheahan February 24, 2005  
Mark W. Sheahan  
Vice President and Treasurer  
(Principal Financial Officer)

James A. Graner February 24, 2005  
James A. Graner  
Vice President and Controller  
(Principal Accounting Officer)

|                  |                                 |
|------------------|---------------------------------|
| L. R. Mitau      | Director, Chairman of the Board |
| R. G. Bohn       | Director                        |
| W. J. Carroll    | Director                        |
| J. W. Eugster    | Director                        |
| J. K. Gilligan   | Director                        |
| J. H. Moar       | Director                        |
| M. A. Morfitt    | Director                        |
| M. H. Rauenhurst | Director                        |
| D. A. Roberts    | Director                        |
| W. G. Van Dyke   | Director                        |
| R. W. Van Sant   | Director                        |

David A. Roberts, by signing his name hereto, does hereby sign this document on behalf of himself and each of the above named directors of the Registrant pursuant to powers of attorney duly executed by such persons.

David A. Roberts February 24, 2005  
David A. Roberts  
(For himself and as attorney-in-fact)

## Exhibit Index

| Exhibit Number | Description  |
|----------------|--|
| 2.1            | Stock Purchase Agreement By and Among PMC Global, Inc. Gusmer Machinery Group, Inc. and Graco Inc., dated as of February 4, 2005 (Incorporated by reference to exhibit 2.1 to the Company's Report on Form 8-K dated February 10, 2005.) |
| 2.2            | Stock Purchase Agreement By and Among PMC Europe Investments, S.L. and Graco Inc. dated as of February 4, 2005   |

(Incorporated by reference to Exhibit 2.2 to the Company's Report on Form 8-K dated February 10, 2005.)

- 3.1 Restated Articles of Incorporation as amended September 24, 2004.
- 3.2 Restated Bylaws as amended June 13, 2002. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)
- 4.1 Rights Agreement dated as of February 25, 2000, between the Company and Wells Fargo, formerly known as Norwest Bank Minnesota, National Association, as Rights Agent, including as Exhibit A the form of the Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Shares. (Incorporated by reference to Exhibit 4 to the Company's Report on Form 8-K dated February 25, 2000.)
- 4.2 Credit agreement dated December 31, 2004, between the Company and Wachovia Bank, N.A.
- \*10.1 2004 Corporate and Business Unit Annual Bonus Plan. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended March 26, 2004.)
- \*10.2 Executive Officer Annual Incentive Bonus Plan.
- \*10.3 Nonemployee Director Stock Option Plan, as amended and restated February 23, 2001. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended March 30, 2001.)
- \*10.4 Long Term Stock Incentive Plan, as amended and restated December 10, 1999. (Incorporated by reference to Exhibit 10.5 to the Company's 1999 Annual Report on Form 10-K.)
- \*10.5 Graco Inc. Stock Incentive Plan dated May 1, 2001. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2001.)
- 10.6 Employee Stock Incentive Plan as adopted by the Board of Directors in February 1999. (Incorporated by reference to Exhibit 10.23 to the Company's 2002 Annual Report on Form 10-K.)
- \*10.7 Deferred Compensation Plan Restated, effective December 1, 1992. (Incorporated by reference to Exhibit 2 to the Company's Report on Form 8-K dated March 11, 1993.) Amendment 1 dated September 1, 1996. (Incorporated by reference to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997, File No. 001-09249.)
- \*10.8 CEO Award Program. (Incorporated by reference to Exhibit 10.9 of the Company's 2004 Annual Report on Form 10-K.)
- \*10.9 Retirement Plan for Nonemployee Directors. (Incorporated by reference to Attachment C to Item 5 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 1991, File No. 001-09249.)
- \*10.10 Restoration Plan 1998 Restatement. (Incorporated by reference to Exhibit 10.8 to the Company's 1997 Annual Report on Form 10-K, File No. 001-09249.) First Amendment to Restoration Plan 1998 Restatement. (Incorporated by reference to Exhibit 10.11 of the Company's 2003 Annual Report on Form 10-K.)
- \*10.11 Summary of Compensation of the Non-Employee Members of the Board of Directors of Graco Inc. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 8-K dated February 25, 2005.)
- \*10.12 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Nonemployee Director Stock Option Plan (Incorporated by reference to Exhibit 10.11 to the Company's 2001 Annual Report on Form 10-K.)
- \*10.13 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Graco Inc. Stock Incentive Plan. (Incorporated by reference to Exhibit 10.22 to the Company's 2002 Annual Report on Form 10-K.) Amended form of agreement for awards made to nonemployee directors. (Incorporated by reference to Exhibit 10.3 to the Company's Report on Form 10-Q for the thirteen weeks ended March 26, 2004.)
- \*10.14 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Long Term Stock Incentive Plan. (Incorporated by reference to Exhibit 10.12 to the Company's 2001 Annual Report on Form 10-K.)
- \*10.15 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Graco Inc. Stock Incentive Plan. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 2002.) Amended form of agreement for awards made to Chief Executive Officer in 2001 and 2002. Amended form of agreement for awards made to executive officers in 2003. (Incorporated by reference to Exhibit 10.15 of the Company's 2004 Annual Report on Form 10-K.) Amended form of agreement for awards made to Chief Executive Officer in 2004. Amended form of agreement for awards made to executive officers in 2004. (Incorporated by reference to Exhibit 10.2 and 10.4 to the Company's Report on Form 10-Q for the thirteen weeks ended March 26, 2004.)
- \*10.16 Executive Deferred Compensation Agreement. Form of supplementary agreement entered into by the Company which provides a retirement benefit to selected executive officers, as amended by Amendment 1, effective September 1, 1990. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 11, 1993, File No.001-09249.)
- \*10.17 Election Form. Form of agreement used for the 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.
- \*10.18 Key Employee Agreement. Form of agreement with officers and other key employees relating to change of control. (Incorporated by reference to Exhibit 10.15 to the Company's 2001 Annual Report on Form 10-K.)
- \*10.19 Executive Long Term Incentive Agreement (Restricted Stock). Form of agreement used for award of restricted stock to executive officers under the Graco Inc. Stock Incentive Plan. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)

- \*10.20 Trust Agreement for Nonemployee Director Deferred Stock Account dated September 30, 1997, between the Company and Wells Fargo, formerly known as Norwest Bank Minnesota, N.A. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 26, 1997, File No. 001-09249.)
- \*10.21 Letter Agreement with President and Chief Executive Officer, dated June 5, 2001. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2001.)
- \*10.22 Form of salary protection arrangement between the Company and executive officers. (Incorporated by reference to Exhibit 10.21 to the Company's 1995 Annual Report on Form 10-K, File No. 001-09249.)
- \*10.23 Executive Group Long-Term Disability Policy.
- 11 [Statement of Computation of Earnings per share](#) included in Note 1 on page 42.
- 21 [Subsidiaries of the Registrant](#) included herein on page 55.
- 23 [Independent Auditors' Consent](#) included herein on page 56X.
- 24 [Power of Attorney](#) included herein on page 57.
- 31.1 [Certification of President and Chief Executive Officer](#) pursuant to Rule 13a-14(a) included herein on page 58.
- 31.2 [Certification of Vice President and Controller](#) pursuant to Rule 13a-14(a) included herein on page 59.
- 31.3 [Certification of Vice President and Treasurer](#) pursuant to Rule 13a-14(a) included herein on page 60.
- 32 [Certification of President and Chief Executive Officer; Vice President and Controller, and Vice President and Treasurer](#) pursuant to Section 1350 of Title 18, U.S.C. included herein on page 61.
- 99 [Cautionary Statement](#) Regarding Forward-Looking Statements included herein on page 62.

\*Management Contracts, Compensatory Plans or Arrangements.

Pursuant to Item 601(b)(4)(iii) of Regulation S-K, copies of certain instruments defining the rights of holders of certain long-term debt of the Company and its subsidiaries are not filed as exhibits because the amount of debt authorized under any such instrument does not exceed 10 percent of the total assets of the Company and its subsidiaries. The Company agrees to furnish copies thereof to the Securities and Exchange Commission upon request.

## Exhibit 21

### Subsidiaries of Graco Inc.

The following are subsidiaries of the Company as of December 31, 2004:

| Subsidiary                                 | Jurisdiction of Organization | Percentage of Voting Securities Owned by the Company |
|--|------------------------------|--|
| Equipos Graco Argentina S.A.               | Argentina                    | 100%*  |
| Graco Canada Inc.                          | Canada                       | 100%   |
| Graco do Brasil Limitada                   | Brazil                       | 100%*  |
| Graco Europe N.V.                          | Belgium                      | 100%*  |
| Graco Fluid Equipment (Shanghai) Co., Ltd. | China (PRC)                  | 100%   |
| Graco GmbH                                 | Germany                      | 100%   |
| Graco Hong Kong Limited                    | Hong Kong                    | 100%*  |
| Graco K.K.                                 | Japan                        | 100%   |
| Graco Korea Inc.                           | Korea                        | 100%   |
| Graco Limited                              | England                      | 100%*  |
| Graco Minnesota Inc.                       | United States                | 100%   |
| Graco N.V.                                 | Belgium                      | 100%*  |
| Graco S.A.S.                               | France                       | 100%   |
| Graco South Dakota**                       | United States                | 100%   |

\* Includes shares held by selected directors and/or executive officers of the Company or the relevant subsidiary to satisfy the requirements of local law.

\*\* Shares 100% held by Graco Minnesota Inc.

## Exhibit 23

### Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in Registration Statements No. 333-17691, No. 333-17787, No. 33-54205, No. 333-03459, No. 333-75307, and No. 333-63128 on Form S-8 of our report dated February 25, 2005, relating to the financial statements and financial statement schedule of Graco Inc. and management's report on the effectiveness of internal control over financial reporting, appearing in this Annual Report on Form 10-K of Graco Inc. for the year ended December 31, 2004.

**Exhibit 24**

**Power of Attorney**

Know all by these presents, that each person whose signature appears below hereby constitutes and appoints David A. Roberts or Mark W. Sheahan, that person's true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution for that person and in that person's name, place and stead, in any and all capacities, to sign the Report on Form 10-K for the year ended December 31, 2004, of Graco Inc. (and any and all amendments thereto) and to file the same with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as that person might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitutes, may lawfully do or cause to be done by virtue hereof.

In witness whereof, this Power of Attorney has been signed by the following persons on the date indicated.

Date

\R. G. Bohn  
R. G. Bohn

February 18, 2005

\W. J. Carroll  
W. J. Carroll

February 18, 2005

\J. W. Eugster  
J. W. Eugster

February 18, 2005

\J. K. Gilligan  
J. K. Gilligan

February 18, 2005

\L. R. Mitau  
L. R. Mitau

February 18, 2005

\J. H. Moar  
J. H. Moar

February 18, 2005

\M. A. Morfitt  
M. A. Morfitt

February 18, 2005

\M. H. Rauenhurst  
M. H. Rauenhurst

February 18, 2005

\D. A. Roberts  
D. A. Roberts

February 18, 2005

\W. G. Van Dyke  
W. G. Van Dyke

February 18, 2005

\R. W. Van Sant  
R. W. Van Sant

February 18, 2005

**Exhibit 31.1**

**Certifications**

I, David A. Roberts, certify that:

1. I have reviewed this annual report on Form 10-K 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 officers 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 officers 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 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: February 24, 2005

David A. Roberts  
David A. Roberts  
President and Chief Executive Officer

## Exhibit 31.2

### Certifications

I, James A. Graner, certify that:

1. I have reviewed this annual report on Form 10-K 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 officers 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 officers 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 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: February 24, 2005

James A. Graner  
James A. Graner  
Vice President and Controller

### Exhibit 31.3

#### Certifications

I, Mark W. Sheahan, certify that:

1. I have reviewed this annual report on Form 10-K 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 officers 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 officers 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 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: February 24, 2005

Mark W. Sheahan  
Mark W. Sheahan  
Vice President and Treasurer

### Exhibit 32

#### 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: February 24, 2005

David A. Roberts  
David A. Roberts  
President and Chief Executive Officer

Date: February 24, 2005

James A. Graner  
James A. Graner  
Vice President and Controller

Date: February 24, 2005

Mark W. Sheahan  
Mark W. Sheahan  
Vice President and Treasurer

Exhibit 99

### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Graco Inc. (the "Company") wishes to take advantage of the "safe harbor" provisions regarding forward-looking statements of the Private Securities Litigation Reform Act of 1995 and is filing this Cautionary Statement in order to do so.

From time to time various forms filed by the Company with the Securities and Exchange Commission, including the Company's Form 10-K, Form 10-Q and Form 8-K, its Annual Report to Shareholders, and press releases, other written documents or oral statements released by the Company, may contain forward-looking statements. Forward-looking statements generally use words such as "expect," "foresee," "anticipate," "believe," "project," "should," "estimate," "will", and similar expressions, and reflect the Company's expectations concerning the future. Such statements are based upon currently available information, but various risks and uncertainties may cause the Company's actual results to differ materially from those expressed in these statements. Among the factors which management believes could affect the Company's operating results are the following:

- With respect to the Company's business as a whole, the Company's prospects and operating results may be affected by:
  - changes in world economies, including expansions, downturns or recessions and fluctuations in capital goods investment activity, interest rates, and foreign currency exchange rates;
  - the ability of the Company to successfully integrate acquisitions, in particular the recent acquisitions of Liquid Control Corporation and Gusmer Corporation;
  - international trade factors, including changes in international trade policy, such as export controls, trade sanctions; increased tariff barriers and other restrictions; weaker protection of the Company's proprietary technology in certain foreign countries; the burden of complying with foreign laws and standards; and potentially burdensome taxes;
  - the ability of the Company to: develop new products and technologies; maintain and enhance its market position relative to its competitors; maintain and enhance its distribution channels; identify and enter into new markets; realize productivity and product quality improvements; offset cost pressures from labor, materials and overhead with price increases; and control expenses;
  - disruption in operations, transportation, communication, customer operations, distribution, payment or sources of supply, including the cost and availability of skilled labor, materials and energy, caused by political or economic instability, acts of God, labor disputes, war, embargo, weather, flood, fire, infectious disease, or other cause beyond its reasonable control, including military conflict in the Middle East or on the Korean peninsula and terrorist activity throughout the world;
  - pricing pressure and lack of availability of key materials used in the manufacture of products;
  - worldwide competition from low-cost manufacturers, including those that copy the Company's products;
  - breakdown, interruption in or inadequate upgrading of the Company's information processing software, hardware or networks;
  - successful implementation of a new enterprise resource planning ("ERP") software system throughout the Company;
  - changes in the markets in which the Company participates, including consolidation of competitors and major customers, price competition, and products demanded;
  - changes in accounting standards or in the application by the Company of critical accounting policies;
  - compliance with corporate governance requirements;
  - growth in either the severity or magnitude of the products liability claims against the Company, particularly with respect to silica or asbestos; and

— changes in the return on investments in the Company's retirement plan.

- The prospects and operating results of the Company's Contractor Equipment segment may be affected by: variations in the level of residential, commercial and institutional building and remodeling activity; the loss of, or significant reduction in sales to large customers; the pricing power of large customers; the availability and cost of construction financing; changes in the environmental regulation of coatings; consolidation in the paint equipment manufacturing industry and paint manufacturing industry; changes in the technology of paint and coating applications; changes in the buying and channel preferences of the end user; the Company's success in converting painters outside North America from brush and roller to spray equipment; changes in the business practices (including inventory management) of the major distributors of contractor equipment; changes in construction materials and techniques; changes in the cost of labor in foreign markets; the regional market strength of certain competitors; the level of government spending on infrastructure development and road construction, maintenance and repair; and the nature and extent of highway safety regulation.
- The prospects and operating results of the Company's Industrial/ Automotive Equipment segment may be affected by: the capital equipment spending levels of customers; the availability and cost of financing; changes in the environmental regulation of coatings; changes in the technical and performance characteristics of materials, including powder; changes in application technology; the ability of the Company to meet changing customer requirements; consolidation or other change in the channels of distribution; the pricing strategies of competitors; consolidation in the fluid handling equipment manufacturing industry; changes in the worldwide procurement practices of the major automobile manufacturers; changes in automotive manufacturing processes; and consolidation in the automobile manufacturing industry worldwide.
- The prospects and operating results of the Company's Lubrication Equipment segment may be affected by: consolidation in the oil production industry; the development of extended life lubricants for vehicles; the reduction in the need for changing vehicle lubricants; consumer trends in "do-it-yourself" vs. "do-it-for-me" oil changes; the successful development of vehicles that use power sources other than the internal combustion engine; consolidation of automotive dealerships; trends in spending by state and local governments; and variations in the equipment spending levels of the major oil companies.



