

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **March 30, 2007**

Commission File Number: 001-9249

GRACO INC.

(Exact name of registrant as specified in its charter)

Minnesota

(State of incorporation)

41-0285640

(I.R.S. Employer Identification Number)

88 - 11th Avenue N.E.
Minneapolis, Minnesota

(Address of principal executive offices)

55413

(Zip Code)

(612) 623-6000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes X No _____

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

Large Accelerated Filer X Accelerated Filer _____ Non-accelerated Filer _____

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

Yes _____ No X

66,520,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of April 18, 2007.

GRACO INC. AND SUBSIDIARIES

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PART I

Item 1. GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited) (In thousands, except per share amounts)

| | <u>Thirteen Weeks Ended</u> | |
|--|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Net Sales | \$197,495 | \$192,216 |
| Cost of products sold | 92,633 | 88,989 |
| Gross Profit | 104,862 | 103,227 |
| Product development | 8,272 | 7,212 |
| Selling, marketing and distribution | 29,263 | 27,942 |
| General and administrative | 15,240 | 13,421 |
| Operating Earnings | 52,087 | 54,652 |
| Interest expense | 258 | 125 |
| Other expense (income), net | (106) | 5 |
| Earnings before Income Taxes | 51,935 | 54,522 |
| Income taxes | 18,200 | 19,100 |
| Net Earnings | \$ 33,735 | \$ 35,422 |
| Basic Net Earnings per Common Share | \$.51 | \$.52 |
| Diluted Net Earnings per Common Share | \$.50 | \$.51 |
| Cash Dividends Declared per Common Share | \$.17 | \$.15 |

See notes to consolidated financial statements.

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

| | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 4,767 | \$ 5,871 |
| Accounts receivable, less allowances of | | |

| | | |
|------------------------------------|------------|------------|
| \$6,100 and \$5,800 | 142,137 | 134,105 |
| Inventories | 87,366 | 76,311 |
| Deferred income taxes | 22,772 | 20,682 |
| Other current assets | 2,144 | 2,014 |
| | <hr/> | <hr/> |
| Total current assets | 259,186 | 238,983 |
| Property, Plant and Equipment | | |
| Cost | 289,719 | 278,318 |
| Accumulated depreciation | (156,579) | (153,794) |
| | <hr/> | <hr/> |
| Property, plant and equipment, net | 133,140 | 124,524 |
| Prepaid Pension | 27,703 | 26,903 |
| Goodwill | 67,173 | 67,174 |
| Other Intangible Assets, net | 48,195 | 50,325 |
| Other Assets | 3,420 | 3,694 |
| | <hr/> | <hr/> |
| Total Assets | \$ 538,817 | \$ 511,603 |
| | <hr/> | <hr/> |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | | |
|---|------------|------------|
| Current Liabilities | | |
| Notes payable to banks | \$ 33,361 | \$ 18,363 |
| Trade accounts payable | 28,761 | 27,442 |
| Salaries, wages and commissions | 13,850 | 26,303 |
| Dividends payable | 11,006 | 11,055 |
| Other current liabilities | 53,994 | 45,766 |
| | <hr/> | <hr/> |
| Total current liabilities | 140,972 | 128,929 |
| Retirement Benefits and Deferred Compensation | 37,011 | 36,946 |
| Uncertain Tax Positions | 5,800 | — |
| Deferred Income Taxes | 13,317 | 14,724 |
| Shareholders' Equity | | |
| Common stock | 66,536 | 66,805 |
| Additional paid-in capital | 140,676 | 130,621 |
| Retained earnings | 139,645 | 138,702 |
| Accumulated other comprehensive income (loss) | | |
| Cumulative translation adjustment | (67) | (60) |
| Pension liability adjustment | (5,073) | (5,064) |
| | <hr/> | <hr/> |
| Total shareholders' equity | 341,717 | 331,004 |
| | <hr/> | <hr/> |
| Total Liabilities and Shareholders' Equity | \$ 538,817 | \$ 511,603 |
| | <hr/> | <hr/> |

