

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 28, 2001 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. 001-9249

Graco Inc.

(Exact name of Registrant as specified in its charter)

Minnesota 41-0285640  
(State or other jurisdiction (I.R.S. Employer Identification No.)  
of incorporation or organization)

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 March 8, 2002, 31,533,255 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 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 28,551,784 shares held by non-affiliates of the registrant was approximately \$1.2 billion on March 8, 2002.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on May 7, 2002, are incorporated by reference into Part III, as specifically set forth in said Part III.

GRACO INC.

INDEX TO ANNUAL REPORT

ON FORM 10-K

	Page
Part I	
Item 1 Business.....	3
Item 2 Properties.....	7
Item 3 Legal Proceedings.....	7
Item 4 Submission of Matters to a Vote of Security Holders.....	7
Executive Officers of the Company.....	8
Part II	
Item 5 Market for the Company's Common Stock and Related Shareholder Matters.....	9
Item 6 Selected Financial Data.....	9
Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations.....	10
Item 8 Financial Statements and Supplementary Data.....	15
Item 9 Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.....	32

Part III  
Item 10 Directors and Executive Officers of the Company.....32  
Item 11 Executive Compensation.....32  
Item 12 Security Ownership of Certain Beneficial Owners and Management.....32  
Item 13 Certain Relationships and Related Transactions.....32

Part IV  
Item 14 Exhibits, Financial Statement Schedule, and Reports on Form 8-K....32

Signatures .....34

NOTE: Certain exhibits listed in the Index to Exhibits beginning on page 35, and filed with the Securities and Exchange Commission, have been omitted. Copies of such exhibits may be obtained upon written request directed to:

Treasurer  
Graco Inc.  
P.O. Box 1441  
Minneapolis, Minnesota  
55440-1441

## PART I

### Item 1. Business

#### General Information

Graco Inc. ("Graco" or "the Company") supplies equipment for the management of fluids in both industrial and commercial settings. 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 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 industries. It designs, manufactures and markets products and pre-engineered packages to move, measure, control, dispense and spray a wide variety of fluids and viscous materials.

Among Graco's strategic objectives is that of being the highest quality, lowest cost, most responsive supplier in the world for its principal products. In working to achieve this goal, Graco has organized its manufacturing operations around product-focused factories which contain product-based cells. Graco's strategic objectives include generating at least 30 percent of each year's sales from products introduced in the last three years, generating at least 5 percent of each year's sales from sales in markets entered in the last three years, expanding its distribution network and pursuing strategic acquisitions.

#### Operating Segment Information

Graco's businesses are classified by management into three operating segments: (1) Industrial/Automotive Equipment, (2) Contractor Equipment, and (3) Lubrication Equipment. Financial information concerning these operating segments is set forth in Part II, Item 7, at page 11, and in Note B to the Consolidated Financial Statements.

#### Industrial/Automotive Equipment

Graco's Industrial/Automotive Equipment segment focuses its product design and marketing efforts on four key areas of application: sealants and adhesives, process, liquid finishing and protective coatings. The markets served include automotive assembly and components plants, wood products, rail, marine, aerospace, farm and construction equipment, truck, bus and recreational vehicles, and approximately thirty other industries.

Worldwide, the equipment designed and manufactured by this segment is sold through general and specialized distributors, integrators and robot 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.

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

Important drivers of product development in the Industrial/Automotive segment are the desire by customers to control costs by reducing the amount of material used, the desire to improve quality and increase productivity by automating production processes, and the need to reduce volatile organic compounds ("VOCs") emissions in order to meet environmental 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 2001, Graco introduced the Pro(TM) Xs line of manual and automatic electrostatic spray guns. The Pro Xs, which replaces Graco's existing line of electrostatic guns, provides a better finish and has a lighter-weight body with more durable components and an ergonomically designed handle for better operator comfort. In addition, this new line offers more models in a broader price range.

The PrecisionFlo XL(TM), a lower-priced electronically-controlled fluid metering system targeted at sealants and adhesives applications, was introduced in 2001. This system provides more precise control of fluid delivery, thereby reducing material consumption and improving quality.

The Triton(TM) 308 spray package was introduced in 2001 for the finishing of wood and metal parts. It contains an air-operated diaphragm pump and versatile spray gun which can be used in air spray and high volume-low pressure ("HVLP") applications. This pump delivers a consistent spray pattern and provides an effective alternative to traditional pressure pots and standard diaphragm pumps. The Triton package allows Graco to expand its product offering to the low end of this market.