**RESTATED ARTICLES OF INCORPORATION**  
**OF**  
**GRACO INC.**  
(Approved by the Board of Directors on February 20, 2004)

**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 Multifoods Tower, 33 South Sixth Street, Suite 4100, Minneapolis, Minnesota 55402, 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 5 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 6 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 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 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 8 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 6) of the corporation or (b) to effect a Business Combination (as defined in Article 6), 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.

# PROMISSORY NOTE

\$50,000,000

December 31, 2004

Graco Inc.  
88 11th Avenue Northwest  
Minneapolis, Minnesota 55413  
(Individually and collectively "Borrower")

Wachovia Bank, National Association  
301 South Tryon Street  
Charlotte, North Carolina 28202  
(Hereinafter referred to as "Bank")

Borrower promises to pay to the order of Bank, in lawful money of the United States of America, at its office indicated above or wherever else Bank may specify, the sum of \$50,000,000 (as the same may be reduced from time to time pursuant to that Section hereof titled "Reduction or Termination of Commitment", the "Committed Amount") or such sum as may be advanced and outstanding from time to time, with interest on the unpaid principal balance at the rate and on the terms provided in this Promissory Note (including all renewals, extensions or modifications hereof, this "Note").

**LINE OF CREDIT ADVANCES.** Borrower may borrow, repay and reborrow, and, upon the request of Borrower, Bank shall advance and readvance under this Note from time to time until the maturity hereof (each, including any portion thereof, an "Advance" and together the "Advances"), so long as the principal balance outstanding under this Note after such Advance plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit does not exceed the Committed Amount. Bank shall have no obligation to make Advances under this Note or issue Letters of Credit if a Default has occurred and is continuing. As of the date of each proposed Advance, Borrower shall be deemed to represent that each representation made in the Loan Documents is true in all material respects as of such date.

**USE OF PROCEEDS.** Borrower shall use the proceeds of the loan(s) evidenced by this Note for the commercial purposes of Borrower, as follows: refinance of existing debt and general business purposes (including without limitation acquisition financing).

**LETTERS OF CREDIT.** Upon the request of Borrower, Bank shall issue standby "Letters of Credit", provided that, after such issuance, the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit shall not exceed \$10,000,000 and the principal balance outstanding under this Note plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit shall not exceed the Committed Amount. Subject to the terms of this Note, Borrower may borrow hereunder to pay reimbursement obligations due Bank under Letters of Credit. With respect to each issuance of a Letter of Credit, Borrower shall execute Bank's form "Letter of Credit Application". Upon termination of Bank's obligation to Advance under this Note, whether by maturity, Default or otherwise, Borrower shall deliver immediately to Bank cash collateral in an amount equal to the aggregate amount of outstanding undrawn Letters of Credit or provide Bank with other credit support for such undrawn Letters of Credit reasonably acceptable to Bank.

**Letter of Credit Fees.** Borrower shall pay a Standby LC Fee with respect to each Letter of Credit from the date of issuance through the date of expiration, draw or other termination, at the Standby LC Fee rate on the amount of each Letter of Credit. Borrower shall pay to Bank Bank's standard processing fees in connection with amendment, issuance, renewal or extension of each Letter of Credit.

**FACILITY FEE.** Borrower shall pay a Facility Fee from the date hereof through the Maturity Date at the Facility Fee rate on the Committed Amount.

**INTEREST RATES AND FEES.** The variable pricing grid below is referred to herein as the "Pricing Grid". The "LIBOR Spread", "Facility Fee", and the "Standby LC Fee" shall be determined at any time by reference to the Leveraged Ratio calculated as of the end of the most recent fiscal quarter preceding the day such fee is determined for which financial statements have been delivered under that Section of this Note titled "Financial Information" and the Pricing Grid. All interest and fees are stated as annual rates in the Pricing Grid.

## Variable Pricing Grid

| Leverage Ratio    | LIBOR Spread | Facility Fee | Standby LC Fee |
|-------------------|--------------|--------------|----------------|
| ≤ 1.0x            | 0.37%        | 0.08%        | 0.45%          |
| > 1.0x and ≤ 2.0x | 0.475%       | 0.10%        | 0.575%         |
| > 2.0x and ≤ 3.0x | 0.58%        | 0.12%        | 0.70%          |
| > 3.0x            | 0.80%        | 0.15%        | 0.95%          |

**INTEREST RATE DEFINITIONS. LIBOR-Based Rate.** "LIBOR-Based Rate" means, with respect to any Advance, LIBOR for the Interest Period applicable to such Advance plus the applicable LIBOR Spread, as the applicable LIBOR Spread may change from time to time.

**LIBOR.** "LIBOR" means, with respect to each Interest Period, the rate for U.S. dollar deposits with a maturity equal to the number of months in such Interest Period, as reported on Telerate page 3750 as of 11:00 a.m., London time, on the second London business day before such Interest Period begins(or if not so reported, then as determined by Bank from another recognized source or interbank quotation).

**Prime Rate.** "Prime Rate" means Bank's Prime Rate, as that rate may change from time to time with changes to occur on the date Bank's Prime Rate changes.

**LIBOR-Based Rate Advance.** "LIBOR-Based Rate Advance" means an Advance bearing interest at a rate determined by reference to a LIBOR-Based Rate.

**Prime Rate Advance.** "Prime Rate Advance" means an Advance bearing interest at a rate determined by reference to the Prime Rate.

**Interest Period.** “Interest Period” means, in respect of each LIBOR-Based Rate Advance, the period commencing on the date of such Advance or the last day of the immediately preceding Interest Period applicable to such Advance and ending one, two, three or six months thereafter, as the Borrower shall have elected in the applicable notice of borrowing, continuation or conversion; provided (i) any Interest Period that ends in a month for which there is no day which numerically corresponds to the last day of the immediately preceding Interest Period shall end on the last day of the month and (ii) any Interest Period that would otherwise extend past the Maturity Date of this Note shall end on the Maturity Date of this Note.

**INTEREST RATE SELECTION AND ADJUSTMENT. Interest Rate Options.** Interest shall accrue on the unpaid principal balance of each Advance from the date of such Advance at a rate per annum equal to a LIBOR-Based Rate or Prime Rate, as selected by Borrower in accordance herewith (each, an “Interest Rate”). Interest for each Interest Period shall accrue each day during such Interest Period, commencing on and including the first day to but excluding the last day.

When the Prime Rate is selected for an Advance, it shall be adjusted from time to time, effective as of the date of each change in Bank’s Prime Rate and the Prime Rate shall continue to apply until another Interest Rate option is selected for that Advance pursuant to the subsection entitled “Notice and Manner of Borrowing and Rate Conversion”. When a LIBOR-Based Rate is selected for an Advance, the LIBOR component of such rate shall be fixed for each Interest Period for which it is determined, and such Advance shall be continued as a LIBOR-Based Rate Advance with the same Interest Period until another Interest Rate option is selected for that Advance pursuant to the subsection entitled “Notice and Manner of Borrowing and Rate Conversion.” There shall be no more than 10 LIBOR-Based Rate Advances having different Interest Periods outstanding at any time. Each borrowing of, conversion to or from, or continuation as, a LIBOR-Based Rate Advance will be in an amount such that, after giving effect thereto, the aggregate outstanding principal amount of all LIBOR-Based Rate Advances having the same Interest Period shall be \$1,000,000 or increments of \$500,000 in excess thereof.

**Funding Loss Protection.** Borrower shall indemnify Bank against Bank’s loss or expense as a consequence of (a) Borrower’s failure to make any payment when due on a loan or Advance bearing interest at a LIBOR-Based Rate, (b) any payment, prepayment or conversion of any loan or Advance bearing interest at a LIBOR-Based Rate on a day other than the last day of the Interest Period (whether due to acceleration, maturity or otherwise), or (c) any failure to make a borrowing or conversion after giving notice thereof (“Indemnified Loss or Expense”). The amount of such Indemnified Loss or Expense shall be determined by Bank based upon the assumption that Bank funded 100% of that portion of the loan in the London interbank market and Bank shall provide justification for such to Borrower upon Borrower’s request.

**Default Rate.** In addition to all other rights contained in this Note, if a Default occurs, and as long as a Default continues, (a) Borrower shall no longer have the option to request a LIBOR-Based Rate and (b) the outstanding principal amount of this Note and all other overdue Obligations shall bear interest at a rate per annum equal to the Prime Rate plus 2% (“Default Rate”); provided, however, that during the balance of any Interest Period applicable to an LIBOR-Based Rate Advance, the Default Rate with respect to such Advance shall be a rate per annum equal to the LIBOR-Based Rate applicable to such Advance plus 2%. The Default Rate shall also apply from acceleration until the Obligations or any judgment thereon is paid in full.

**Notice and Manner of Borrowing and Rate Conversion.** Borrower shall give Bank irrevocable telephonic notice of each proposed Advance not later than 11:00 a.m. local time at the office of Bank first shown above on the same business day as such proposed Advance. Each such notice shall specify (i) the date of such Advance, which shall be a business day, (ii) the amount of such Advance, (iii) whether such Advance is to be initially funded as a Prime Rate Advance or a LIBOR-Based Rate Advance, and (iv) in the case of a LIBOR-Based Rate Advance, the duration of the Interest Period applicable thereto. Notices received after 11:00 a.m. local time at the office of Bank first shown above shall be deemed received on the next business day.

Subject to the above limitations, Borrower shall have the option from time to time to convert all or any part of an Advance into a Prime Rate Advance or a LIBOR-Based Rate Advance, or to continue all or any part of a LIBOR-Based Rate Advance as such with the same or a different Interest Period; provided, however, that a LIBOR-Based Rate Advance may be converted or continued only on the last day of the Interest Period applicable thereto. Borrower shall give Bank irrevocable telephonic notice of any continuation or conversion of an Advance not later than 11:00 a.m. local time at the office of Bank first shown above on the date of the requested continuation or conversion. Each such notice shall specify (i) the date of such continuation or conversion, (ii) the amount to be continued or converted, and (iii) in the case of continuations as or conversions to LIBOR-Based Rate Advances, the Interest Period applicable thereto.

At the Maturity Date or upon acceleration all LIBOR-Based Rate Advances shall automatically convert to Prime Rate Advances.

**Interest and Fee Computation.** Interest and fees, if any, shall be computed on the basis of the actual days in the year and the actual number of days in the applicable period. The computation determines the annual effective yield by taking the stated (nominal) rate for a year’s period and then dividing said rate by number of days in the year to determine the daily periodic rate to be applied for each day in the applicable period.

**REPAYMENT TERMS.** Accrued interest on each LIBOR-Based Rate Advance shall be due at the sooner of the end of the applicable Interest Period or the Maturity Date. Accrued interest on Prime Rate Advances, accrued Standby LC Fees and accrued Facility Fees shall be due and payable in consecutive monthly payments commencing on January 31, 2005, and continuing on the last day of each month thereafter until fully paid. In any event, all principal and accrued interest shall be due and payable on December 30, 2005 (the “Maturity Date”).

If Borrower subscribes to Bank’s cash management services and such services are applicable to this line of credit, the terms of such service shall control the manner in which funds are transferred between the applicable demand deposit account and the line of credit for credit or debit to the line of credit.

**APPLICATION OF PAYMENTS.** Monies received by Bank from any source for application toward payment of the Obligations shall be applied to accrued interest and then to principal. If a Default occurs, and so long as such Default is continuing, monies may be applied to the Obligations in any manner or order deemed appropriate by Bank.

If any payment received by Bank under this Note or other Loan Documents is rescinded, avoided or for any reason returned by Bank because of any adverse claim or threatened action, the returned payment shall remain payable as an obligation of all persons liable under this Note or other Loan Documents as though such payment had not been made.

**REDUCTION OR TERMINATION OF COMMITMENT.** Borrower may at any time and from time to time, upon not less than three business days’ prior written notice to Bank, permanently reduce in part the Commitment Amount or terminate entirely the commitment of the Bank to make Advances under this Note, in each case without premium or penalty, provided that any such partial reduction of the Commitment Amount shall be in integral multiples of \$500,000 and no such partial reduction shall reduce the Commitment Amount to an amount which is less than the sum at the time of the principal balance outstanding under this Note plus the aggregate amount of undrawn Letters of Credit plus the aggregate amount of unreimbursed drawings under all Letters of Credit. Upon any termination by Borrower in its entirety of the commitment of the Bank to make Advances under this Note, Borrower shall pay all of the Obligations in full.

**DEFINITIONS. Affiliate.** Affiliate shall have the meaning as defined in 11 U.S.C. § 101, except that the term “Borrower” shall be substituted for the term “Debtor” therein. **Agreement Accounting Principles.** Agreement Accounting Principles means generally accepted accounting principles as in effect in the United States from time to time. **Loan Documents.** The term “Loan Documents”, as used in this Note and the other Loan Documents, refers to all documents executed in connection with or related to the loan evidenced by this Note and any prior notes which evidence all or any portion of the loan evidenced by this Note, and any letters of credit issued pursuant to any loan agreement to which this Note is subject, any applications for such letters of credit and any other documents executed in connection therewith or related thereto and any renewals or modifications thereof, whenever any of the foregoing are executed, but does not include swap agreements (as defined in 11 U.S.C. § 101). **Material Adverse Effect.** The term Material Adverse Effect shall mean, with respect to any event, act, condition or occurrence of whatever nature (including any adverse determination in any litigation, arbitration, or governmental investigation or proceeding), whether singly or in conjunction with any other event or events, act or acts, condition or conditions, or occurrence or occurrences whether or not related, a material adverse change in, or a material adverse effect on, (a) the business, results of operations, financial condition, assets or liabilities of Borrower and its Subsidiaries taken as a whole, (b) the ability of Borrower to perform any of its obligations under the Loan Documents, (c) the rights and remedies of the Bank under any of the Loan Documents or (d) the legality, validity or enforceability of any of the Loan Documents. **Obligations.** The term “Obligations”, as used in this Note and the other Loan Documents, refers to any and all indebtedness, promises, covenants, agreements and other obligations under this Note and under any other Loan Document. Any reference in this Note or in any other Loan Document to payment, or final payment, in full of the Obligations shall mean the payment in full in cash of all Obligations other than contingent indemnification Obligations (or, in the case of undrawn Letters of Credit, the cash collateralization thereof or provision of other credit support therefor in accordance with the terms of the Section hereof titled “Letters of Credit”). **Subsidiary.** Subsidiary shall mean any business in which Borrower holds, directly or indirectly, a controlling interest. **Certain Other Terms.** All terms that are used but not otherwise defined in any of the Loan Documents shall have the definitions provided in the Uniform Commercial Code.

**ATTORNEYS’ FEES AND OTHER COLLECTION COSTS.** Borrower shall pay all of Bank’s reasonable expenses incurred to enforce or collect any of the Obligations including, without limitation, reasonable arbitration, paralegals’, attorneys’ and experts’ fees and expenses, whether incurred without the commencement of a suit, in any trial, arbitration, or administrative proceeding, or in any appellate or bankruptcy proceeding.

**USURY.** If at any time the effective interest rate under this Note would, but for this paragraph, exceed the maximum lawful rate, the effective interest rate under this Note shall be the maximum lawful rate, and any amount received by Bank in excess of such rate shall be applied to principal and then to fees and expenses, or, if no such amounts are owing, returned to Borrower.

**GRACE/CURE PERIOD. Grace Period.** The failure of timely payment of the interest or fees shall not be a Default until 5 days after such payment is due. **Cure Period.** Except as provided below, any Default, other than non-payment, may be cured within 30 days after written notice thereof is mailed to Borrower by Bank. Borrower’s right to cure shall be applicable only to curable defaults and shall not apply, without limitation, to Defaults based upon False Warranty or, except as provided below, Bankruptcy.

**DEFAULT.** If any of the following occurs and is not cured within the applicable Cure Period, a default (“Default”) under this Note shall exist: **Nonpayment; Nonperformance.** The failure of timely payment or performance of the Obligations or Default, however denominated, under this Note or any other Loan Documents. **False Warranty.** A warranty or representation made or deemed made in the Loan Documents or furnished to Bank by Borrower in connection with the loan evidenced by this Note proves materially false, or if of a continuing nature, becomes materially false. **Cross Default.** At Bank’s option, any default in payment or performance of any obligation under any other loans, contracts or agreements of Borrower or any Subsidiary of Borrower with Bank or its affiliates. **Bankruptcy.** Appointment of a receiver for, assignment for the benefit of creditors of, or commencement of any bankruptcy or insolvency proceeding by or against, Borrower or any of its Subsidiaries (which proceeding, if not instituted, consented to or acquiesced in by Borrower or such Subsidiary, remains undismissed or unstayed and in effect for a period of 60 consecutive days). **Material Business Alteration.** Without prior written consent of Bank, a material alteration in the kind or type of Borrower’s business.