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

| | <u>Thirteen Weeks Ended</u> | |
|--|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Cash Flows from Operating Activities | | |
| Net Earnings | \$ 33,735 | \$ 35,422 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation and amortization | 6,959 | 5,781 |
| Deferred income taxes | (3,478) | (1,706) |
| Share-based compensation | 2,218 | 2,164 |
| Excess tax benefit related to share-based payment arrangements | (848) | (2,000) |
| Change in: | | |
| Accounts receivable | (7,631) | (6,471) |
| Inventories | (10,985) | (7,934) |
| Trade accounts payable | 1,711 | 4,906 |

| | | |
|--|-----------------|-----------------|
| Salaries, wages and commissions | (12,469) | (9,825) |
| Retirement benefits and deferred compensation | (989) | 19 |
| Other accrued liabilities | 9,281 | 11,883 |
| Uncertain tax positions | 5,800 | — |
| Other | (165) | 50 |
| Net cash provided by operating activities | 23,139 | 32,289 |
| Cash Flows from Investing Activities | | |
| Property, plant and equipment additions | (13,267) | (4,371) |
| Proceeds from sale of property, plant and equipment | 149 | 19 |
| Net cash used in investing activities | (13,118) | (4,352) |
| Cash Flows from Financing Activities | | |
| Borrowings on notes payable and lines of credit | 29,415 | 4,333 |
| Payments on notes payable and lines of credit | (14,476) | (8,310) |
| Excess tax benefit related to share-based payment arrangements | 848 | 2,000 |
| Common stock issued | 8,355 | 10,200 |
| Common stock retired | (23,985) | (17,404) |
| Cash dividends paid | (11,010) | (9,922) |
| Net cash provided by (used in) financing activities | (10,853) | (19,103) |
| Effect of exchange rate changes on cash | (272) | (315) |
| Net increase (decrease) in cash and cash equivalents | (1,104) | 8,519 |
| Cash and cash equivalents | | |
| Beginning of year | 5,871 | 18,664 |
| End of period | \$ 4,767 | \$ 27,183 |

See notes to consolidated financial statements.

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

- The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of March 30, 2007 and the related statements of earnings and cash flows for the thirteen weeks then ended have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of March 30, 2007, and the results of operations and cash flows for all periods presented.

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

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

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

| | <u>Thirteen Weeks Ended</u> <u>March 30, 2007</u> | <u>March 31, 2006</u> |
|--|--|-----------------------|
| Net earnings available to common shareholders | \$ 33,735 | \$ 35,422 |
| Weighted average shares outstanding for basic earnings per share | 66,667 | 68,428 |
| Dilutive effect of stock options computed using the | | |

| | | |
|--|--------|--------|
| treasury stock method and the average market price | 1,048 | 1,121 |
| Weighted average shares outstanding for diluted earnings per share | 67,715 | 69,549 |
| Basic earnings per share | \$.51 | \$.52 |
| Diluted earnings per share | \$.50 | \$.51 |

Stock options to purchase 948,000 and 1,000 shares are not included in the 2007 and 2006 calculations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirteen weeks ended March 30, 2007 is shown below (in thousands, except per share amounts):

| | <u>Option Shares</u> | <u>Weighted Average Exercise Price</u> | <u>Options Exercisable</u> | <u>Weighted Average Exercise Price</u> |
|--------------------------------|--------------------------|--|--------------------------------|--|
| Outstanding, December 29, 2006 | 3,956 | \$ 24.79 | 2,272 | \$16.94 |
| Granted | 539 | 41.36 | | |
| Exercised | (114) | 11.44 | | |
| Canceled | (19) | 35.57 | | |
| Outstanding, March 30, 2007 | <u>4,362</u> | <u>\$ 27.14</u> | <u>2,620</u> | <u>\$19.91</u> |

The aggregate intrinsic value of exercisable option shares was \$50.7 million as of March 30, 2007, with a weighted average contractual term of 5.2 years. There were approximately 4.3 million vested share options and share options expected to vest as of March 30, 2007, with an aggregate intrinsic value of \$54.9 million, a weighted average exercise price of \$26.81 and a weighted average contractual term of 6.5 years.

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

| | <u>Thirteen Weeks Ended</u> | |
|---------------------------|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Cash received | \$1,305 | \$3,409 |
| Aggregate intrinsic value | 3,407 | 6,359 |
| Tax benefit realized | 1,200 | 2,300 |

The Company recognized share-based compensation of \$2.2 million in both the first quarter of 2007 and the first quarter of 2006. As of March 30, 2007, there was \$13.2 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.4 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

| | <u>Thirteen Weeks Ended</u> | |
|---------------------------------------|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Expected life in years | 6.0 | 6.3 |
| Interest rate | 4.6% | 4.6% |
| Volatility | 26.2% | 27.8% |
| Dividend yield | 1.6% | 1.4% |
| Weighted average fair value per share | \$12.05 | \$12.81 |

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

| | <u>Thirteen Weeks Ended</u> | |
|---------------------------------------|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Expected life in years | 1.0 | 1.0 |
| Interest rate | 4.9% | 4.6% |
| Volatility | 24.4% | 24.0% |
| Dividend yield | 1.6% | 1.4% |
| Weighted average fair value per share | \$9.79 | \$10.18 |

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

| | <u>Thirteen Weeks Ended</u> | |
|--|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |

Pension Benefits

| | | |
|------------------------------------|----------|----------|
| Service cost | \$ 1,479 | \$ 1,440 |
| Interest cost | 2,882 | 2,608 |
| Expected return on assets | (4,800) | (4,175) |
| Amortization and other | 255 | 192 |
| | <u>—</u> | <u>—</u> |
| Net periodic benefit cost (credit) | \$ (184) | \$ 65 |
| | <u>—</u> | <u>—</u> |

Postretirement Medical

| | | |
|---------------------------|----------|----------|
| Service cost | \$ 150 | \$ 250 |
| Interest cost | 300 | 420 |
| Amortization and other | (50) | 186 |
| | <u>—</u> | <u>—</u> |
| Net periodic benefit cost | \$ 400 | \$ 856 |
| | <u>—</u> | <u>—</u> |

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

| | <u>Thirteen Weeks Ended</u> | |
|--|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Net income | \$ 33,735 | \$ 35,422 |
| Foreign currency translation adjustments | (7) | 515 |
| Pension liability adjustment, net of tax | (9) | (19) |
| | <u>—</u> | <u>—</u> |
| Comprehensive income | \$ 33,719 | \$ 35,918 |
| | <u>—</u> | <u>—</u> |

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. The Company does not track assets by segment. Sales and operating earnings by segment for the thirteen weeks ended March 30, 2007 and March 31, 2006 were as follows (in thousands):

| | <u>Thirteen Weeks Ended</u> | |
|---------------------------|-----------------------------|-----------------------|
| | <u>March 30, 2007</u> | <u>March 31, 2006</u> |
| Net Sales | | |
| Industrial | \$105,065 | \$100,160 |
| Contractor | 69,751 | 74,352 |
| Lubrication | 22,679 | 17,704 |
| | <u>—</u> | <u>—</u> |
| Consolidated | \$197,495 | \$192,216 |
| | <u>—</u> | <u>—</u> |
| Operating Earnings | | |
| Industrial | \$ 34,418 | \$ 32,083 |
| Contractor | 17,027 | 21,042 |
| Lubrication | 3,064 | 4,755 |
| Unallocated corporate | (2,422) | (3,228) |
| | <u>—</u> | <u>—</u> |
| Consolidated | \$ 52,087 | \$ 54,652 |
| | <u>—</u> | <u>—</u> |

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

| | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|---|-----------------------|----------------------|
| Finished products and components | \$ 51,909 | \$ 44,969 |
| Products and components in various stages of completion | 29,795 | 26,841 |
| Raw materials and purchased components | 36,188 | 35,258 |
| | <u>—</u> | <u>—</u> |
| | 117,892 | 107,068 |
| Reduction to LIFO cost | (30,526) | (30,757) |
| | <u>—</u> | <u>—</u> |
| Total | \$ 87,366 | \$ 76,311 |
| | <u>—</u> | <u>—</u> |

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

| | <u>Estimated Life (Years)</u> | <u>Original Cost</u> | <u>Amorti- zation</u> | <u>Foreign Currency Translation</u> | <u>Book Value</u> |
|---|-----------------------------------|--------------------------|---------------------------|---|-----------------------|
| <u>March 30, 2007</u> | | | | | |
| Customer relationships and distribution network | 4 - 8 | \$ 26,102 | \$ (8,272) | \$ 4 | \$17,834 |
| Patents, proprietary technology | | | | | |

| | | | | | |
|---|--------|------------------|--------------------|--------------|-----------------|
| and product documentation | 5 - 15 | 22,243 | (5,261) | 4 | 16,986 |
| Trademarks and trade names | 3 - 10 | 4,684 | (1,582) | 13 | 3,115 |
| | | <u>53,029</u> | <u>(15,115)</u> | <u>21</u> | <u>37,935</u> |
| Not Subject to Amortization: | | | | | |
| Brand names | | 10,260 | — | — | 10,260 |
| | | <u>10,260</u> | <u>—</u> | <u>—</u> | <u>10,260</u> |
| Total | | <u>\$ 63,289</u> | <u>\$ (15,115)</u> | <u>\$ 21</u> | <u>\$48,195</u> |
| <u>December 29, 2006</u> | | | | | |
| Customer relationships and distribution network | 4 - 8 | \$ 26,102 | \$ (7,335) | \$ 6 | \$18,773 |
| Patents, proprietary technology and product documentation | 5 - 15 | 22,243 | (4,443) | 5 | 17,805 |
| Trademarks, trade names and other | 3 - 10 | 5,114 | (1,641) | 14 | 3,487 |
| | | <u>53,459</u> | <u>(13,419)</u> | <u>25</u> | <u>40,065</u> |
| Not Subject to Amortization: | | | | | |
| Brand names | | 10,260 | — | — | 10,260 |
| | | <u>10,260</u> | <u>—</u> | <u>—</u> | <u>10,260</u> |
| Total | | <u>\$ 63,719</u> | <u>\$ (13,419)</u> | <u>\$ 25</u> | <u>\$50,325</u> |