Graco's product offering to the protective coatings markets was improved with the introduction of Xtreme(TM) pump lowers. These lowers contain features which make them much easier to maintain: a quick disconnect coupler, which permits quick and easy disconnect of the air motor rod from the pump rod without tools, and a QuikAccess(TM) intake, which allows quick on-the-job maintenance using only a hammer. The life of the pumps has been substantially extended by the

addition of PlasmaCoat(TM) rods and XtremeSeal(TM) packings, which allow the pump to handle a wide variety of materials.

In late summer 2001, most Industrial/Automotive manufacturing and distribution functions were consolidated on the Minneapolis campus as recently expanded space in the Riverside Plant became available. This move allowed the Company to more closely align its Industrial/Automotive distribution and manufacturing operations. Spray guns for Industrial/Automotive will continue to be manufactured in Sioux Falls, South Dakota.

Graco will close its manufacturing facility in Bielefeld, Germany by mid-year 2002. Some product lines manufactured there will be discontinued and the rest will be transferred to the manufacturing facilities in Minneapolis, Minnesota.

In December 2000, Graco received TE 9000 certification. Automotive manufacturers established the TE 9000 supplement to ISO 9000 in the mid-1990's, to ensure that the machine tools they buy would perform as required. In order to obtain TE 9000 certification, suppliers must demonstrate that they are pursuing a plan that will meet customer requirements for product quality, reliability, maintainability and durability. Certification allows Graco to maintain its preferred business association with these customers.

Products. Products offered by the Industrial/Automotive segment include air, electric and hydraulic-powered pumps that pressurize and transfer paints, stains, chemicals, sealants, adhesives, food, and other viscous materials through various application devices, including air, airless, air-assisted airless, electrostatic, and HVLP spray guns. Fluid pressures ranging from 20 to more than 6,000 pounds per square inch and flow rates from under 1 gallon 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, are also offered.

#### Contractor Equipment

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

The equipment is sold primarily through retail stores which sell paint and other coatings, and secondarily through general equipment distributors. In 2000, Graco began marketing a limited line of sprayers through the home center channel. In 2001, sales to Home Depot, a home center retailer, totaled 11% of the Company's consolidated sales. Manufacturers' representatives are used to sell the ASM product line to general distribution and Graco-branded equipment to the rental market.

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

Recent Developments. In March 2001, Graco acquired the stock of ASM Company, Inc., a manufacturer and marketer of spray tips, guns, poles and other accessories for the professional painter, with its principal place of business in Orange, California. This acquisition brought Graco an expanded presence in the home center, hardware and rental markets. ASM operations were moved to Graco's South Dakota manufacturing facility over the balance of the year. Production in southern California ceased in November. Graco will continue to offer ASM products and has added several electric paint sprayers and pressure washers to the line since the acquisition. Manufacturers' representatives are used to sell the ASM line to the market.

In late summer 2001, the division expanded its presence in Rogers, Minnesota to include the entire facility as Industrial/Automotive manufacturing and distribution functions were moved to the newly expanded Riverside Plant in Minneapolis.

In 2001, Graco introduced the Ultra(R) Max, an upgraded Ultra(R) sprayer, and standardized construction across all models in the Ultra line. This sprayer line now has an interactive digital display on the SmartControl(TM) microprocessor which contains a pressure monitor, gallon counter, AutoClean(TM) Shut-off Timer and diagnostics. The AutoClean system stops the sprayer automatically after the system is cleaned by reverse flushing.

A new line of gas hydraulic airless sprayers called the HydraMax(TM) was released in 2001. These sprayers, with an advanced design hydraulic motor, are designed to outperform the competition by offering the painter maximum pressure output, maximum tip size supported, maximum delivery rating and better control of pressure, all resulting in improved quality and productivity. The HydraMax contains a number of innovative features, including a digital tracking system and easy-to- remove parts for quick cleaning.

The LineDriver(TM), introduced in 2001, is an innovative motorized ride-on accessory, that connects to a line striper and reduces operator fatigue, improves quality and allows a painter to increase speed and change directions instantly.

In 2001, the Magnum(TM) line of airless sprayers, which is sold primarily through the home center channel, was extended by adding a new lower-priced product called the Magnum DX. The Magnum DX, a light-weight compact, low-flow piston pump, is targeted at the handyman who needs an airless sprayer for periodic use.

Products. The segment's primary product lines are airless paint sprayers and associated accessories such as 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. 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 and gasoline are available. HVLP equipment provides the ability to spray with reduced overspray, a benefit where regulation of volatile emissions has increased. Replacement and maintenance parts, such as packings, seals and hoses, which must be replaced periodically in order to maintain efficiency and prevent loss of material, are also offered for sale.