**REMEDIES UPON DEFAULT.** If a Default occurs under this Note or any Loan Documents, Bank may at any time thereafter so long as such Default is continuing, take the following actions: **Acceleration Upon Default/Termination.** Accelerate the maturity of this Note and, at Bank’s option, any or all other Obligations, whereupon this Note and the accelerated Obligations shall be immediately due and payable, and terminate Bank’s obligation to make Advances under this Note or issue Letters of Credit; provided, however, if the Default is based upon a bankruptcy or insolvency proceeding commenced by or against Borrower, all Obligations shall automatically and immediately be due and payable, all LIBOR - Based Rate Advances shall convert to Prime Rate Advances and Bank’s obligation to make Advances under this Note or issue Letters of Credit shall terminate. **Cumulative.** Exercise any rights and remedies as provided under the Note and other Loan Documents, or as provided by law or equity.

**REPRESENTATIONS. Power and Authorization.** Borrower has the power and authority to execute, deliver and perform, and by all necessary action has authorized the execution, delivery and performance of, all of its obligations under this Note and any other Loan Document to which it is a party. **Organization and Authority.** Borrower and each Subsidiary of Borrower is duly created, validly existing and in good standing under the laws of the state of its organization, and has all powers, governmental licenses, authorizations, consents and approvals required to operate its business as now conducted except where the failure to have any such power, governmental license, authorization, consent or approval could not be reasonably expected to have a Material Adverse Effect. Borrower and each Subsidiary of Borrower is duly qualified, registered and in good standing in each jurisdiction where qualification or registration is required by the nature of its business or the character and location of its property, business or customers, and in which the failure to so qualify or be so registered or in good standing, as the case may be, in the aggregate, could be reasonably expected to have a Material Adverse Effect. **No Litigation.** Except as disclosed to Bank in writing prior to the execution and delivery of this Note, there are no pending or, to the knowledge of Borrower, threatened suits, regulatory or administrative proceedings, arbitrations or penalties against Borrower or any Subsidiary of Borrower that could be reasonably expected to have a Material Adverse Effect. **ERISA.** Each employee pension benefit plan, as defined in ERISA, maintained by Borrower meets, as of the date hereof, the minimum funding standards of ERISA and all applicable regulations thereto and requirements thereof, and of the Internal Revenue Code of 1986, as amended. No “Prohibited Transaction” or “Reportable Event” (as both terms are defined by ERISA) has occurred with respect to any such plan. **Regulation U.** None of the proceeds of the credit shall be used directly or indirectly for the purpose of purchasing or carrying any margin stock in violation of any of the provisions of Regulation U of the Board of Governors of the Federal Reserve System (“Regulation U”), or for the purpose of reducing or retiring any indebtedness which was originally incurred to purchase or carry margin stock or for any other purchase which might render the loan evidenced by this Note a “Purpose Credit” within the meaning of Regulation U.

**FINANCIAL INFORMATION.** Borrower agrees that from the date hereof until payment in full of the Obligations: **Annual.** Borrower shall deliver to Bank, within 120 days after the close of each fiscal year, audited financial statements reflecting its operations during such fiscal year, including, without limitation, a balance sheet, profit and loss statement, statement of cash flows and officer’s compliance certificate with supporting schedules; all on a consolidated basis with respect to Borrower and its Subsidiaries, and in reasonable detail, prepared in conformity with generally accepted accounting principles, applied (except as otherwise disclosed in such financial statements) on a basis consistent with that of the preceding year. All such statements shall be examined by Deloitte & Touche LLP or another independent certified public accountant of recognized national standing selected by Borrower. The opinion of such independent certified public accountant shall not be acceptable to Bank if qualified due to any limitations in scope imposed by Borrower or any other person or entity. Any other qualification of the opinion by the accountant shall render



the acceptability of the financial statements subject to Bank's approval. **Quarterly.** Borrower shall deliver to Bank, within 120 days after the close of each fiscal year and within 45 days after the end of each of the first three fiscal quarters in any fiscal year, audited quarterly financial statements including, without limitation, a balance sheet, profit and loss statement, statement of cash flows and officer's compliance certificate, with supporting schedules; all on a consolidated basis with respect to Borrower and its Subsidiaries, all in reasonable detail and (except for the absence of footnote disclosures and subject to year-end adjustments) prepared in conformity with generally accepted accounting principles, applied (except as otherwise disclosed in such financial statements) on a basis consistent with that of the preceding year. **Additional Information.** Borrower shall deliver to Bank such information as Bank may reasonably request from time to time pertaining to Borrower's corporate status, operations and financial condition. Borrower shall permit Bank and its representatives to meet with Borrower and discuss the business and finances of Borrower from time to time as Bank may reasonably request. **Accuracy.** All information provided Bank by Borrower shall be complete and accurate in all material respects.

**AFFIRMATIVE COVENANTS.** Borrower agrees that from the date hereof until payment in full of the Obligations: **Maintenance of Corporate Status.** Borrower shall maintain its corporate existence and qualification or registration in all jurisdictions where it is required to be qualified or registered under applicable law and shall not suffer loss of good standing status where it is incorporated or in jurisdictions where it is required to be qualified or registered under applicable law (except, in the case of foreign qualification, registration or good standing, where the failure to maintain such qualification or registration or the loss of such good standing status, as the case may be, could not be reasonably expected to have a Material Adverse Effect). **Compliance With Laws.** Borrower will, and will cause each of its Subsidiaries to, comply with all laws, rules, regulations and requirements of any governmental authority applicable to its properties, except where the failure to do so, either individually or in the aggregate, could not reasonably be expected to result in a Material Adverse Effect. **Insurance.** Borrower will, and will cause each of its Subsidiaries to, maintain, with financially sound and reputable insurance companies, adequate insurance coverage with respect to its properties and business against loss or damage of the kinds and in the amounts customarily insured against by companies of established reputation engaged in the same or similar businesses including, without limitation, commercial general liability insurance, workers compensation insurance, and business interruption insurance. **Maintain Properties.** Borrower will, and will cause each of its Subsidiaries to, maintain, preserve and keep its property in good repair, working order and condition, making all needed replacements, additions and improvements thereto.

**FINANCIAL COVENANTS.** Borrower agrees that from the date hereof until final payment in full of the Obligations, using the financial information for Borrower and its Subsidiaries, calculated on a consolidated basis: **Minimum Consolidated Interest Coverage Ratio.** Borrower will not, as of the last day of any fiscal quarter of Borrower, commencing with the fiscal quarter ending December 31, 2004, permit the Consolidated Interest Coverage Ratio for the period of four fiscal quarters ending on such day, to be less than 3.0 to 1.0. **Maximum Leverage Ratio.** Borrower will not, as of the last day of any fiscal quarter of Borrower, commencing with the fiscal quarter ending December 31, 2004, permit the Leverage Ratio for the period of four consecutive fiscal quarters ending on such day, to be greater than 3.0 to 1.0. **Definitions Applicable to Financial Covenants:** "Consolidated Interest Coverage Ratio" means, for any period of four consecutive fiscal quarters of Borrower, the ratio of (i) Consolidated EBIT for such period to (ii) Consolidated Interest Expense for such period. "Leverage Ratio" means, as of the last day of any fiscal quarter of Borrower, the ratio of (i) Consolidated Total Debt to (ii) Consolidated EBITDA. The Leverage Ratio shall be calculated based upon (a) for Consolidated Total Debt, Consolidated Total Debt as of the last day of each such fiscal quarter, and (b) for Consolidated EBITDA, the actual amount for the period of four consecutive fiscal quarters of Borrower ending on such day. "Consolidated EBIT" means, for any period of four consecutive fiscal quarters of Borrower, on a consolidated basis for Borrower and its Subsidiaries in accordance with Agreement Accounting Principles, the sum of the amounts for such period, without duplication, of (i) net income, plus (ii) interest expense plus (iii) income taxes. "Consolidated Interest Expense" means, for any period of four consecutive fiscal quarters of the Borrower, total interest expense (whether paid or accrued) of the Borrower and its Subsidiaries for such period determined in accordance with Agreement Accounting Principles. "Consolidated Total Debt" means the aggregate principal amount of all Indebtedness on a consolidated basis of Borrower and its Subsidiaries as of a referenced date. "Indebtedness" means, without duplication, (i) obligations for borrowed money, (ii) obligations representing the deferred purchase price of property or services (other than accounts payable or accrued expenses arising in the ordinary course of such person's business payable on terms customary in the trade), (iii) obligations, whether or not assumed, secured by liens on or specifically payable out of the proceeds or production from property now or hereafter owned or acquired by such person, (iv) Letter of Credit obligations and (v) obligations which are evidenced by notes, acceptances, or other instruments. "Consolidated EBITDA", means for any period of four consecutive fiscal quarters of Borrower, on a consolidated basis for Borrower and its Subsidiaries in accordance with Agreement Accounting Principles, the sum of the amounts for such period, without duplication, of (i) Consolidated EBIT, plus (ii) depreciation plus (iii) amortization expense.

**INDEMNIFICATION.** The Borrower agrees to indemnify and hold harmless Bank, its officers, employees, directors, and authorized agents ("Indemnified Persons") from and against any and all liabilities, losses, damages, penalties, or costs and expenses of any kind, including, without limitation, the reasonable fees and disbursements of counsel, which may be incurred by any of them in connection with any claim or investigative, administrative or judicial proceeding relating to or arising out of the Loan Documents, the Obligations or any actual or proposed use of proceeds of this Note; provided that no Indemnified Persons may recover hereunder any liabilities, losses, damages, penalties, or costs and expenses determined by a court of competent jurisdiction to have been caused by gross negligence or willful misconduct of such Indemnified Person. The foregoing indemnity obligation shall be an Obligation hereunder. The indemnity provided for herein shall survive payment of the Obligations.

**WAIVERS AND AMENDMENTS.** No waivers, amendments or modifications of this Note and other Loan Documents shall be valid unless in writing and signed by an officer of the party against which enforcement of the same is sought. No waiver by Bank of any Default shall operate as a waiver of any other Default or the same Default on a future occasion. Neither the failure nor any delay on the part of Bank in exercising any right, power, or remedy under this Note and other Loan Documents shall operate as a waiver thereof, nor shall a single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or remedy.

Each of Borrower and any other person liable under this Note (an "Obligor") waives presentment, protest, notice of dishonor, demand for payment, notice of intention to accelerate maturity, notice of acceleration of maturity, notice of sale and all other notices of any kind (except for notices expressly required by this Note or any of the other Loan Documents). Further, each Obligor other than Borrower agrees that Bank may extend, modify or renew this Note or make a novation of the loan evidenced by this Note for any period, and each Obligor agrees that Bank may grant any releases, compromises or indulgences with respect to any collateral securing this Note, or with respect to any other Obligor, all without notice to or consent of such Obligor and without affecting the liability of such Obligor.

**MISCELLANEOUS PROVISIONS. Assignment.** This Note and the other Loan Documents shall inure to the benefit of and be binding upon the parties and their respective successors and assigns. Bank's interests in and rights under this Note and the other Loan Documents are assignable, in whole or in part, by Bank only with the prior written consent of Borrower (which may not be unreasonably withheld), except that no such consent of Borrower shall be required at any time a Default has occurred and is continuing. Borrower shall not assign its rights and interest hereunder without the prior written consent of Bank, and any attempt by Borrower to assign without Bank's prior written consent is null and void. Any assignment shall not release Borrower from the Obligations. **Applicable Law.** This Note and, unless otherwise provided in any other Loan Document, the other Loan Documents shall be governed by and construed under the laws of the state named in Bank's address on the first page hereof without regard to that state's conflict of laws principles. **Jurisdiction.** Borrower irrevocably agrees to non-exclusive personal jurisdiction in the state named in Bank's address on the first page hereof. **Severability.** If any provision of this Note or of the other Loan Documents shall be prohibited or invalid under applicable law, such provision shall be ineffective but only to the extent of such prohibition or invalidity, without invalidating the remainder of such provision or the remaining provisions of this Note or other such document. **Notices.** Any notices to Borrower

shall be sufficiently given, if in writing and mailed or delivered to the Borrower's address shown above or such other address as provided hereunder, and to Bank, if in writing and mailed or delivered to Wachovia Bank, National Association, Mail Code 201 S. College Street, Charlotte, NC 28244 or such other address as Bank may specify in writing from time to time. Written notices to Bank must include the mail code. Any notice permitted to be given to Bank telephonically shall be given by calling Lekeisha Neely (or such other individual as Bank may specify in writing from time to time) at (704) 374-6145 (or such other telephone number as Bank may specify in writing from time to time). In the event that Borrower changes Borrower's address at any time prior to the date the Obligations are paid in full, Borrower agrees to promptly give written notice of said change of address by registered or certified mail, return receipt requested, all charges prepaid. **Plural; Captions.** All references in the Loan Documents to nouns of reference mean both the singular and plural form, as the case may be, and the term "person" shall mean any individual, person or entity. The captions contained in the Loan Documents are inserted for convenience only and shall not affect the meaning or interpretation of the Loan Documents. **Advances.** Bank may, in its sole discretion, make other advances, which shall be deemed to be advances under this Note, even though the stated principal amount of this Note may be exceeded as a result thereof. **Posting of Payments.** All payments received during normal banking hours after 2:00 p.m. local time at the office of Bank first shown above shall be deemed received at the opening of the next banking day. **Fees and Taxes.** Borrower shall promptly pay all documentary, intangible recordation and/or similar taxes on this transaction whether assessed at closing or arising from time to time.

**CONFIDENTIALITY.** Bank agrees to keep confidential all non-public information provided to it by or on behalf of Borrower or any Subsidiary of Borrower pursuant to this Note or any of the other Loan Documents, and to limit its use of such information to the evaluation, administration and/or enforcement of this Note or any of the other Loan Documents; provided, however, that nothing herein shall prevent Bank from disclosing such information (i) to any actual or prospective assignee in connection with the contemplated assignment of Bank's interests in and rights under this Note so long as such actual or potential assignee has, prior to receiving any such information, agreed in writing to preserve the confidential nature thereof on terms no less restrictive than those contained in this Section, (ii) to its employees, directors, agents, attorneys, accountants and other professional advisors as need to know such information, (iii) in response to any order of any court or other governmental authority or as may otherwise be required by law, or (iv) in connection with the exercise by Bank of any remedy under this Note or any of the other Loan Documents.

**ARBITRATION.** Upon demand of any party hereto, whether made before or after institution of any judicial proceeding, any claim or controversy arising out of or relating to the Loan Documents between parties hereto (a "Dispute") shall be resolved by binding arbitration conducted under and governed by the Commercial Financial Disputes Arbitration Rules (the "Arbitration Rules") of the American Arbitration Association (the "AAA") and the Federal Arbitration Act. Disputes may include, without limitation, tort claims, counterclaims, a dispute as to whether a matter is subject to arbitration, claims brought as class actions, or claims arising from documents executed in the future. A judgment upon the award may be entered in any court having jurisdiction. Notwithstanding the foregoing, this arbitration provision does not apply to disputes under or related to swap agreements. **Special Rules.** All arbitration hearings shall be conducted in the city named in the address of Bank first stated above. A hearing shall begin within 90 days of demand for arbitration and all hearings shall conclude within 120 days of demand for arbitration. These time limitations may not be extended unless a party shows cause for extension and then for no more than a total of 60 days. The expedited procedures set forth in Rule 51 et seq. of the Arbitration Rules shall be applicable to claims of less than \$1,000,000.00. Arbitrators shall be licensed attorneys selected from the Commercial Financial Dispute Arbitration Panel of the AAA. The parties do not waive applicable Federal or state substantive law except as provided herein. **Preservation and Limitation of Remedies.** Notwithstanding the preceding binding arbitration provisions, the parties agree to preserve, without diminution, certain remedies that any party may exercise before or after an arbitration proceeding is brought. The parties shall have the right to proceed in any court of proper jurisdiction or by self-help to exercise or prosecute the following remedies, as applicable: (i) all rights to foreclose against any real or personal property or other security by exercising a power of sale or under applicable law by judicial foreclosure including a proceeding to confirm the sale; (ii) all rights of self-help including peaceful occupation of real property and collection of rents, set-off, and peaceful possession of personal property; (iii) obtaining provisional or ancillary remedies including injunctive relief, sequestration, garnishment, attachment, appointment of receiver and filing a voluntary or involuntary bankruptcy proceeding; and (iv) when applicable, a judgment by confession of judgment. Any claim or controversy with regard to any party's entitlement to such remedies is a Dispute. **Waiver of Exemplary Damages.** The parties agree that they shall not have a remedy of punitive or exemplary damages against other parties in any Dispute and hereby waive any right or claim to punitive or exemplary damages they have now or which may arise in the future in connection with any Dispute whether the Dispute is resolved by arbitration or judicially. **Waiver of Jury Trial.** THE PARTIES ACKNOWLEDGE THAT BY AGREEING TO BINDING ARBITRATION THEY HAVE IRREVOCABLY WAIVED ANY RIGHT THEY MAY HAVE TO JURY TRIAL WITH REGARD TO A DISPUTE.