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

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

| | <u>March 30, 2007</u> | <u>Dec. 29, 2006</u> |
|--|-----------------------|----------------------|
| Accrued insurance liabilities | \$ 7,959 | \$ 7,833 |
| Accrued warranty and service liabilities | 6,380 | 6,675 |
| Accrued trade promotions | 5,113 | 7,265 |
| Payable for employee stock purchases | 1,069 | 5,846 |
| Income taxes payable | 16,971 | 3,920 |
| Other | 16,502 | 14,227 |
| | <u>\$53,994</u> | <u>\$45,766</u> |

A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific product warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

| | Thirteen Weeks Ended <u>March 30, 2007</u> | Year Ended <u>Dec. 29, 2006</u> |
|--------------------------------|--|------------------------------------|
| Balance, beginning of year | \$ 6,675 | \$ 7,649 |
| Charged to expense | 991 | 4,442 |
| Margin on parts sales reversed | 758 | 1,944 |
| Reductions for claims settled | (2,044) | (7,360) |
| | <u>—</u> | <u>—</u> |
| Balance, end of period | <u>\$ 6,380</u> | <u>\$ 6,675</u> |

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

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

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

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

Item 2.

GRACO INC. AND SUBSIDIARIES

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

Results of Operations

First quarter net earnings of \$33.7 million were 5 percent below net earnings in the first quarter last year. The decrease resulted from a lower gross margin rate and higher expenses, which more than offset the favorable impact of a 3 percent increase in sales.

Results include the operations of Lubriquip, which was acquired in July 2006. The integration of Lubriquip is on track for completion by the end of the year and the consolidation of Gusmer operations was completed in the first quarter. Costs and expenses related to the integration and consolidation activities totaled approximately \$1 million in the first quarter of 2007.

Foreign currency translation rates had a favorable impact on first quarter sales and net earnings. Translated at consistent exchange rates, sales increased 1 percent and net earnings decreased 8 percent.

Net Sales

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

| | <u>Thirteen Weeks Ended</u> | |
|---------------------------|-----------------------------|-----------------------|
| | <u>March 20, 2007</u> | <u>March 31, 2006</u> |
| By Segment | | |
| Industrial | \$105,065 | \$100,160 |
| Contractor | 69,751 | 74,352 |
| Lubrication | 22,679 | 17,704 |
| | <hr/> | <hr/> |
| Consolidated | \$197,495 | \$192,216 |
| | <hr/> | <hr/> |
| By Geographic Area | | |
| Americas ¹ | \$120,546 | \$132,212 |
| Europe ² | 49,377 | 39,546 |
| Asia Pacific | 27,572 | 20,458 |
| | <hr/> | <hr/> |
| Consolidated | \$197,495 | \$192,216 |
| | <hr/> | <hr/> |

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

² Europe, Africa and Middle East

Industrial segment sales increased 5 percent. A decrease in the Americas was more than offset by double-digit percentage increases in Europe and Asia Pacific.

Contractor segment sales decreased 6 percent. Segment sales in Europe increased 40 percent while sales were lower in the Americas and Asia Pacific. In the Americas, growth in the home center channel was not enough to offset the decline in the professional paint stores channel.

Lubrication segment sales increased 28 percent due to sales of Lubriquip products, acquired in mid-2006. Sales in this segment increased in all geographic areas.

Gross Profit

Gross profit as a percentage of sales was 53.1 percent compared to 53.7 percent for the first quarter last year. The decrease was due mainly to lower margin rates on Lubriquip products and higher production and material costs, offset somewhat by the favorable impacts of currency translation and pricing.

Operating Expenses

Total operating expenses increased \$4 million including approximately \$1.5 million related to Lubriquip. The Contractor segment incurred approximately \$1 million of expenses related to the market testing of a new line of sprayers in the home center channel.

Income Taxes

The effective tax rate of 35 percent was the same as last year's rate for the first quarter.

Liquidity and Capital Resources

Significant uses of cash in the first quarter of 2007 included \$24 million for purchases and retirement of Company common stock, \$13 million for capital additions and \$11 million for payment of dividends. During the first quarter of 2006, significant uses of cash included \$17 million for purchases and retirement of Company common stock and \$10 million for dividends.