**IN WITNESS WHEREOF,** Borrower, on the day and year first above written, has caused this Note to be executed under seal.

Graco Inc.  
Taxpayer Identification Number: 41-0285640

By: \_\_\_\_\_ (SEAL)  
Name: \_\_\_\_\_, Title: \_\_\_\_\_

Agreed and Accepted as of the  
day and year first above written:

Wachovia Bank, National Association

By: \_\_\_\_\_  
Name: \_\_\_\_\_, Title: \_\_\_\_\_

**EXECUTIVE OFFICER  
ANNUAL INCENTIVE BONUS PLAN**

**1. Definitions.** When the following terms are used herein with initial capital letters, they shall have the following meanings:

- 1.1 **Base Salary** — a specific dollar amount for each Participant as identified in Schedule A.
- 1.2 **Compensation Committee** — the Management Organization and Compensation Committee of the Board of Directors of Graco Inc.; it is intended that the Compensation Committee will satisfy the requirements of Section 162(m) of the Code by being comprised of two or more “outside directors.”
- 1.3 **Code** — the Internal Revenue Code of 1986, as it may be amended from time to time, and any proposed, temporary or final Treasury Regulations promulgated thereunder.
- 1.4 **Company** — Graco Inc., a Minnesota corporation, and any of its affiliates that adopt the Plan.
- 1.5 **Eligible Employee** — the chief executive officer and any executive officer of the Company designated by the Compensation Committee.
- 1.6 **Participant** — an Eligible Employee designated by the Compensation Committee, at any time ending on or before the 90th day of each Performance Period, as subject to the Plan.
- 1.7 **Performance Period** — the Company's fiscal year.
- 1.8 **Plan** — this Executive Officer Annual Incentive Bonus Plan.
- 1.9 **Maximum Targeted Bonus Percentage** — the maximum potential bonus payout expressed as a percentage of Participant's Base Salary as identified in Schedule B.
- 1.10 **Company Performance Target(s)** — the financial growth target(s) established by the Compensation Committee for a Performance Period and reflected in the percentages identified in Schedule C. The Company Performance Target(s) shall be directly and specifically tied to one or more of the following financial measures: consolidated pre-tax earnings, net revenues, net earnings, operating income, earnings before interest and taxes, cash flow, return on equity, return on net assets employed or earnings per share [hereinafter “Financial Measure(s)”] for the applicable Performance Period, all as computed in accordance with generally accepted accounting principles as in effect from time to time and as applied by the Company in the preparation of its financial statements and subject to other special rules and conditions as the Compensation Committee may establish at any time ending on or before the 90th day of the applicable Performance Period. Any Financial Measure may be stated in absolute terms or as compared to another company or companies. Such Financial Measures shall constitute the sole bases upon which the Company Performance Targets shall be based.

**2. Administration.**

- 2.1 **Determinations must be made prior to each Performance Period** — At any time ending on or before the 90th day of each Performance Period, the Compensation Committee shall:
  - (a) designate the Participants in the Plan for that Performance Period;
  - (b) indicate the Base Pay of each Participant for the Performance Period by amending Schedule A in writing;
  - (c) establish Targeted Bonus Percentages for the Performance Period by amending Schedule B in writing;
  - (d) establish Company Performance Target(s) for the Performance Period by amending Schedule C in writing.
- 2.2 **Certification** — Following the close of each Performance Period and prior to payment of any bonus under the Plan, the Compensation Committee must certify in writing that the Company Performance Target(s) and all other factors upon which a bonus is based have been attained.
- 2.3 **Shareholder Approval** — The material terms of the Plan shall be disclosed to and approved by shareholders of the Company in accordance with Section 162(m) of the Code. No bonus shall be paid under the Plan unless such shareholder approval has been obtained.

**3. Bonus Payment**

- 3.1 **Maximum** — Each Participant shall receive a bonus payment for each Performance Period calculated in accordance with the formula set forth in subparagraph 3.2 and in an amount not greater than the Participant's Maximum Targeted Bonus Percentage multiplied by the Participant's Base Salary.
- 3.2 **Formula** — Subject to other provisions of this Plan, each Participant shall receive a bonus payment for each Performance Period calculated as follows:
  - (a) Each of the Company Performance Targets shall be assigned a weight expressed as a percent of the Participant's Maximum Targeted Bonus Percentage.

(b) At the conclusion of each Performance Period, the percent of the Participant's Maximum Targeted Bonus Percentage achieved for each applicable Financial Measure shall be calculated.

(c) The percentages achieved by performing the calculation described in subparagraph 3.2(b) shall be added together and this sum shall be multiplied by the Participant's Maximum Targeted Bonus Percentage.

(d) The amount obtained by performing the calculation described in subparagraph 3.2(c) shall be multiplied by the Participant's Base Salary.

### 3.3 Limitations

(a) **No payment if Company Performance Targets not achieved** — In no event shall any Participant receive a bonus payment hereunder if the Company Performance Targets and all other factors on which the bonus payment is based are not achieved during the Performance Period.

(b) **No payment in excess of preestablished amount** — No Participant shall receive a payment under the Plan for any Performance Period in excess of One Million Dollars (\$1,000,000).

(c) **Pro-ration or elimination of Bonus payment** — Participation in the Plan ceases with resignation, termination, retirement, death or long-term disability. A Participant who resigns or is terminated effective during the Performance Period is ineligible for a bonus payment. A Participant who retires, dies or becomes eligible for long-term disability benefits under the Company's long-term disability benefit plan during the Performance Period will be paid a bonus based on a calculation performed in accordance with the provisions of subparagraph 3.2, provided, however, the Participant's Base Salary shall be pro-rated to the date of retirement, death or eligibility for long-term disability benefits.

4. **Time and Form of Payments; Taxability** — Subject to any deferred compensation election pursuant to any such plans of the Company, a bonus payment shall be made to the Participant in one or more cash payments as soon as determined by the Compensation Committee after it has certified that the Company Performance Target(s) and all other factors upon which the bonus payment for the Participant is based have been achieved.

4.1 **Nontransferability** — Participants and beneficiaries shall not have the right to assign, encumber or otherwise anticipate the payments to be made under the Plan, and the benefits provided hereunder shall not be subject to seizure for payment of any debts or judgments against any Participant or any beneficiary.

4.2 **Tax Withholding** — In order to comply with all applicable federal or state income tax laws or regulations, the Company may take such action as it deems appropriate to ensure that all applicable federal or state payroll, withholding, income or other taxes, which are the sole and absolute responsibility of a Participant, are withheld or collected from such Participant.

5. **Amendment and Termination** — The Compensation Committee may amend the Plan prospectively at any time and for any reason deemed sufficient by it without notice to any person affected by the Plan and may likewise terminate or curtail the benefits of the Plan, both with regard to persons expecting to receive benefits hereunder in the future and persons already receiving benefits at the time of such action, provided that no amendment to the Plan shall be effective which would increase the maximum amount payable to a Participant under paragraph 3.3(b), which would change the Financial Measures upon which Company Performance Targets must be based as set forth in subparagraph 1.10 of this Plan or which would modify the requirements for eligibility under subparagraph 1.5, unless the shareholders of the Company shall have approved such change in accordance with the requirements of Section 162(m).

### 6. Miscellaneous

6.1 **Effective Date** — January 1, 2004

6.2 **Term of the Plan** — Unless the Plan shall have been discontinued or terminated, the Plan shall terminate on December 31, 2007. No bonus shall be granted after the termination of the Plan; provided, however, that a payment with respect to a Performance Period which begins before such termination may be made thereafter. In addition, the authority of the Compensation Committee to amend the Plan shall extend beyond the termination of the Plan.

6.3 **Headings** — Headings are given to the Sections and subsections of the Plan solely as a convenience to facilitate reference. Such headings shall not be deemed in any way material or relevant to the construction or interpretation of the Plan or any provision thereof.

6.4 **Applicability to Successors** — The Plan shall be binding upon and inure to the benefit of the Company and each Participant, the successors and assigns of the Company, and the beneficiaries, personal representatives and heirs of each Participant. If the Company becomes a party to any merger, consolidation or reorganization, this Plan shall remain in full force and effect as an obligation of the Company or its successors in interest.

6.5 **Employment Rights and Other Benefit Programs** — The provisions of the Plan shall not give any Participant any right to be retained in the employment of the Company. In the absence of any specific agreement to the contrary, the Plan shall not affect any right of the Company, or of any affiliate of the Company, to terminate, with or without cause, the Participant's employment at any time. The Plan shall not replace any contract of employment, whether oral or written, between the Company and any Participant, but shall be considered a supplement thereto. The Plan is in addition to, and not in lieu of, any other employee benefit plan or program in which any Participant may be or become eligible to participate by reason of employment with the Company. Receipt of benefits hereunder shall have such effect on contributions to and benefits under such other plans or programs as the provisions of each such other plan or program may specify.

6.6 **No Trust or Fund Created** — The Plan shall not create or be construed to create a trust or separate fund of any kind or a fiduciary relationship between the Company or any affiliate and a Participant or any other person. To the extent that any person acquires a right to receive payments from the Company or any affiliate pursuant to the Plan, such right shall be no greater than the right of any unsecured general creditor of the Company or of any affiliate.

6.7 **Governing Law** — The validity, construction and effect of the Plan or any bonus payable under the Plan shall be determined in accordance with the laws of the State of Minnesota.

6.8 **Severability** — If any provision of the Plan is or becomes or is deemed to be invalid, illegal or unenforceable in any jurisdiction such provision shall be construed or deemed amended to conform to applicable laws, or if it cannot be so construed or deemed amended without, in the determination of the Compensation Committee, materially altering the purpose or intent of the Plan, such provision shall be stricken as to such jurisdiction, and the remainder of the Plan shall remain in full force and effect.

6.9 **Qualified Performance-Based Compensation** — All of the terms and conditions of the Plan shall be interpreted in such a fashion as to qualify all compensation paid hereunder as qualified performance-based compensation within the meaning of Section 162(m) of the Code.

SCHEDULE A

BASE SALARY FOR PERFORMANCE PERIOD  
BEGINNING ON \_\_\_\_\_ AND ENDING ON \_\_\_\_\_

| <u>Name</u> | <u>Base Salary</u>   |
|-------------|--|
|             |  |
|             | Actual paid salary for the calendar year that most closely coincides with Company fiscal year but not in excess of \$1,250,000 |

SCHEDULE B

TARGETED BONUS PERCENTAGE FOR PERFORMANCE PERIOD  
BEGINNING ON \_\_\_\_\_ AND ENDING ON \_\_\_\_\_

| <u>Name</u> | <u>Minimum Targeted Bonus Percentage<br/>as a Percentage of<br/>Base Salary</u> | <u>Maximum Targeted Bonus Percentage<br/>as a Percentage of<br/>Base Salary</u> |
|-------------|---|---|
|             |   |   |
|             |   |   |
|             |   |   |

SCHEDULE C

COMPANY PERFORMANCE TARGETS  
FOR PERFORMANCE PERIOD  
BEGINNING ON \_\_\_\_\_ AND ENDING ON \_\_\_\_\_

| <u>Financial Measure(s)</u> | <u>Company<br/>Performance<br/>Target(s)<br/>Weight</u> | <u>Minimum Company<br/>Performance Target(s)</u> | <u>Maximum Company<br/>Performance Target(s)</u> |
|-----------------------------|---|--|--|
|                             |   |  |  |
|                             | ____%   | \$ _____   | \$ _____   |
|                             | ____%   | \$ _____   | \$ _____   |
|                             |   |  |  |

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

**ELECTION/CHANGE IN ELECTION FORM**

|                   |  |
|-------------------|--|
| <b>SUBMIT TO:</b> | Secretary to the Board, Legal Department, Graco Inc., P.O. Box 1441, Mpls, MN. 55440-1441  |
| <b>NAME:</b>      | <div style="border-bottom: 1px solid black; height: 1.2em; width: 100%;"></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 in advance of the taxable year in which the services are to be performed. The election will remain in effect for and may not be change during the entire taxable year. In the event that a Change in Election Form is not received, the Initial Election will remain in effect for taxable years going forward. 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 his election 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. The previous payment election is irrevocable with respect to services performed in the current taxable year and taxable years prior thereto.**

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 die 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 die 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 agree to such Terms.

\_\_\_\_\_  
Date

\_\_\_\_\_  
Signature

**GRACO INC.  
NONEMPLOYEE DIRECTOR  
STOCK AND DEFERRED STOCK PROGRAM**

### TERMS

1. Purpose of the Stock and Deferred Stock Program. The purpose of the Graco Inc. Nonemployee Director Stock and Deferred Stock Program (the "Program") is to provide an opportunity for nonemployee members of the Board of Directors (the "Board") of Graco Inc. ("Graco" or the "Company") to increase their ownership of Graco Common Stock ("Common Stock") and thereby align their interest in the long-term success of the Company with that of the other shareholders. Each nonemployee director may elect to receive all or a portion of his or her retainer and/or any fees payable for attendance at Board or Committee meetings in the form of shares of Common Stock or defer the receipt of such shares until a later date pursuant to an election made under the Program.

2. Eligibility. Directors of the Company who are not also officers or other employees of the Company or its subsidiaries are eligible to participate in the Program ("Eligible Directors").

3. Administration. The Program will be administered by the Secretary of the Company (the "Administrator"). Since the issuance or crediting of shares of Common Stock pursuant to the Program is based on elections made by Eligible Directors, the Administrator's duties under the Program will be limited to matters of interpretation and administrative oversight. All questions of interpretation of the Program will be determined by the Administrator, and each determination, interpretation or other action that the Administrator makes or takes pursuant to the provisions of the Program will be conclusive and binding for all purposes and on all persons. The Administrator will not be liable for any action or determination made in good faith with respect to the Program.

4. Election to Receive Stock and Stock Issuance.

4.1. Election to Receive Stock/Credit in Lieu of Cash. On forms provided by the Company, each Eligible Director may irrevocably elect ("Stock Election") in lieu of cash, (i) to be issued shares of Common Stock or (ii) to have credited to an account ("Deferred Stock Account") the number of shares of Common Stock having a Fair Market Value, as defined in Section 4.3, equal to 25%, 50%, 75% or 100% of the annual cash retainer (the "Retainer") and/or 25%, 50%, 75% or 100% of any fees payable for attendance at Board or Committee meetings (the "Meeting Fees") payable to that director for services rendered as a director ("Participating Director"). Eligible Directors are customarily paid the Retainer and the Meeting Fees in quarterly installments in arrears at the end of each calendar quarter. Any Stock Election must be received by the Company before the commencement of the first full taxable year with respect to which such election is made. Any Stock Election may only be amended or revoked ("Amended Stock Election") in accordance with the procedure set forth in Section 4.4.

4.2. Issuance of Stock/Application of Credit in Lieu of Cash. If the Stock Election is for the issuance of shares of Common Stock, shares of Common Stock having a Fair Market Value equal to the amount of the Retainer and/or Meeting Fees so elected shall be issued to each Participating Director when each quarterly installment of the Retainer and the Meeting Fees is customarily paid. The Company shall not issue fractional shares, but in lieu thereof shall pay cash of equivalent value using the same Fair Market Value used to determine the number of Shares to be issued on the relevant issue date. If the Stock Election is for a credit to a Deferred Stock Account, the number of

shares of Common Stock (rounded to the nearest hundredth of a share) having a Fair Market Value equal to the amount of the Retainer and/or the Meeting Fees so elected shall be credited to the Participating Director's Deferred Stock Account when each quarterly installment of the Retainer and Meeting Fees is customarily paid. In the event that a Participating Director elects to receive less than 100% of each quarterly installment of the Retainer and/or Meeting Fees in shares of Common Stock, either issued or credited, he or she shall receive the balance of the quarterly installment in cash.