At March 30, 2007, the Company had various lines of credit totaling \$145 million, of which \$115 million was unused. Internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

Outlook

First quarter sales fell short of expectations due mostly to soft demand in the North American Industrial and Contractor businesses. Management expects that 2007 will continue to be a challenging sales growth environment in North America. Spending over the remainder of the year will be adjusted accordingly, however, the Company will continue to invest for the future by funding key growth strategies.

SAFE HARBOR CAUTIONARY STATEMENT

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

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Item 4. Controls and Procedures

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's Chairman, President and Chief Executive Officer, Chief Financial Officer and Treasurer, Vice President and Controller 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.

Changes in internal controls

During the quarter, there was no change in the Company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the Company's internal control over financial reporting.

PART II OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2006 Annual Report on Form 10-K.

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

Issuer Purchases of Equity Securities

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

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

Information on issuer purchases of equity securities follows:

| <u>Period</u> | (a) Total Number of Shares <u>Purchased</u> | (b) Average Price Paid <u>per Share</u> | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or <u>Programs</u> | (d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or |
|---------------|--|--|--|--|
|---------------|--|--|--|--|

| | | | | Programs (at <u>end of period</u>) |
|------------------------------|---------|---------|---------|--|
| Dec. 30, 2006 - Jan 26, 2007 | 133,600 | \$40.27 | 133,600 | 4,909,900 |
| Jan 27, 2007 - Feb 23, 2007 | 170,000 | \$41.11 | 170,000 | 4,739,900 |
| Feb 24, 2007 - Mar 30, 2007 | 283,800 | \$39.46 | 283,800 | 4,456,100 |

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

None

Item 6. Exhibits

- 4.1 Credit agreement dated April 1, 2006, between the Company and Wachovia Bank, N.A. (Promissory Note and Offering Basis Loan Agreement) (Incorporated by reference to Exhibit 4.1 to the Company's Report on Form 10-Q for the thirteen weeks ended March 31, 2006.); as extended by letter from Wachovia Bank, N.A. to Graco Inc., dated March 26, 2007.
- 10.1 Stock Option Agreement. Form of agreement used for award in 2007 of non-incentive stock options to executive officers under the Graco Inc. Amended and Restated Stock Incentive Plan (2006). Form of agreement for award made to Chief Executive Officer in 2007.
- 31.1 Certification of Chairman, President and Chief Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a)
- 32 Certification of Chairman, President and Chief Executive Officer and Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GRACO INC.

Date: April 24, 2007

By:/s/David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer
(Principal Executive Officer)

Date: April 24, 2007

By:/s/James A. Graner

James A. Graner
Chief Financial Officer and Treasurer
(Principal Financial Officer)

March 26, 2007

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

Attention: Janel W. French

Re: Promissory Note from Graco Inc. ("**Borrower**") to Wachovia Bank, National Association ("**Wachovia**") in the original principal amount of \$25,000,000.00 dated March 31, 2006, including any amendments (the "**Note**").

Obligor # 000004151380481

Obligation # 000000000000265

Dear Janel:

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

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

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

Very truly yours,

Wachovia Bank, National Association

By: /s/C. Jeffrey Seaton

C. Jeffrey Seaton
Managing Director

GRACO INC.
AMENDED AND RESTATED STOCK INCENTIVE PLAN (2006)

EXECUTIVE OFFICER
STOCK OPTION AGREEMENT
(Non-Qualified)

THIS AGREEMENT, made this «Day_of_Month_» day of «Month_and_Year», by and between Graco Inc., a Minnesota corporation (the “Company”) and «F_Name_MI» «L_Name» (the “Employee”).

WITNESSETH THAT:

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

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

1. Grant of Option

The Company grants to Employee, the right and option (the “Option”) to purchase all or any part of an aggregate of «Words» («Number») shares of Common Stock of the Company, par value USD 1.00 per share, at the price of USD «Price» per share on the terms and conditions set forth in this Agreement. The date of grant of the Option is «Date» (the “Date of Grant”).

2. Duration and Exercisability

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

Vesting Schedule

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

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

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

3. Effect of Termination of Employment

- A. If Employee’s employment terminates for any reason other than Employee’s gross and willful misconduct, death, retirement (as defined in Section 3D), or disability (as defined in Section 3D), Employee shall have the right to exercise that portion of the Option exercisable upon the date of termination of employment at any time within the period beginning on the day after termination of employment and ending at the close of trading on the Exchange thirty (30) days later.
- B. If Employee’s employment terminates by reason of Employee’s gross and willful misconduct during employment, including, but not limited to, wrongful appropriation of Company funds, serious violations of Company policy, breach of fiduciary duty or the conviction of a felony, the unexercised portion of the Option shall terminate as of the time of the misconduct. If the Company determines subsequent to the termination of Employee’s employment for whatever reason, that Employee engaged in conduct during employment that would constitute gross and willful misconduct justifying termination, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Company thereafter determines that Employee engaged in gross and willful misconduct during employment which would have justified termination at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise.
- C. If Employee shall die while employed by the Company or an affiliate or within thirty (30) days after a termination of employment which meets the criteria of Section 3A, and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of Employee’s estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining shares at any time during a period beginning on the day after the date of Employee’s death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.