4.3. Fair Market Value. For purposes of converting dollar amounts into shares of Common Stock, the Fair Market Value of each share of Common Stock shall be equal to the closing price of one share of the Company's Common Stock on the New York Stock Exchange-Composite Transactions on the last business day of the calendar quarter for which such shares are issued or credited.

4.4. Change in Election. Each Participating Director may irrevocably elect in writing to change an earlier Stock Election, either to elect to be issued shares of Common Stock or to have credited to the Participating Director's Deferred Stock Account, a number of shares of Common Stock having a Fair Market Value equal to a percentage of the Participating Director's Retainer and/or Meeting Fees different from the percentages previously elected or to receive the entire Retainer and/or Meeting Fees in cash (an "Amended Stock Election"). An Amended Stock Election shall not become effective until the commencement of the first full taxable year after the date of receipt of such Amended Stock Election by the Company.

4.5. Termination of Service as a Director. If a Participating Director leaves the Board before the conclusion of any calendar quarter, he or she will be paid the quarterly installment of the Retainer and Meeting Fees entirely in cash, notwithstanding that a Stock Election or Amended Stock Election is on file with the Company. The date of termination of a Participating Director's service as a director of the Company will be deemed to be the date of termination recorded on the personnel or other records of the Company.

4.6. Dividend Credit. Each time a dividend is paid on the Common Stock, each Participating Director who has a Deferred Stock Account shall receive a credit to his or her Deferred Stock Account equal to that number of shares of Common Stock (rounded to the nearest one-hundredth of a share) having a Fair Market Value on the dividend payment date equal to the amount of the dividend payable on the number of shares of Common Stock credited to the Participating Director's Deferred Stock Account on the dividend record date.

5. Payment of Deferred Stock Account. Subject to the regulations and rulings issued under Section 409A of the Internal Revenue Code, as amended (the "IRC"), the following rules apply.

5.1. Payment Election. At the time of making the Stock Election in which the Participating Director elects to have a Deferred Stock Account credited in accordance with the provisions of Section 4.1, the Participating Director will also elect the manner and timing for payment of the amounts credited to his or her Deferred Stock Account ("Payment Election") from the alternatives described in Section 5.2. The Participating Director may change the manner and timing for payment of amounts to be credited to his or her Deferred Stock Account by executing another Payment Election; provided, however, that the previously made Payment Election will be irrevocable as to all amounts credited to the Participating Director's Deferred Stock Account prior to the effective date of the new Payment Election. A new Payment Election shall not become effective until the commencement of the first full taxable year after the date of receipt of such new Payment Election by the Company.

5.2. Payment from Deferred Stock Accounts. A Participating Director may elect to receive payment from his or her Deferred Stock Account in a lump sum or installments. Payments, whether in a lump sum or by installments, shall be made in shares of Common Stock plus cash in lieu of any fractional share. Unless the Participating Director elects to receive payment in installments, credits to a Participating Director's Deferred Stock Account shall be payable in full on January 10 of the year following the Participating Director's termination from service as defined in regulations and rulings issued under Section 409A of the IRC, the first business day after January 10, or such other date as elected by the Participating Director pursuant to Section 5.1. If the Participating Director elects to receive payment from his or her Deferred Stock Account in installments, each installment payment will be made annually on January 10 of each year, or the first business day after January 10, and the amount of each payment will be computed by multiplying the number of shares credited to the 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 shall be for the whole number of shares remaining credited to the Deferred Stock Account, plus cash in lieu of any fractional share.

## 6. Beneficiary.

6.1. Beneficiary Designation. A Participating Director may designate a beneficiary or beneficiaries who, upon his or her death, shall immediately receive the full distribution of all unpaid credits to said Participating Director's Deferred Stock Account, including distributions for which the Participating Director has elected installment payments. All designations shall be in writing and shall be effective only if and when delivered to the Company during the lifetime of the Participating Director. Unless otherwise indicated by the Participating Director, no amounts shall be paid to the estate or heirs of beneficiaries who die before the Participating Director.

6.1. Change of Beneficiary. A Participating Director may from time to time during his or her lifetime change his or her beneficiary or beneficiaries by a written instrument delivered to the Company. In the event a Participating Director shall not designate a beneficiary or beneficiaries pursuant to this Section, or if for any reason such designation shall be ineffective, in whole or in part, the distribution that otherwise would have been paid to such Participating Director shall be paid to his or her estate and in such event, the term "beneficiary" shall include his or her estate.

## 7. Limitation on Rights of Eligible and Participating Directors.

7.1. Service as a Director. Nothing in the Program will interfere with or limit in any way the right of the Company's Board or its shareholders to remove an Eligible or Participating Director from the Board. Neither the Program nor any action taken pursuant to it will constitute or be evidence of any agreement or understanding, express or implied, that the Company's Board or its shareholders have retained or will retain an Eligible or Participating Director for any period of time or at any particular rate of compensation.

7.2. Nonexclusivity of the Program. Nothing contained in the Program is intended to effect, modify or rescind any of the Company's existing compensation programs or programs or to create any limitations on the Board's power or authority to modify or adopt compensation arrangements as the Board may from time to time deem necessary or desirable.



8. Program Amendment, Modification and Termination. The Board may suspend or terminate the Program at any time. The Board may amend the Program from time to time in such respects as the Board may deem advisable in order that the Program will conform to any change in applicable laws or regulations or in any other respect that the Board may deem to be in the Company's best interests.

9. Participants are General Creditors of the Company. The Participating Directors and beneficiaries thereof shall be general, unsecured creditors of the Company with respect to any payments to be made pursuant to the Program and shall not have any preferred interest by way of trust, escrow, lien or otherwise in any specific assets of the Company. If the Company shall, in fact, elect to set aside monies or other assets to meet its obligations hereunder (there being no obligation to do so), whether in a grantor's trust or otherwise, the same shall, nevertheless, be regarded as part of the general assets of the Company subject to the claims of its general creditors, and neither any Participating Director nor any beneficiary thereof shall have a legal, beneficial or security interest therein.

10. Miscellaneous.

10.1. Securities Law and Other Restrictions. Notwithstanding any other provision of the Program or any Stock Election or Amended Stock Election delivered pursuant to the Program, the Company will not be required to issue any shares of Common Stock under the Program and a Participating Director may not sell, assign, transfer or otherwise dispose of shares of Common Stock issued pursuant to the Program, unless:

(a) there is in effect with respect to such shares a registration statement under the Securities Act of 1933, as amended (the "Securities Act") and any applicable state securities laws or an exemption from such registration under the Securities Act and applicable state securities laws, and

(b) there has been obtained any other consent, approval or permit from any other regulatory body that the Administrator, in his or her sole discretion, deems necessary or advisable. The Company may condition such issuance, sale or transfer upon the receipt of any representations or agreements from the parties involved, and the placement of any legends on certificates representing shares of Common Stock, as may be deemed necessary or advisable by the Company, in order to comply with such securities law or other restriction.

10.2. Adjustment to Shares. In the event of any reorganization, merger, consolidation, recapitalization, liquidation, reclassification, stock dividend, stock split, combination of shares, rights offering, divestiture or extraordinary dividend, an appropriate adjustment shall be made in the number and/or kind of securities available for issuance under the Plan to prevent the dilution or the enlargement of the rights of the Eligible and Participating Directors.

11. Governing Law. The validity, construction, interpretation, administration and effect of the Program and any rules, regulations and actions relating to the Program will be governed by and construed exclusively in accordance with the laws of the State of Minnesota, to the extent that federal laws and regulations do not apply.

Paul Revere  
Insurance Group[LOGO]

March 15, 1996

Graco Inc.  
ATTN: Karen Chapin  
P.O. Box 1441  
Minneapolis, MN 55440

Group Number: G-42326  
Effective Date: 04-01-1995

Dear Policyholder:

We are pleased to enclose your Group Insurance Policy.

Please sign and return the duplicate of this letter, thereby acknowledging receipt of the group insurance policy indicated above and accepting policy terms including any changes made to the master application. Any changes are reflected on the photocopy attached to the contract. A postage-paid, self-addressed envelope is enclosed for your convenience.

Thank you for letting us service your group insurance needs.

Sincerely,

/s/Arthur F. Newman  
Arthur F. Newman  
Vice President Group  
The Paul Revere Insurance Company

ATTACHMENT

**We hereby acknowledge receipt of the group insurance policy indicated above and accept policy terms.**

(Date)

(Policyholder)

(Signature)

(Title)

Paul Revere Insurance Group, 18 Chestnut Street, Worcester, MA 01608-1528, (508) 799-4441

G.O. # 806

Satellite # 719

THE PAUL REVERE LIFE INSURANCE COMPANY  
Worcester, Massachusetts 01608

Amendment No. PD8-1

Group Policy Number: G-42326

Policyholder: GRACO INC.

Effective Date of Revision: April 1, 1995

It is hereby understood and agreed upon that the above group policy or policies issued by the Paul Revere Life Insurance Company shall be amended as follows:

Said group policy with any of its amendments is deleted and the attached group policy is substituted therefore.

This amendment is hereby incorporated into and made a part of the said group policy or policies.

THE PAUL REVERE LIFE INSURANCE COMPANY  
January 23, 1996  
Date of Issue

/s/Secretary  
Secretary

/s/President  
President

*The Paul Revere Life*  
Insurance Company [LOGO]

Group Policy Number: 42326

Policyholder: GRACO INC.

Effective Date: March 1, 1993

State of Issue: Minnesota

Revision Date: April 1, 1995

**THE PAUL REVERE LIFE INSURANCE COMPANY** agrees to pay the Group Insurance Benefits set forth in this Policy. This Policy provides long term disability insurance benefits for the replacement of income loss due to Disability. Benefits are paid to or on behalf of all Employees of the policyholder who become insured according to the provisions of this Policy. This Policy is based upon yearly renewable term products. The duration of this Policy, subject to Termination and all other Policy provisions, is shown in the Duration Rider.

The premium for the benefits provided by this Policy shall be paid by the policyholder. All premiums are computed according to the provisions of this Policy. The first premium is due on the date this Policy begins. All other premiums due while this Policy is in force are to be paid in advance monthly on the premium due date.

The provisions on the following pages are part of this Policy.

Signed by the officers of The Paul Revere Life Insurance Company at Worcester, Massachusetts.

/s/Secretary  
Secretary

/s/President  
President

#### GROUP INSURANCE POLICY

#### NON-PARTICIPATING

#### POLICYHOLDER SUBSIDIARIES AND AFFILIATES APPROVED FOR COVERAGE

Application to add an affiliate or subsidiary must be made in writing on an approved application form. All agreements made between the policyholder and Us are binding on all Employers. The list of approved affiliates and/or subsidiaries is shown below.

The policyholder acts for and on behalf of all accepted Employers. All agreements made between the policyholder and Us are binding on all Employers. No other Employer may discontinue, modify, reduce or terminate this Policy.

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| <b>DURATION AND RATE RIDER</b>  | <b>RIDER</b> |
| Duration of the Policy/Rate Guarantee   |              |

SCHEDULE OF BENEFITS

Classification of Eligible Employees:

Class 1 – Corporate Officers and Executive Officers earning a minimum base salary of \$105,000; Sales Directors whose base salary and on-plan bonus together total \$105,000 or more; and, other Managing Directors earning a minimum base salary of \$105,000.

Amount of Disability Income Benefit:

33.33% of the first \$12,000.00 of Monthly Earnings and

67% of the remaining Monthly Earnings:

Maximum Benefit: \$17,500.00 per month.  
Minimum Benefit - 15% of basic monthly earnings, up to a maximum of \$100.00

Non-Evidence Limit: \$16,000.00 Maximum Monthly Benefit

Maximum Benefit Period:

| <u>Insured's Age When Disability Begins</u> | <u>Maximum Benefit Period</u> |
|---|-------------------------------|
| Less than Age 60                            | To Age 65                     |
| Age 60                                      | 5 Years                       |
| Age 61                                      | 4 Years                       |
| Age 62                                      | 42 Months                     |
| Age 63                                      | 36 Months                     |
| Age 64                                      | 30 Months                     |
| Age 65                                      | 24 Months                     |
| Age 66                                      | 21 Months                     |
| Age 67                                      | 18 Months                     |
| Age 68                                      | 15 Months                     |
| Age 69 and over                             | 12 Months                     |

Elimination Period: 180 Days

GENERAL PROVISIONS

DEFINITIONS

Here are some of the terms used in this Policy. Other terms are defined where used in this Policy. All defined terms are important in describing rights under this Policy. Please refer back to these meanings as you read. Defined terms are presented with capital letters to help identify them as such. Masculine pronouns used in this Policy apply to both sexes.

**ACTIVELY AT WORK** or **ACTIVE WORK** means that an Employee

1. is present at the Employer's place of business or a work site other than the Employee's home, as designated by the Employer, and

2. is performing the duties of his job; and
3. is producing the work product required by his job.

**DISABLED OR DISABILITY** — these terms mean either Total Disability or Residual Disability. The definitions of these terms are presented in the Long Term Disability Benefit (Section 2). One or more may apply to the Employee.

**DOCTOR** means a person, other than the insured, who is licensed to practice the healing arts and who is practicing within the scope of his license. The term covers only a licensed medical practitioner whose services are required to be covered by the law of the jurisdiction where the treatment is rendered. See the **CLAIMS** section for the provision on **CHOICE OF DOCTOR**.

**DOCTOR'S CARE** means the regular and personal care of a Doctor that, under prevailing medical standards, is appropriate for the condition causing the Disability.

**EARNINGS (SALES DIRECTORS)** means, for purposes of determining an Employee's total disability benefit, the Employee's basic annual, monthly or weekly pay based on a work week of not more than 40 hours, prior to becoming disabled and as last reported to Us in writing by the Employer and verified by Us. It includes earnings from Incentive Bonuses, but not overtime or other special pay. Incentive Bonuses are averaged for the lesser of the 24 month period immediately prior to the date disability begins or the period of employment. Earnings from sources other than the Employer are not included in determining total disability benefits.

**EARNINGS (ALL OTHER EMPLOYEES)** means, for purposes of determining an Employee's total disability benefit, the Employee's basic annual, monthly or weekly pay based on a work week of not more than 40 hours, prior to becoming disabled and as last reported to Us in writing by the Employer and verified by Us. Commissions, bonuses, overtime or other special pay is not included. Earnings from sources other than the Employer are not included in determining total disability benefits.

**EMPLOYEE** means any person who works Full-time for the Employer. An Employee must be paid by the Employer for work done at the Employer's usual place of business or some other location that is usual for the Employee's particular duties.

For the purposes of this long term disability benefit, the term Employee does not include any person performing services for the Employer

- pursuant to a contractual relationship with the Employer;
- subject to the terms of a leasing agreement between the Employer and a leasing organization; or
- who receives income which is reported by the Employer on IRS Form 1099.

**EMPLOYER** means the policyholder or a branch or a division of the policyholder, and any company legally affiliated with or subsidiary to the policyholder that has been approved by Us.

A **subsidiary** is an entity with controlling stock ownership (51% or more) held by the Employer who is the policyholder.

An **affiliate** is a company whose business is controlled by the policyholder through stock ownership, contract, common officers or otherwise.

**EVIDENCE OF INSURABILITY** means written proof given to Us that an Employee is insurable. This proof must be based on medical and financial information and must be acceptable to Us.

**FULL-TIME** means, for an Employee, his Employer's normal work week of at least 30 hours. For Employees whose work weeks vary above and below this number, We will determine eligibility by averaging the hours worked during weeks in the month.

**IMPORTANT DUTIES** means, with respect to an Employee's occupation, the material and substantial duties of that occupation.

**INCURRED DATE OF DISABILITY** means the first date the Employee satisfies the required definition of Disability. This date is determined by Us.

**INJURY** means accidental bodily loss or harm incurred while insured under this Policy.

**MONTHLY EARNINGS** means the Employee's annualized Earnings divided by twelve (12).

**NON-EVIDENCE LIMIT** means the greatest amount of insurance an Employee may have without providing Evidence of Insurability.

1. The Employee may be eligible for more than this amount initially; or
2. the amount of existing insurance may be increased to an amount in excess of any Non-Evidence Limit; or
3. the amount of insurance currently in excess of the Non-Evidence Limit may be further increased.

In any of these situations, the Employee must send Us Evidence of Insurability. If We do not approve the Evidence of Insurability, the Employee's insurance is limited, but in no event will the Employee's insurance be less than the lowest amount shown in the Non-Evidence Limit provision of the Schedule of Benefits.

**PERIOD OF DISABILITY** means a continuous period of time during which an Employee is Disabled as the result of Injury or Sickness whether from one or more causes.

**PRIOR PLAN** means the Employer's group long term disability insurance program in effect the day before the effective date of this Policy. This Policy replaces that plan or a portion of it.