- D. If Employee's termination of employment is due to retirement or disability, all shares remaining under the Option shall become immediately exercisable. Employee shall be deemed to have retired if the termination of employment occurs for reasons other than the Employee's gross and willful misconduct, death, or disability after Employee (i) has attained age 55 and 10 years of service with the Company or an affiliate, or (ii) has attained age 65. Employee shall be deemed to be disabled if the termination of employment occurs because Employee is unable to work due to an impairment which would qualify as a disability under the Company's long term disability program. Employee may exercise the shares remaining unexercised at any time during a period beginning on the day after the date of Employee's termination of employment and ending at the close of trading on the Exchange on the tenth anniversary of the Date of Grant. If Employee should die during the period between the date of Employee's retirement or disability and the expiration of the Option, the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent may exercise the unexercised portion of the Option at any time during a period beginning the day after the date of Employee's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later, provided, however, in no event shall the Option be exercisable following the tenth anniversary of the Date of Grant.
- E. Notwithstanding anything to the contrary contained in this Section 3, if the Employee's employment is terminated by retirement (as defined in Section 3D) and Employee has not given the Company written notice to his/her immediate supervisor and the Chief Executive Officer, of Employee's intention to retire not less than six (6) months prior to the date of his/her retirement, then in such event, for purposes of this Agreement only, said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3A, *provided, however*, that in the event that the Chief Executive Officer determines that said termination of employment without six (6) months prior written notice is in the best interests of the Company, such termination shall be deemed to be a retirement and shall be subject to Section 3D.
- F. If the Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased optionee, the Company shall be under no obligation to issue stock hereunder unless and until the Company is satisfied that the person(s) exercising the Option is the duly appointed legal representative of the deceased optionee's estate or the proper legatee or distributee thereof.
- G. For purposes of this Section 3, if the last day of the relevant period is a day upon which the Exchange is not open for trading or the Common Stock is not trading on that day, the relevant period will expire at the close of trading on such earlier business day on which the Exchange is open and the Common Stock is trading.

4. Manner of Exercise

- A. Employee or other proper party may exercise the Option only by delivering within the term of the Option written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the Option is being exercised and, except as provided in Sections 4B(2) and 4C, accompanied by payment-in-full of the Option price for all shares designated in the notice.
- B. The Employee may, at Employee's election, pay the Option price as follows:
- (1) by cash or check (bank check, certified check, or personal check)
 - (2) by delivering to the Company for cancellation, shares of Common Stock of the Company which have been held by the Employee for not less than six (6) months with a fair market value equal to the Option price.

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

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

5. Payment of Withholding Taxes

Upon exercise of any portion of this Option, Employee shall pay to the Company an amount sufficient to satisfy any federal, state, or local withholding tax requirements which arise as a result of the exercise of the Option or provide the Company with satisfactory indemnification for such payment. Employee may pay such amount by delivering to the Company for cancellation shares of Common Stock of the Company with a fair market value equal to the minimum amount of such withholding tax requirement by (i) electing to have the Company withhold shares otherwise to be delivered with a fair market value equal to the minimum statutory amount of such taxes required to be withheld by the Company, or (ii) electing to surrender to the Company previously owned shares with a fair market value equal to the amount of such minimum tax obligation.

6. Change of Control

- A. Notwithstanding Section 2A hereof, the entire Option shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:
- (1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
 - (a) the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or
 - (b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

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

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 6, a Trust Person shall not be deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Employee or any group that includes the Employee, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of Section 6A(4); and

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

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or
- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
 - (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of Common Stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets, either directly or through one or more subsidiaries), in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,
 - (b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of Common Stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and
 - (c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial Agreement, or of the action of the Board, providing for such Business Combination; or
- (5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

B. A Change of Control shall not be deemed to have occurred with respect to an Employee if:

- (1) the acquisition of the 25% or greater interest referred to in Section 6A(1) is by a group, acting in concert, that includes the Employee or
- (2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding Company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share

exchange, disposition of assets, liquidation or dissolution referred to in Sections 6A(4) or 6A(5) by a group, acting in concert, that includes that Employee.

7. Adjustments

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

8. Miscellaneous

- A. This Option is issued pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. This Agreement shall not create an employment relationship between Employee and the Company and shall not confer on Employee any right with respect to continuance of employment by the Company or any of its affiliates or subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time.
- C. Neither Employee, the Employee's legal representative, nor the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.
- D. This option has been granted to Employee as a purely discretionary benefit and shall not form part of Employee's salary or entitle Employee to receive similar option grants in the future. Benefits received under the Plan shall not be used in calculating severance payments, if any.
- E. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- F. The internal law, and not the law of conflicts, of the State of Minnesota, USA, shall govern all questions concerning the validity, construction and effect of this Agreement, the Plan and any rules and regulations relating to the Plan or this Option
- G. Employee hereby consents to the transfer by his/her employer or the Company of information relating to his/her participation in the Plan, including the personal data set forth in this Agreement, between them or to other related parties in the United States or elsewhere, or to any financial institution or other third party engaged by the Company, but solely for the purpose of administering the Plan and this Option. Employee also consents to the storage and processing of such data by such persons for this purpose.

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

GRACO INC.

By _____
«F_Name_MI» «L_Name»
Chairman, President and Chief Executive Officer

EMPLOYEE

«F_Name_MI» «L_Name»

Exhibit 10.1

**GRACO INC.
AMENDED AND RESTATED STOCK INCENTIVE PLAN (2006)**

**CHIEF EXECUTIVE OFFICER
STOCK OPTION AGREEMENT
(Non-Qualified)**

THIS AGREEMENT, made this «Day_of_Month_» day of «Month_and_Year», by and between Graco Inc., a Minnesota corporation (the "Company") and «F_Name_MI». «L_Name» ("Mr. «L_Name»" or the "Employee").

WITNESSETH THAT:

WHEREAS, the Company pursuant to the Graco Inc. Amended and Restated Stock Incentive Plan (2006) (the "Plan") wishes to grant this stock option to Employee;

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

1. Grant of Option

The Company grants to Employee, the right and option (the “Option”) to purchase all or any part of an aggregate of «Words» («Number») shares of Common Stock of the Company, par value USD 1.00 per share, at the price of USD «Price» per share on the terms and conditions set forth in this Agreement. The date of grant of the Option is «Date» (the “Date of Grant”).

2. Duration and Exercisability

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

Vesting Schedule

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

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

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

3. Effect of Termination of Employment

- A. If Employee’s employment terminates for any reason other than Employee’s gross and willful misconduct, death, retirement (as defined in Section 3D), or disability (as defined in Section 3D), Employee shall have the right to exercise that portion of the Option exercisable upon the date of termination of employment at any time within the period beginning on the day after termination of employment and ending at the close of trading on the Exchange thirty (30) days later.
- B. If Employee’s employment terminates by reason of Employee’s gross and willful misconduct during employment, including, but not limited to, wrongful appropriation of Company funds, serious violations of Company policy, breach of fiduciary duty or the conviction of a felony, the unexercised portion of the Option shall terminate as of the time of the misconduct. If the Company determines subsequent to the termination of Employee’s employment for whatever reason, that Employee engaged in conduct during employment that would constitute gross and willful misconduct justifying termination, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Company thereafter determines that Employee engaged in gross and willful misconduct during employment which would have justified termination at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise. Gross and willful misconduct shall not include any action or inaction by Mr. Roberts contrary to the direction of the Board with respect to any initiative, strategy or action of the Company, which action or inaction Mr. Roberts believes is in the best interest of the Company.
- C. If Employee shall die while employed by the Company or an affiliate or within thirty (30) days after a termination of employment which meets the criteria of Section 3A, and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of Employee’s estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining shares at any time during a period beginning on the day after the date of Employee’s death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.
- D. If Employee’s termination of employment is due to retirement or disability, all shares remaining under the Option shall become immediately exercisable. Employee shall be deemed to have retired if the termination of employment occurs for reasons other than the Employee’s gross and willful misconduct, death, or disability after Employee (i) has attained age 55 and 10 years of service with the Company or an affiliate, or (ii) has attained age 65. Employee shall be deemed to be disabled if the termination of employment occurs because Employee is unable to work due to an impairment which would qualify as a disability under the Company’s long term disability program. Employee may exercise the shares remaining unexercised at any time during a period beginning on the day after the date of Employee’s termination of employment and ending at the close of trading on the Exchange on the tenth anniversary of the Date of Grant. If Employee should die during the period between the date of Employee’s retirement or disability and the expiration of the Option, the executor(s) or administrator(s) of the Employee’s estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent may exercise the unexercised portion of the Option at any time during a period beginning the day after the date of Employee’s death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later, provided, however, in no event shall the Option be exercisable following the tenth anniversary of the Date of Grant. Notwithstanding anything to the contrary contained in Section 3, if the Employee’s employment is terminated by retirement (as defined in this Section 3D) and Employee has not given written notice to the Chair of the Management Organization and Compensation Committee of the Board of Directors (the “Committee”), of Employee’s intention to retire not less than six (6) months prior to the date of his retirement, then in such event, for purposes of this Agreement only, said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3A, *provided, however*, that in the event that the Committee determines that said termination of employment without six

(6) months prior written notice is in the best interests of the Company, such termination shall be deemed to be a retirement and shall be subject to this Section 3D.