**RETIREMENT PLAN** means, for the purpose of determining benefit reductions, a plan that provides retirement benefits to employees. It also includes any retirement plan for which the insured is eligible as a result of his job with the Employer, including any plan that is part of any federal, state, county, municipal or association retirement system.

The term does not include:

1. Profit Sharing Plans as defined in 401(a);
2. Thrift plans (e.g., 401(k)s);
3. Individual Retirement Accounts (IRAs);
4. Tax Sheltered Annuities (TSAs); or
5. Stock Ownership Plans as defined in Internal Revenue Code section 4975.

When used in this Policy, the term "Retirement Benefits" means the following benefits payable from a Retirement Plan:

1. retirement benefits payable from the Employer's Retirement Plan upon early or normal retirement; or
2. disability benefits payable from the Employer's Retirement Plan.

**SICKNESS** means an illness or disease. It also includes pregnancy.

**WE, US or OUR** means The Paul Revere Life Insurance Company.

## **GENERAL PROVISIONS**

### **BECOMING ELIGIBLE FOR EMPLOYEE INSURANCE**

An Employee is eligible for insurance if he is a member of an eligible class listed in the Schedule of Benefits and is not excluded in the list shown below. No Employee is eligible

1. who is scheduled to work less than six months in any twelve month period; or
2. who works less than the required number of hours as defined in the definition of "Full-time;" or
3. who is employed as an airline pilot, co-pilot or crew member unless specifically mentioned in the Classification of Eligible Employees found on the Schedule of Benefits.

An Employee who is not a citizen of the United States must be a permanent resident of the United States, Canada or Puerto Rico in order to be an eligible Employee. An Employee who is not a citizen is considered not eligible for insurance if he leaves the United States, Canada or Puerto Rico for 180 or more consecutive days.

### **SERVICE WAITING PERIOD**

The service waiting period is a period of active Full-time employment the Employee must complete before becoming eligible for insurance.

An Employee is eligible for insurance on the later of the Effective Date of this Policy or the date the Employee begins work for the Employer on an active Full-time basis.

### **CHANGING CLASSES**

An Employee becomes eligible for insurance when he transfers from an ineligible class to an eligible class. For the purposes of this provision, he is considered to be a new Employee at that time. We use all past periods of Full-time work for the Employer to determine the Employee's eligibility date. Any period of part-time work does not count. An Employee cannot become eligible for insurance before moving into an eligible class.

### **RE-HIRED EMPLOYEES**

A re-hired Employee is treated as a new Employee and must satisfy a new service waiting period. However, if an Employee is re-hired within one year from the date of ineligibility for insurance, We use all past periods of Full-time work for the Employer to determine the date the Employee satisfies the waiting period. If an Employee is re-hired after one year, any past periods of work will not count when We determine the date the Employee satisfies the waiting period. An Employee cannot become eligible for insurance before the last date re-hired.

### **REINSTATEMENT**

If an Employee requests Us to reinstate insurance that terminated while he was still eligible to be insured by this Policy, We must first approve Evidence of Insurability. Evidence must be given at the Employee's expense. The Employee's insurance does not begin until the date We specify after approving the evidence.

### **EFFECTIVE DATE OF EMPLOYEE INSURANCE**

The Employee must be Actively At Work on the date his insurance goes into effect. If the effective date occurs on a vacation, holiday or weekend, the Employee must have been Actively At Work on the last scheduled working day. If an Employee is absent from work for any other reason, including absence due to Injury, Sickness or leave of absence, insurance does not become effective until return to Full-time work.

**NON-CONTRIBUTORY INSURANCE** means that the Employer pays all of the cost of the insurance. All eligible Employees must be enrolled unless they were eligible for insurance but not covered under the Prior Plan. Insurance will become effective on the date the Employee is eligible for insurance and Actively At Work.

If the amount of insurance exceeds the Non-Evidence Limit, the amount of an Employee's insurance in excess of the Non-Evidence Limit will become effective when:

1. the Employee becomes eligible for insurance; and
2. We approve the Employee's Evidence of Insurability. Evidence for amounts over the Non-Evidence Limit is submitted at Our expense.

### **OTHER PROVISIONS**

Application to add an affiliate or subsidiary must be made in writing. All agreements made between the Policyholder and Us are binding on all Employers. The list of approved affiliates and/or subsidiaries is shown on the policy page before the Table of Contents.

If an Employer is a partnership or a sole proprietorship, a partner or proprietor must also qualify as an Employee to be eligible for insurance. Earnings definitions for owners of such entities will be applied.

### **CHANGE IN AMOUNTS OF INSURANCE FOR INDIVIDUAL EMPLOYEES**

The amount of insurance for which an Employee is eligible is shown in the Schedule of Benefits. The benefits offered and the amounts of those benefits may vary by class.

Benefits may increase or decrease due to a change in class or Earnings. The Employer must notify Us in writing of any change in class or Earnings. This notification must be received before the Employee ceases active, Full-time employment.

Any change in an Employee's amount of insurance becomes effective on the date the Employee is eligible for the change.

Any amount of the change that exceeds the Non-Evidence Limit will become effective on the later of the date We approve the Employee's Evidence of Insurability or the date the Employee becomes eligible for the increase.

The Employee must be Actively At Work on the date a change in the amount of insurance becomes effective. If the effective date of the change occurs on a vacation, holiday or weekend, the Employee must have been Actively At Work on the last scheduled working day. If an Employee is absent from work for any other reason, including absence due to Injury, Sickness or leave of absence, a change does not become effective until return to Full-time work.

## **POLICYHOLDER REQUESTS FOR PLAN CHANGES**

Any revisions to:

1. change benefits;
2. add affiliated or subsidiary employers;
3. change contribution basis; or
4. make other plan changes

must be requested in writing by the Policyholder and will not be effective before the later of:

1. the applicant's signature date; or
2. the date The Paul Revere approves the change(s).

If this Policy is revised to increase or decrease benefits after its effective date, an eligible Employee becomes insured for the revised benefits on the effective date of the revision, subject to the Actively At Work requirement and to the applicable pre-existing condition limitation.

## **TERMINATION OF EMPLOYEE INSURANCE**

An Employee's insurance terminates on the earliest of:

1. the date this Policy terminates;
2. the first day for which the Employee fails or refuses to make any required premium payment;
3. the first day for which premium on behalf of the Employee is not made;
4. the date the Employee no longer works in an eligible class; or
5. the date the Employee no longer works for the Employer.

Termination of insurance will not affect any claim incurred before the date of termination.

## **LEAVE OF ABSENCE**

Coverage may be continued when an Employee is on an unpaid leave under the Federal Family and Medical Leave Act (FMLA) for any of the following reasons:

1. to provide care after the birth or adoption of a son or daughter; or
2. to provide care after the placement of a foster child; or
3. to provide care to a spouse, son, daughter, or parent due to serious illness.

Upon approval by the Employer of an Employee's leave of absence for the above reasons, coverage will be continued, subject to premium payments, for up to three (3) months from the date the leave of absence began or, if sooner, until Employee termination. If an Employee becomes Disabled while on leave, benefits will be based upon Earnings as last reported to Us immediately prior to the beginning of the leave.

## **RECURRENT DISABILITY — SAME INJURY OR SICKNESS**

If, after the end of a Disability, the Employee becomes Disabled from the same or related causes, We will deem it a separate Disability subject to a new Elimination Period and a new Maximum Benefit Period. However, if such recurrence occurs within 6 months of the end of the prior period, We will deem it a continuation of the prior Disability. However, no benefit is payable for any day the Employee is not Disabled, and no benefit period is extended by time not Disabled. The gross amount payable prior to any adjustments as outlined in this Policy would be the amount determined at the original date of Disability. A recurrent Disability ends on the first to occur of the following dates:

1. the last day of 6 consecutive months during which the Employee was not Disabled by the same Sickness or Injury.
2. the first day the Employee ceases to be disabled by the same Injury or Sickness, even if immediately disabled by a different Injury or Sickness.
3. the date the last benefit for the Injury or Sickness becomes due.

The recurrent Disability provision applies only to Disabilities that began under this Policy. If the Employee becomes eligible for coverage under any other group long term disability policy, this recurrent disability section will cease to apply to him.

## **CONCURRENT DISABILITY**

If a Disability is caused by more than one Injury or Sickness, or from both, We will pay benefits as if the Disability were caused by only one Injury or Sickness. We will not pay more than one Disability benefit for the same period. We will pay the larger benefit.

## **LONG TERM DISABILITY INCOME BENEFIT**

## WHAT WE PAY

We pay monthly disability benefits to an Employee who satisfies the following definitions. The maximum amount We pay is shown in the Schedule of Benefits. Benefit payments may be reduced if the Employee receives income from other sources. When and how this occurs is described in the provision entitled Benefit Reductions.

### Own Occupation Benefit with Residual Disability

**TOTAL DISABILITY** or **TOTALLY DISABLED FROM THE EMPLOYEE'S OWN OCCUPATION** means that until he reaches the end of his Maximum Benefit Period, the Employee:

1. is unable to perform the important duties of his own occupation on a Full-time or part-time basis because of an Injury or Sickness that started while insured under this Policy; and
2. does not work at all; and
3. is under Doctor's Care.

If the Employee is employed and is earning wages or a salary, he will be considered Residually Disabled as defined below.

**RESIDUAL DISABILITY** or **RESIDUALLY DISABLED** means, as a result of Injury or Sickness, the Employee is unable to perform the important duties of his own occupation on a Full-time basis, but:

1. he is able to perform one or more of the important duties of his own occupation, or any other occupation, on a Full-time or part-time basis; and
2. he is earning less than 80% of his Prior Earnings.

To qualify for the Own Occupation Benefit with Residual Disability, the Employee:

1. must satisfy the Elimination Period with the required number of days of Total and/or Residual Disability as defined in this Policy; and
2. must be receiving Doctor's Care. We will waive the Doctor's Care requirement if We receive written proof acceptable to Us that further Doctor's Care would be of no benefit to the Employee.

### **SPECIAL PROVISIONS RELATING TO DISABILITY**

The loss of a professional or occupational license for any reason does not, in itself, constitute Disability.

An Employee's Disability is determined relative to his ability or inability to work. It is not determined by the availability of a suitable position with his Employer.

### **WHEN WE PAY BENEFITS**

Benefits begin to accrue on the first day after the Employee completes the Elimination Period shown in the Schedule of Benefits. Benefits are paid monthly while the Employee is Disabled.

### **PARTIAL MONTH PAYMENT**

For any day a Disability benefit is payable in a period of less than a whole month, We pay one thirtieth of the applicable monthly benefit.

### **RECOVERY OF OVERPAYMENTS**

If the monthly benefit for any month is overpaid, We have the right to recover the amount overpaid. We may deduct the amount overpaid from any future payments.

### **REHABILITATION BENEFIT**

We will pay for the cost of services incurred in connection with a program of vocational rehabilitation if:

1. We enter into a written agreement with the Employee on both the program and the services; and
2. the cost of the services is not covered by another plan or program.

Participating in such a program will not affect the Employee's eligibility for benefits under this Policy.

### **PERIOD OF TIME BEFORE BENEFITS BEGIN TO ACCRUE**

Before benefits begin to accrue, the Employee must be Totally or Residually Disabled for a certain number of days.

**ELIMINATION PERIOD** means the length of time that the Employee must be Totally or Residually Disabled before benefits begin. The length of the Employee's Elimination Period is shown in the Schedule of Benefits. The Employee must satisfy the Elimination Period before the Accumulation Period ends.

**ACCUMULATION PERIOD** means the period of time from the Incurred Date of Disability during which the Employee must satisfy the Elimination Period. The Elimination Period is shown on the Schedule of Benefits. The Accumulation Period is equal to two times the Elimination Period. If the Employee does not satisfy the Elimination Period within the Accumulation Period, or if the Employee returns to work for 180 consecutive days, a new Period of Disability begins.

For purposes of the Elimination Period provision, **INCURRED DATE OF DISABILITY** means the first date the Employee satisfies the definition of Total or Residual Disability. This date is determined by Us.

### **BENEFIT CALCULATION FOR TOTAL DISABILITY**



The amount of an Employee's Total Disability benefit is the least of:

1. the Employee's Monthly Earnings multiplied by the benefit percent less all other income benefits as shown in the provision entitled **Benefit Reductions**; or
2. the maximum monthly benefit, or
3. the Non-Evidence Limit, if Evidence of Insurability has not been approved by Us for a higher maximum.

The benefit percent, the maximum monthly benefit and the Non-Evidence Limit are shown on the Schedule of Benefits.

#### MAXIMUM BENEFIT PERIOD FOR TOTAL DISABILITY

The maximum benefit period is shown in the Schedule of Benefits. It is the maximum length of time for which We pay benefits. It applies to all Periods of Disability whether from one or more causes. In no case do We pay benefits after the earliest of:

1. the date the Employee is no longer Totally Disabled; or
2. the end of the Maximum Benefit Period shown in the Schedule of Benefits; or
3. the date the Employee dies; or
4. the date benefits would cease according to any exclusion or limitation contained in this Policy; or
5. the date benefits equaling or exceeding the long term disability benefit become payable to the Employee under the Employer's Retirement Plan.

If the maximum benefit period is limited to a certain number of years or months rather than age, the full benefit period may be restored after the Employee has worked Full-time for six consecutive months.

#### RETURN TO WORK ADJUSTMENT BENEFIT FOR RESIDUAL DISABILITY

When an Employee returns to work from any continuous Period of Disability immediately following completion of the Employee's Elimination Period but before the end of the benefit period, We pay the Employee a monthly benefit for each whole month following return to work.

#### WHAT WE PAY

During the first 24 months that an Employee returns to work for any employer during any continuous Period of Disability and while continuing to meet the applicable definitions pertaining to Residual Disability:

1. We will not apply the requirement that the Employee's Loss of Earnings must exceed 20% for Residual Disability benefits; and
2. in lieu of the Disability benefit, We will pay a special Return to Work Adjustment Benefit.

The amount of the Return to Work Adjustment Benefit will be the amount of the Total Disability benefit otherwise payable after reduction for other income sources. The Return to Work Adjustment Benefit will be further reduced to the extent that the sum of the benefit plus the Employee's earnings from any employer plus other income sources (as defined in the **Benefit Reduction** section) would exceed 100% of the Employee's Prior Earnings.

#### INDEXATION OF PRIOR EARNINGS

After 12 monthly Disability benefits have been paid, the amount of Prior Earnings used to calculate the Employee's Return to Work Adjustment Benefit will be increased by 7%. The initial Prior Earnings amount will be increased on each anniversary of the Employee's completing the Elimination Period.

#### MAXIMUM BENEFIT PERIOD

The Return to Work Adjustment Benefits are not paid beyond the first to occur of:

1. the date the 24th monthly Return to Work Adjustment Benefit is paid during any continuous Period of Disability; or
2. the date the Employee is no longer Residually Disabled; or
3. the end of the Maximum Benefit Period shown in the Schedule of Benefits; or
4. the date the Employee dies; or
5. the date benefits would cease according to any exclusion or limitation contained in this Policy; or
6. the date benefits become payable under any other employer's group long term disability insurance plan; or
7. the date benefits equaling or exceeding the long term disability benefit become payable to the Employee under the Employer's Retirement Plan.

#### BENEFIT CALCULATION FOR RESIDUAL DISABILITY

#### DEFINITIONS

The following are terms used within the Residual Disability Benefit and the Return to Work Adjustment Benefit.

**INITIAL TOTAL DISABILITY BENEFIT** means the benefit that would have been payable immediately following the completion of the Elimination Period after integration with Social Security and/or other income sources.

**LOSS OF EARNINGS** means the Employee's Prior Earnings minus the Employee's Actual Monthly Residual Earnings for the month the benefit is due. The difference must be due to the Injury or Sickness causing the Residual Disability.

**ACTUAL MONTHLY RESIDUAL EARNINGS** means the Employee's salary, wages, commissions, bonuses, fees, and income earned for services performed. If the Employee owns any portion of a business or profession, it means the following:

Sole Proprietor earnings means the net profit of the business for federal income tax purposes. Net profit is defined as gross business revenues less deductible operating expenses.

Partner earnings means the partner's proportionate share of the partnership net profit as reported for federal income tax purposes. The partnership's net profit is defined as gross partnership revenues less deductible operating expenses.

Employee/Shareholder earnings means the total gross salary, pension/profit sharing plan contributions made on behalf of the individual, and the proportionate share of the current year corporate net profit.

**PRIOR EARNINGS** means the greater of:

1. the Employee's average monthly earnings from all employment for the 12 whole calendar months immediately preceding his last regular day of active Full-time work; or
2. the Employee's highest average monthly earnings from all employment for any period of 2 successive years during the 5 year period immediately preceding his last regular day of active Full-time work.

In any continuous Period of Disability, immediately following completion of the Employee's Elimination Period but before the end of the benefit period, We pay the Employee a monthly Residual Disability benefit for each whole month while the Employee is Residually Disabled, as defined.

During the first 24 months, We will pay a monthly benefit according to the **Return to Work Adjustment Benefit** provisions. After the first 24 months of Residual Disability and for the remainder of any continuous Period of Disability, the Employee's Residual Disability benefit is proportionate to his Total Disability benefit. The proportion depends on the actual amount of earnings the Employee earns from work. To determine the monthly Residual Disability benefit, We use the following formula:

|                         |   |                    |   |                         |
|-------------------------|---|--------------------|---|-------------------------|
| <u>Loss of Earnings</u> |   | The Initial Total  |   | The Employee's Residual |
| Prior Earnings          | X | Disability Benefit | = | Disability Benefit      |

If the Loss of Earnings for any month is 80% or more of Prior Earnings, We will pay the Total Disability benefit. However, if the Loss of Earnings is less than 20% of Prior Earnings, then no Residual Disability benefit is payable.

## INDEXATION OF PRIOR EARNINGS

After 12 monthly Disability benefits have been paid, the amount of Prior Earnings used to calculate the Employee's Residual Disability benefit will be increased by 7%. The initial Prior Earnings amount will be increased on each anniversary of the Employee's completing the Elimination Period.

## MAXIMUM BENEFIT PERIOD FOR RESIDUAL DISABILITY

Residual Disability benefits are not paid beyond the first to occur of the following:

1. The date the Employee is no longer Residually Disabled; or
2. The end of the Maximum Benefit Period shown in the Schedule of Benefits; or
3. The date the Employee dies; or
4. The date benefits become payable under any employer's long term disability insurance plan; or
5. The date the Employee is earning more than 80% of his indexed Prior Earnings; or
6. The date benefits would cease according to any exclusion or limitation contained in this Policy; or
7. The date benefits equaling or exceeding the long term disability benefit become payable to the Employee under the Employer's Retirement Plan.

## FAMILY SURVIVOR INCOME BENEFIT

### WHAT WE PAY

We pay a Family Survivor Income Benefit when We receive proof that all the following conditions have been satisfied:

1. the Employee becomes Totally Disabled while insured for this benefit;
2. Disability benefits have been payable to the Employee; and
3. the Employee dies while Disabled and while in the maximum benefit period.

### WHOM WE PAY

Benefits are payable to the Employee's lawful spouse, if living and mentally competent. If the spouse is not living at the time benefits are payable, they are paid in equal shares to each Child. If the spouse is not mentally competent, We will pay according to applicable state law.

We decide to whom payments are made. After We make payment, We have no further liability.

**CHILD** means the Employee's natural born, step-child, adopted Child, and any Child for whom the Employee is the legal guardian. Each Child must be unmarried and under the age of twenty-one in order to be eligible to receive this benefit. Unmarried children under the age of twenty-five are also eligible if they are enrolled in a school as full-time students. Students who, by reason of illness, injury, or physical or mental disability as documented by a Doctor, are unable to carry a full-time course load will be covered, provided that the course load is at least 60% of what is considered to be full-time.

### HOW WE PAY

We pay a single lump sum benefit equal to three times the Disability benefit payable to the Employee, after benefit reduction, for the last full calendar month before the Employee's death. If the Employee dies before a full calendar month's benefit has been paid, the survivor benefit will be based on the Disability benefit that would have been paid at the end of the first month after satisfying the Elimination Period.

### ASSIGNMENT

This benefit may not be assigned, attached or applied to the debts of the survivor unless required by law.

## ADJUSTABLE COST OF LIVING BENEFIT

If we pay the employee total or residual disability benefits for 12 months in any continuous period of disability, and if further benefits are payable in the continuous period of disability for months after the 12th month, we will increase further these total or residual disability benefits by a cost of living factor annually to the end of the Maximum Benefit Period in which benefits are payable under this Adjustable Cost of Living Benefit. We First Calculated the employee's adjusted monthly benefit, considering all benefits from other sources, other income and any benefit adjustments other than prior cost of living adjustments. We then increase the employee's adjusted monthly total or residual disability benefit payment by the applicable cost of living factor according to the CPI on each Review Date as follows:

LET:

A = the CPI for the most recent Index Month;

B = the CPI for the First Index Month;

THEN:

$$\frac{A - B}{B} = \text{Cost of Living Factor}$$

The cost of living adjustment factor used to determine the Adjusted Monthly Benefit payment will be a minimum of four percent, and a maximum of ten percent.

**CPI** means the Consumer Price Index for All Urban Consumers. It is published by the United States Department of Labor. If this index is discontinued or if the method for computing it is materially changed, We may choose another index. We will choose an index which in our opinion most accurately reflects the rate of change in the cost of living in the United States. CPI would then mean the index we choose.

**INDEX MONTH** means the calendar month four months prior to the calendar month in which a Review Date occurs. However, the first Index Month will be the calendar month four months prior to the month in which Disability payments began.

**REVIEW DATE** means the date that occurs after each twelve month Period of Disability in which benefits are payable.

### CONVERSION PRIVILEGE

An insured Employee whose insurance terminates because employment with the Employer terminates may be eligible to convert all or some of his Group Long Term Disability Insurance. To be eligible for conversion, the Employee:

1. must have been insured for Long Term Disability (LTD) benefits under the plan for at least 12 consecutive months; and
2. must submit a completed conversion application and the first premium to The Paul Revere within 31 days of the date his employment terminates.

The Employee will not be eligible for conversion if:

1. employment terminates coincident with termination of this Policy; or
2. the Employee is eligible to receive Total or Residual Disability benefits under this Policy; or
3. the Employee is in an Elimination Period for Total or Residual Disability benefits under this Policy; or
4. the Employee is not receiving benefits but is in a Period of Disability; or
5. the Employee is no longer in a class of Employees eligible for conversion; or
6. the Employee becomes insured for other group long term disability benefits within 31 days of the date of termination; or
7. the Employee retires or ceases to be actively employed; or
8. the coverage would, in our opinion, result in over insurance.

If the Employee is eligible for conversion and applies and pays the first premium within 31 days of the date his employment terminates, We will issue him a certificate of insurance. The certificate:

1. will be effective on the day after the day his Group LTD Insurance would otherwise terminate; and
2. will be on one of the standard certificate forms then being offered by The Paul Revere for the class of risk to which the Employee will belong after his employment with the Employer terminates.

The certificate will be issued without medical Evidence of Insurability.

The premium will be determined by:

1. the certificate form issued;
2. the amount of insurance;
3. the class of risk to which the Employee will belong after his current employment terminates; and
4. the Employee's age.

### BENEFIT REDUCTIONS

While an Employee is Disabled, he may be eligible for benefits from other sources. If so, We reduce our benefit by the amount of such other benefits paid or payable.

Listed below are other income sources that will reduce our benefit.

1. Social Security benefits, including: Primary Social Security and Family Social Security benefits received by an Employee or an Employee's dependents because of the Employee's Disability or retirement. If an Employee fails to apply for Social Security benefits, We determine the amount he was eligible to receive, and, for the purposes of this insurance, he will be considered to receive that amount.

Any general cost of living adjustment received from the Federal Social Security Act, the Railroad Retirement Act, any Veteran's Disability Compensation and Survivor Benefits Act, Workers Compensation or any similar federal or state law which takes effect after long term disability benefits become payable to an Employee is not used to reduce the Employee's benefit.

2. Other disability benefits from:
  - a. Statutory Disability ("Cash Sickness") Plans, where applicable;
  - b. Canadian Federal or Provincial Disability Benefits;
  - c. Railroad Retirement Act Disability Benefits;

- d. Disability benefits with which We are required by law to integrate.
3. Workers' Compensation benefits;
4. That portion of any sick pay or other salary continuation (other than vacation pay) paid to the Employee by the Employer which, when added to the amount of the Employee's benefit, exceeds 100% of the Employee's Earnings as reported prior to Disability and as verified by Us;
5. Total, residual, or partial disability benefits from another group disability plan provided by the Employer;
6. Group disability benefits from the following plans, but only if the plan is Employer-sponsored:
  - a. Association Plans;
  - b. Fraternal Benefit Plans; or
  - c. Union Plans.

Employer-sponsored means a plan that is endorsed, promoted, or facilitated by the Employer. For example, if the Employer made payroll deductions for the plan, or permitted solicitation or enrollment of the plan on company premises and/or company time, We would consider the plan to be Employer-sponsored, even if the Employee pays the entire premium.
7. No fault disability benefits; or
8. Loss of Time awards or settlements involving liability insurance or court actions; or
9. Disability benefits which are part of the Employer's Retirement Plan.
10. Retirement benefits attributable to Employer contributions. For benefits that are paid or payable under an Employer's Retirement Plan, We will end benefits under this Policy if retirement benefits are equal to or greater than our long term disability benefit.

If the Employee's retirement benefit is a lump sum instead of a monthly benefit, We will use the monthly benefit calculated for a lifetime annuity of that lump sum amount. If the Plan requires the Employee to take the lump sum distribution instead of leaving it in the Retirement Plan and he elects to roll the sum into a Qualified vehicle such as an IRA, We will defer the integration until monthly benefits can be received by the Employee without tax penalties.

If any of these benefits, except a retirement benefit, is paid in other than a monthly sum, We divide the amount paid into equal monthly amounts in order to reduce the monthly benefit. The number of monthly amounts depends on the length of time the benefit award covers. If no length of time is stated in the benefit award, We divide the amount paid into sixty equal payments. If any of these benefits is paid on a retroactive basis, We may adjust our monthly payments in order to offset any overpayment which results.

Listed below are other income sources that will **not** reduce our benefit.

1. Individual disability insurance;
2. General Cost of Living increases from federal or state disability or retirement programs that become effective after benefits become payable to the Employee;
3. Non-Qualified Deferred Compensation plans;
4. Whether individually purchased or provided or sponsored by the Employer, savings and investment accounts such as:
  - a. Individual Retirement Accounts (IRAs);
  - b. Internal Revenue Code Section 4975 Employee Stock Option Plans;
  - c. Thrift Plans (401k);
  - d. 401(a) Profit Sharing Plans; or
  - e. Tax Sheltered Annuities.
5. Disability benefits from the following plans (including Franchise Plans), purchased as individual coverage:
  - a. Association Plans;
  - b. Fraternal Benefit Plans; or
  - c. Union Plans.
6. Government or military pensions; or
7. Disabled veterans' benefits; or
8. Retirement benefits attributable to the Employee's contributions.

## ESTIMATED SOCIAL SECURITY BENEFITS

For the purpose of this section, the term Social Security benefits means unreduced disability or retirement benefits that the Employee, his spouse or any of his dependents are entitled to receive because of his disability under:

1. the United States Social Security Act;
2. the Canada Pension Plan;
3. the Quebec Pension Plan; or
4. any similar law, plan or act.

As part of an Employee's proof of loss, We require that the Employee furnish Us evidence that he has duly applied for all other income sources for which he is or may become eligible. In the case of Social Security benefits, this includes:

1. making due application for such benefits; and
2. if the Employee's initial application is denied, and if We so recommend, making any and all available appeals.

Until the Employee has given Us written proof that all available appeals have been exhausted, We may:

1. estimate the Employee's monthly Social Security benefit; and
2. reduce our monthly benefit to the Employee by that amount.

If We reduce the Employee's benefits on this basis, and if all of his appeals are denied, We restore the reduced amounts to the Employee in one payment.

If the Employee signs our Social Security Reimbursement Agreement, We agree not to reduce his benefits by estimated Social Security benefits while the Employee's appeals are pending. In the Social Security Reimbursement Agreement, the Employee promises to pay Us back for any overpayment of his long term disability claim that results from a retroactive award of Social Security benefits. If the Employee does not pay Us back, We have the right to recover our overpayment from any future benefits that may be due him.

With proper authorization from the Employee and his Doctor, We will give the Employee or his legal representative information from our claim file to assist in any appeal of denied Social Security benefits.

## **WORKERS' COMPENSATION BENEFITS**

If an Employee is disabled due to an employment-related Injury, he should file for workers' compensation benefits. Receipt of workers' compensation benefits will reduce Disability benefits under this Policy.

As part of an Employee's proof of loss, We require that the Employee furnish Us evidence that he has duly applied for all other income sources for which he is or may become eligible. In the case of workers' compensation benefits, this includes:

1. making due application for such benefits; and
2. if the Employee's initial application is denied, and if We so recommend, making any and all available appeals.

We must receive written proof that all available appeals have been exhausted.

## **EXCLUSIONS**

### **WHAT WE DO NOT PAY**

We do not pay benefits for any disabilities that result from:

1. war, whether declared or not, or any act or accident of war, or armed or unarmed military or paramilitary conflict;
2. active participation in a riot;
3. the Employee's commission or attempt to commit a felony; or
4. an intentionally self-inflicted injury.

We do not pay benefits during any period in which an Employee is incarcerated.

## **LIMITATIONS**

### **PRE-EXISTING CONDITIONS LIMITATION**

This Policy will not cover any Disability:

1. caused by, or contributed to by a Pre-Existing Condition; or
2. resulting from a Pre-Existing Condition.

**PRE-EXISTING CONDITION** means any Injury or Sickness that causes the Employee, during the three (3) months just before becoming insured under this Policy, to:

1. consult a doctor;
2. seek diagnosis or medical advice or receive medical care or treatment;
3. undergo hospital admission or doctor's visits for testing or for diagnostic studies; or
4. obtain services, supplies, prescription drugs or medicines.

However, this Policy will cover that Disability if it begins after the insured Employee has performed the important duties of his own occupation:

1. on a Full-time basis;
2. for at least twelve (12) months.

In no event will this limitation be applied to loss incurred or disabilities commencing after the Employee has been insured for twenty-four consecutive months, notwithstanding any other eligibility provisions to the contrary.

### **EXCEPTION TO PRE-EXISTING CONDITIONS LIMITATION**

An Employee insured under the prior group policy on the day before the effective date of this Policy is eligible for coverage under this Policy on its effective date regardless of Actively At Work conditions.

#### Benefits for a Disability caused by a Pre-Existing Condition

Benefits for a Disability classified as due to a Pre-Existing Condition may be payable to the insured Employee provided:

1. the condition would have been covered under the prior group policy had that policy remained in force; or
2. on the Incurred Date of Disability the Employee has been insured and working Full-time for twelve (12) months under any combination of this Policy and the prior group policy.

If the above conditions are met, the benefit We pay will be the lesser of:

1. the monthly benefit payable under this Policy; or
2. the monthly benefit which would have been paid under the prior group policy, taking into consideration all provisions of the prior group policy.

Any payment We make is reduced by any payments made for the same Disability under the prior group policy.

In no event will We make payment beyond the first to occur of:

1. the date benefits cease under this Policy; or

2. the date benefits would have ceased under the prior group policy.

#### **EXCEPTION TO PRE-EXISTING CONDITIONS LIMITATION DOES NOT APPLY TO INCREASED BENEFITS**

The exception to the pre-existing conditions limitation will not apply for the amount of benefits in excess of the benefit provided by the prior group policy on the day before this Policy became effective. The portion equal to the increased amount of benefit will be subject to the preexisting conditions limitation.

#### **PRE-EXISTING CONDITIONS LIMITATION APPLIES TO REVISED BENEFITS**

After its effective date, this Policy may be revised to increase the amount or duration of the long term disability benefit payable, to decrease the Elimination Period, or to otherwise increase the terms under which benefits are paid. In that event, benefits for a Disability due to a pre-existing condition will be paid according to the policy terms in effect prior to the effective date of the revision.

For the purposes of this provision, **PRE-EXISTING CONDITION** means any Injury or Sickness that causes the Employee, during the three (3) months just before the revision effective date, to:

1. consult a doctor,
2. seek diagnosis or medical advice or receive medical care or treatment;
3. undergo hospital admission or doctor's visits for testing or for diagnostic studies; or
4. obtain services, supplies, prescription drugs or medicines.

This limitation does not apply to Disabilities that begin after the Employee has been insured while working Full-time for twelve (12) months after the revision effective date.

In no event will this limitation be applied to loss incurred or disabilities commencing after the Employee has been insured for twenty-four (24) consecutive months, notwithstanding any other eligibility provisions to the contrary.