- E. If the Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased optionee, the Company shall be under no obligation to issue stock hereunder unless and until the Company is satisfied that the person(s) exercising the Option is the duly appointed legal representative of the deceased optionee's estate or the proper legatee or distributee thereof.
- F. For purposes of this Section 3, if the last day of the relevant period is a day upon which the Exchange is not open for trading or the Common Stock is not trading on that day, the relevant period will expire at the close of trading on such earlier business day on which the Exchange is open and the Common Stock is trading.

4. Manner of Exercise

- A. Employee or other proper party may exercise the Option only by delivering within the term of the Option written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the Option is being exercised and, except as provided in Sections 4B(2) and 4C, accompanied by payment-in-full of the Option price for all shares designated in the notice.
- B. The Employee may, at Employee's election, pay the Option price as follows:
 - (1) by cash or check (bank check, certified check, or personal check)
 - (2) by delivering to the Company for cancellation, shares of Common Stock of the Company which have been held by the Employee for not less than six (6) months with a fair market value equal to the Option price.

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

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

5. Payment of Withholding Taxes

Upon exercise of any portion of this Option, Employee shall pay to the Company an amount sufficient to satisfy any federal, state, or local withholding tax requirements which arise as a result of the exercise of the Option or provide the Company with satisfactory indemnification for such payment. Employee may pay such amount by delivering to the Company for cancellation shares of Common Stock of the Company with a fair market value equal to the minimum amount of such withholding tax requirement by (i) electing to have the Company withhold shares otherwise to be delivered with a fair market value equal to the minimum statutory amount of such taxes required to be withheld by the Company, or (ii) electing to surrender to the Company previously owned shares with a fair market value equal to the amount of such minimum tax obligation.

6. Change of Control

- A. Notwithstanding Section 2A hereof, the entire Option shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:
 - (1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
 - (a) the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or
 - (b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

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

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 6, a Trust Person shall not be deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Employee or any group that includes the Employee, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of Section 6A(4); and

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

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or
- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
 - (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of Common Stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets, either directly or through one or more subsidiaries), in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,
 - (b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of Common Stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and
 - (c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial Agreement, or of the action of the Board, providing for such Business Combination; or
- (5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

B. A Change of Control shall not be deemed to have occurred with respect to an Employee if:

- (1) the acquisition of the 25% or greater interest referred to in Section 6A(1) is by a group, acting in concert, that includes the Employee or
- (2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding Company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in Sections 6A(4) or 6A(5) by a group, acting in concert, that includes that Employee.

7. Adjustments

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

8. Miscellaneous

- A. This Option is issued pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. This Agreement shall not confer on Employee any right with respect to continuance of employment by the Company or any of its subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time.

- C. Neither Employee, the Employee's legal representative, nor the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.
- D. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- E. The internal law, and not the law of conflicts of the State of Minnesota shall govern all questions concerning the validity, construction and effect of this Agreement, the Plan and any rules and regulations relating to the Plan or this Option.
- F. Employee hereby consents to the transfer to his employer or the Company of information relating to his/her participation in the Plan, including the personal data set forth in this Agreement, between them or to other related parties in the United States or elsewhere, or to any financial institution or other third party engaged by the Company, but solely for the purpose of administering the Plan and this Option. Employee also consents to the storage and processing of such data by such persons for this purpose.

IN WITNESS WHEREOF, the Company, by the Management Organization and Compensation Committee of the Board of Directors, and the Employee have caused this Agreement to be executed and delivered, all as of the day and year first above written.

GRACO INC.
Management Organization and Compensation Committee

By _____
«Chair_Name»
Its Chairman

EMPLOYEE

By _____
«F_Name_MI», «L_Name»

CERTIFICATION

I, David A. Roberts, certify that:

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

Date: April 24, 2007

/s/David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer

CERTIFICATION

I, James A. Graner, certify that:

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

Date: April 24, 2007

/s/James A. Graner

James A. Graner
Chief Financial Officer and Treasurer

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: April 24, 2007

/s/David A. Roberts

David A. Roberts
Chairman, President and Chief Executive Officer

Date: April 24, 2007

/s/James A. Graner

James A. Graner
Chief Financial Officer and Treasurer