#### **PREMIUMS**

##### **PAYMENT OF PREMIUMS**

All premiums are to be paid monthly in advance. The payment is due on or before the premium due date. Make premium payment to The Paul Revere Life Insurance Company and send it to the address requested by Us.

##### **THE GRACE PERIOD**

After the initial premium payment, a grace period of thirty-one days is allowed for all late premiums. This Policy automatically terminates if premium payments have not been made at the end of the grace period. Insurance is in force during this grace period, and premiums are charged.

##### **AMOUNT OF PREMIUMS**

The premium due each month is the total of the current rates for all insured Employees. The initial premium rates are shown in the Schedule of Premium Rates. We have the right to charge new rates effective on any premium due date, unless a Rate Guarantee Rider is in force. Before We can make a change, We must give written notice at least thirty-one days before the new rates take effect.

##### **WAIVER OF PREMIUM**

After the Employee becomes insured, premium is due for that Employee while he is Actively At Work and during his Elimination Period. Premium for the Employee is waived while benefits are payable to him during any continuous Period of Disability. Provided this Policy is in force when the Employee's continuous Period of Disability ends, the Employee will remain insured if he returns to active Full-time work in an eligible class and premium payments for the Employee resume.

##### **PREMIUM CHARGES FOR POLICY PLAN OR BENEFIT CHANGES**

When premium rates are changed because of a change in plan or benefits on other than a premium due date, the new premiums are charged on a pro-rata basis from the effective date of the change to the next monthly premium due date. Full monthly premiums are charged thereafter.

##### **PREMIUM CREDITS**

If We receive notice of an Employee's termination or decrease in amount of insurance, We allow a full premium credit for that Employee from the effective date of the change.

##### **SIMPLIFIED ACCOUNTING FOR INDIVIDUAL EMPLOYEE CHANGES**

When insurance for an Employee is added on other than a premium due date, his premium is charged beginning from the next monthly due date.

When insurance for an Employee is terminated on other than a premium due date, his premium is charged up to the next monthly premium due date. This method of charging premiums is for accounting purposes only and will not extend insurance coverage beyond the date of termination as described in the provision entitled **Termination of Employee Insurance**.

When an Employee's insurance changes on other than a premium due date, the premium is charged beginning from the next monthly premium due date.

##### **INACCURATE CENSUS AND PREMIUM**

Enrollment before the effective date could result inadvertently in premium being paid for a person enrolled but not Actively At Work since before the policy effective date. If this should occur, premium will be refunded as soon as We are notified of the situation.

## **SCHEDULE OF PREMIUM RATES**

The initial premium rates are:

Class 1 - 0.770% of the first \$31,857 of Basic Monthly Earnings.

## **CLAIMS**

### **WE MUST BE NOTIFIED OF INTENT TO FILE A CLAIM**

Written notice of a claim for Disability must be given to Us by the Employer or claimant. The notice must be in writing and must be filed at Our Home Office in Worcester, Massachusetts. Any claim will be based on the written notice. The notice must be received by Us within thirty days after the end of the Elimination Period. If We do not receive notice within thirty days, the claim may be reduced or invalidated. If it can be shown that it was not reasonably possible to submit notice within the thirty day period and it is shown that notice was given as soon as possible, the claim will not be reduced or invalidated.

### **WE FURNISH PROOF OF LOSS FORMS**

After We receive written notice of claim, We provide a proof of loss form. This form should be furnished within fifteen days after We receive written notice. If We fail to furnish this form within fifteen days, the claimant can meet the time period shown below by submitting written proof that explains the reason for the claim. Written proof should establish facts about the claim such as occurrence, nature and extent of the Disability involved. A supply of forms is included in the Employer's administration kit.

### **WHEN TO FILE PROOF OF LOSS**

The claimant must file written proof of the loss within ninety days of the end of the Elimination Period. We have the right to require additional written proof to verify the continuance of any Disability. We may request this additional proof as often as We feel is necessary, within reason.

If proof of loss is not submitted and received by Us within the required time period, the claim may be reduced or invalidated. If it can be shown that it was not reasonably possible to submit proof within the time period and it is shown that the proof was filed as soon as possible, the claim will not be reduced or invalidated. However, proof of loss may not be submitted more than one year after the time proof is otherwise required.

### **WE MAY EXTEND TIME LIMITS**

If the time limit that We allow for giving notice of claim or for submitting proof of loss is less than the law permits in the state where the claimant lives, We extend Our time limit to agree with the minimum period specified by law. The law must exist at the time this Policy is issued.

### **OUR RIGHT TO REQUIRE EXAMS**

We have the right to require an exam of any claimant as often as it may be required reasonably. The examination may be performed by a physician or vocational expert of Our choice. Any such exam will be at Our own expense.

### **OUR RIGHT TO REQUIRE PROOF OF FINANCIAL LOSS**

We have the right to require written proof of financial loss. This includes, but is not limited to:

1. statements of pre-disability income;
2. statements of income received from all sources while disabled;
3. evidence that due application has been made for all other available benefits;
4. tax returns, tax statements, and accountants' statements; and
5. any other proof We reasonably may require.

We may perform financial audits at Our own expense as often as We reasonably may require. Payment of benefits may be contingent upon the proof of financial loss being satisfactory to Us.

### **HOW WE PAY BENEFITS**

Any accrued benefits payable are subject to Our receiving proof of loss. Any unpaid balance at the end of Our period of liability is paid within a reasonable length of time after Our receiving proof of loss.

### **TO WHOM WE PAY BENEFITS**

In the case of death, any unpaid accrued benefits are paid, at Our option, to the Employee's estate or to one or more of the Employee's surviving relatives based on Our selection.

All other benefits payable under this Policy are paid to the Employee. After We have made payment, Our obligation with respect to the amount paid ends.

### **CHOICE OF DOCTOR**

For treatment purposes, the Employee is free to select any Doctor. For purposes of Disability certification, the Employee must select a Doctor who is not related by blood or marriage and who is not an Employee of the policyholder.

### **LEGAL ACTIONS AND LIMITATIONS**

No action at law or in equity may be brought to recover under this Policy unless proof of loss has been filed according to the terms of this Policy. In addition, the claimant must wait sixty days after filing proof of loss before taking action. If any action is to be taken, it must be taken within three years from the end of the sixty day time period. If any time limit in this Policy is less than the law specifies in the state where the claimant lives at the time this Policy is issued, We extend the time limit to agree with the minimum period specified by such law.

## TERMINATION

**This Policy automatically terminates at the end of the 31 day grace period if premium payments have not been made.**

We have the right to terminate this Policy if:

1. less than one hundred percent (100%) of Employees eligible are insured for any noncontributory benefit; or
2. less than seventy-five percent (75%) of the eligible Employees are insured for any contributory benefit; or
3. fewer than ten (10) employees are insured; or
4. the policyholder does not report all Employees who are eligible for insurance under this Policy; or
5. the policyholder fails, at any time:
  - a. to furnish promptly any information We reasonably may require; or
  - b. to perform any other obligations pertaining to this Policy.

We may specify in advance written notice to the policyholder a date of termination. We must give the policyholder notice of termination at least thirty (30) days before the termination. It is not our responsibility to notify the Employees.

The Duration Rider includes the date this Policy terminates without renewal. If mutual agreement of renewal conditions cannot be reached, We will provide to the policyholder thirty (30) days advance notice.

The policyholder may terminate the entire contract or may terminate certain affiliates and/or subsidiaries and their Employees at any time. In either case, the policyholder must send Us written notice and include the date the insurance will end. However, no termination of this Policy may take place during a period for which the premiums have been paid. The termination takes effect on the later of:

1. the date given in the notice; or
2. the date We receive the notice.

The policyholder must send Us any unpaid premiums for any insurance We provide while this Policy was in force, even if notice of termination had been given to Us. We determine the portion of the premium to be paid for any period between the premium due date and the date of termination.

## MISCELLANEOUS PROVISIONS

### ENTIRE CONTRACT

The entire contract is made up of this Policy, the application of the policyholder, applications of the Participating Employers, and application by each Employee. A copy of the policyholder's application is attached to this Policy; each Employee retains a copy of his own application.

### STATEMENTS

In the absence of fraud, all application statements made by the policyholder or by an Employee are considered representations not warranties. This means that the statements are made in good faith. No statement voids this Policy, reduces the benefits We provide or is used as defense to claim unless it is contained in a written application and a copy is furnished to the Employee.

### TIME LIMIT FOR CERTAIN DEFENSES

After two years from the effective date of this Policy, no misstatement made by Policyholder, except a fraudulent misstatement made in the application, may be used to void this Policy. After two years from the effective date of the Employer's participation in this Policy, no misstatement made by the Employer, except a fraudulent misstatement made in the application, may be used to void the Employer's participation in this Policy. After two years, no misstatement or omission made by the Employee, except a fraudulent misstatement made in an application, may be used to deny a claim for any Disability that begins after the end of the two year period.

If any time limit in this Policy is other than that specified by the law of the state where the claimant lives, We amend the time limit to agree with the period specified by such law.

### MISREPRESENTATION/RESCISSION

Certain amounts of insurance or increases in insurance may be subject to Evidence of Insurability.

1. If an Employee makes a representation on his application for such an amount; and
2. if such representation or omission was material to Our approval of his application; and
3. if We discover within two (2) years of the effective date of the insurance or the increase that the material fact or omission was a misrepresentation,

then We may, at Our option, rescind that amount or increase. This means that the amount or increase will never have been in effect. All premium paid for insurance that is rescinded will be refunded.

### MISSTATEMENT OF FACT

If any important facts about an individual in relation to his insurance are found to be misstated, We adjust Our premium to the correct amount. If the misstatement affects the amount of insurance, the true facts are used to determine the correct amount of insurance. Delay in reporting changes is not considered a misstatement.

### AGENCY

The Employer acts on his own behalf or as an agent of the Employees. The Employer is not an agent of The Paul Revere.

### WE PROVIDE CERTIFICATES OF INSURANCE



We issue certificates of insurance for each insured Employee. These are delivered to the Employer to be given to the Employee. The certificate states what the insurance coverage is and to whom We pay benefits. If the terms of this Policy and the Employee's certificate differ, this Policy governs.

## INSURANCE INFORMATION

The Employer will provide Us with the information We need to administer this insurance contract and compute the premium.

This information will include:

1. that relative to Employees:
  - a. who newly qualify;
  - b. whose class changes;
  - c. whose Earnings amount changes;
  - d. whose insurance terminates;
  - e. who are on leaves of absence;
  - f. full census data as requested; and
2. any other information about this Policy that reasonably may be requested.

We have the right to verify this information. Employer records that may be relevant, in Our opinion, will be open for inspection by Us at any reasonable time.

## CHANGES IN THIS POLICY

We may change the terms of this Policy if We receive a written request from the policyholder. All changes that are made are stated in riders or amendments to this Policy. These documents must be signed by Our President and Secretary. The Employee's consent is not needed to make a policy change.

We may change this Policy if there is a change in the Federal Social Security Act that affects Our liability. The change will take effect as of the date the Federal Social Security Act changes. We may make other changes mandated by state or Federal law.

## CLERICAL ERRORS OR DELAYS

Clerical errors or omissions do not result in the denial of insurance. If there is any delay in posting the date of any termination of insurance, the delay does not extend any insurance provided by this Policy.

## ASSIGNMENT OF BENEFITS

The Employee may not assign the right, title or interest of this long term disability benefit to a third party.

## WORKERS' COMPENSATION

This Policy does not affect or take the place of Workers' Compensation insurance.

THE PAUL REVERE LIFE INSURANCE COMPANY

Worcester, Massachusetts 01608

## DURATION AND RATE GUARANTEE RIDER

This Rider is attached to and forms a part of Group Policy G-42326.

Effective Date of this Rider: April 1, 1995

## DURATION OF THE ATTACHED GROUP POLICY

Subject to the conditions set forth in the **TERMINATION OF THIS POLICY** provision of the attached Group Policy, the Group Policy and this Rider are in effect from April 1, 1995, through February 28, 1996. Shortly before the expiration date, the group will be reviewed for renewal. Mutual acceptance of renewal conditions will result in our issuing an updated Duration and Rate Guarantee Rider.

If We decide not to renew this Policy, We will provide to the policyholder 30 days advance written notice.

## RATE GUARANTEE

The **Amount of Premiums** provision of the Group Policy to which this Rider is attached is amended as follows:

Premium rates in effect on the effective date of this Rider will not be changed until the earliest of the following dates:

1. the date this Rider expires; or
2. the date the Group Policy is amended to change eligibility provisions or benefits or to add or drop insurance on any affiliated or subsidiary Employer, or
3. the date the total number of insured Employees changes by more than twenty-five percent from the number of Employees insured on the effective date of this Rider.

If any of the events described in 1, 2, or 3 above occur, the Rate Guarantee portion of this Rider ceases to operate. Any subsequent changes in premium rates under the Group Policy are made in accordance with the section of the Group Policy entitled **Premiums**.

**THE PAUL REVERE LIFE INSURANCE COMPANY**

/s/Secretary  
Secretary

/s/President  
President

**NOTICE CONCERNING POLICYHOLDER RIGHTS IN AN  
INSOLVENCY UNDER THE MINNESOTA LIFE AND HEALTH  
INSURANCE GUARANTY ASSOCIATION LAW**

If the insurer that issued your life, annuity, or health insurance policy becomes impaired or insolvent, you are entitled to compensation for your policy from the assets of that insurer. The amount you recover will depend on the financial condition of the insurer.

In addition, residents of Minnesota who purchase life insurance, annuities, or health insurance from insurance companies authorized to do business in Minnesota are protected, SUBJECT TO LIMITS AND EXCLUSIONS, in the event the insurer becomes financially impaired or insolvent. This protection is provided by the Minnesota Life and Health Insurance Guaranty Association.

**Minnesota Life & Health Insurance Guaranty Association  
750 Norwest Center  
55 East 5th Street  
St.Paul, Minnesota 55101  
(612) 222-2799**

The maximum amount the guaranty association will pay for all policies issued on one life by the same insurer is limited to \$300,000. Subject to this \$300,000 limit, the Guaranty Association will pay up to \$300,000 in life insurance death benefits, \$100,000 in net cash surrender and net cash withdrawal values for life insurance, \$300,000 in health insurance benefits, including any net cash surrender and net cash withdrawal values, \$100,000 in annuity net cash surrender and net cash withdrawal values, \$300,000 in present value of annuity benefits for annuities which are part of a structured settlement or for annuities in regard to which periodic annuity benefits, for a period of not less than the annuitant's lifetime or for a period certain of not less than ten years, have begun to be paid on or before the date of impairment or insolvency, or if no coverage limit has been specified for a covered policy or benefit, the coverage limit shall be \$300,000 in present value. Unallocated annuity contracts issued to retirement plans, other than defined benefit plans, established under section 401, 403(b), or 457 of the Internal Revenue Code of 1986, as amended through December 31, 1992, are covered up to \$100,000 in net cash surrender and net cash withdrawal values, for Minnesota residents covered by the plan provided, however, that the association shall not be responsible for more than \$7,500,000 in claims from all Minnesota residents covered by the plan. If total claims exceed \$7,500,000, the \$7,500,000 shall be prorated among all claimants. These are the maximum claim amounts.

Coverage by the Guaranty Association is also subject to other substantial limitations and exclusions and requires continued residency in Minnesota. If your claim exceeds the Guaranty Association's limits, you may still recover a part or all of that amount from the proceeds of the liquidation of the insolvent insurer, if any exist. Funds to pay claims may not be immediately available. The Guaranty Association assesses insurers licensed to sell life and health insurance in Minnesota after the insolvency occurs. Claims are paid from this assessment.

THE COVERAGE PROVIDED BY THE GUARANTY ASSOCIATION IS NOT A SUBSTITUTE FOR USING CARE IN SELECTING INSURANCE COMPANIES THAT ARE WELL MANAGED AND FINANCIALLY STABLE. IN SELECTING AN INSURANCE COMPANY OR POLICY, YOU SHOULD NOT RELY ON COVERAGE BY THE GUARANTY ASSOCIATION.

THIS NOTICE IS REQUIRED BY MINNESOTA STATE LAW TO ADVISE POLICYHOLDERS OF LIFE, ANNUITY OR HEALTH INSURANCE POLICIES OF THEIR RIGHTS IN THE EVENT THEIR INSURANCE CARRIER BECOMES FINANCIALLY INSOLVENT. THIS NOTICE IN NO WAY IMPLIES THAT THE COMPANY CURRENTLY HAS ANY TYPE OF FINANCIAL PROBLEMS. ALL LIFE, ANNUITY AND HEALTH INSURANCE POLICIES ARE REQUIRED TO PROVIDE THIS NOTICE.