#### Lubrication Equipment

The 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, the mining industry, and industrial lubrication. The purchase of vehicle lubrication equipment is often funded by major oil companies for their customers as a marketing tool.

Products are distributed primarily through independent distributors worldwide, which 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. During 2001, the division outfitted Sears Auto Centers in the United States with oil change packages containing pumps, meters, oil tanks and used oil reservoirs, and supplied lubrication equipment to Wal-Mart Tire & Lube Express for pumping oil, gear lube, grease, and used oil.

Graco supplied an Australian distributor with equipment to configure a mobile lubrication skid for the Australian army. This skid can be transported to remote areas and is used to lubricate trucks, tanks and other vehicles.

Products. 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.

#### Marketing and Distribution

Graco sells its full line of products in each of the following major geographic markets: the Americas (North, Central 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 sells its equipment worldwide principally through independent distributors. In Japan, Korea, and Europe, Graco equipment is sold to distributors through sales subsidiaries. Manufacturers' representatives are used in the Lubrication Equipment and the Contractor Equipment segments.

It is the Company's goal to generate at least 5 percent of each year's revenues from sales in markets entered in the last three years. The home center channel, into which the Contractor Equipment Division introduced the Magnum line of airless sprayers in 2000, is an example of the Company's efforts to reach this goal.

In 2001, Graco's net sales in the Americas were \$341.0 million or approximately 72 percent of the Company's consolidated net sales; in Europe net sales were \$82.4 million or approximately 17 percent; and in the Asia Pacific Region, net sales were \$49.4 million or approximately 11 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. In each of the last three years, the Company achieved its goal of generating at least 30 percent of each year's sales from products introduced in the prior three years. All major research and development activities are conducted in facilities located in Minneapolis, and Rogers, Minnesota. Total research and development expenditures were \$20.8 million, \$20.0 million and \$19.7 million for 2001, 2000 and 1999 respectively.

#### Intellectual Property

Graco owns a number of patents and has patent applications pending both in the United States and in foreign 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. 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 faces competitors with different cost structures and expectations of

profitability. Graco believes it is one of the world's leading producers of high-quality specialized fluid management equipment. It is impossible 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 28, 2001.

#### Employees

As of December 28, 2001, the Company employed approximately 1850 persons on a full-time basis. Of this total, approximately 280 were employees based outside the United States, and 800 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.

#### Item 2. Properties

As of December 28, 2001, the Company's principal operations that occupy more than 10,000 square feet were conducted in the following facilities:

Type of Facility -----	Location -----	Gross Square Footage -----
Owned -----		
Manufacturing/Warehouse/Office	Minneapolis, Minnesota	405,000
Manufacturing/Warehouse/ CED R&D and Marketing	Rogers, Minnesota	333,000
Manufacturing/Office	Minneapolis, Minnesota	202,000
Corporate Headquarters/Lube and Industrial/Automotive R&D and Marketing	Minneapolis, Minnesota	139,000
Manufacturing/Office	Sioux Falls, South Dakota	127,000
European Headquarters/Warehouse	Maasmechelen, Belgium	75,000
Leased -----		
Manufacturing/Office	Bielefeld, Germany	69,000
Office/Warehouse	Yokohama, Japan (2 facilities)	33,000
Office	Plymouth, Michigan	21,000
Office/Warehouse	Gwangju-Gun, Korea (2 facilities)	11,000

During 2001, a 163,000 square foot addition to one of the Company's plants in Minneapolis was completed. This addition permitted the Company to move all Industrial/Automotive and Lubrication distribution operations and some manufacturing production out of the Rogers, Minnesota facility, leaving room for the expansion of manufacturing capability for the Contractor Equipment segment in Rogers.

A 72,000 square foot addition to the Sioux Falls, South Dakota facility was completed during 2001. Part of this space is being used to house the ASM operations that were moved from Orange, California during the latter part of the year. Leases on the two facilities in Orange, California vacated by ASM will expire late in 2002. Subtenants are being sought for this space.

Manufacturing operations in Bielefeld, Germany will cease as of the end of June 2002, although the lease for the facility runs through the end of the year. The Company is looking for subtenants for the remainder of the year.

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

With the expansion of its plant in Sioux Falls, South Dakota and one of its buildings in Minneapolis, Graco's facilities are in satisfactory condition, suitable for their respective uses and are sufficient and adequate to meet current needs. The Company's Main Plant manufacturing/office facility in Minneapolis, while functional, is an older structure and management is reviewing alternatives. Manufacturing capacity exceeded business demand in 2001. Production requirements in the immediate future are expected to be met through existing production capabilities, efficiency and productivity improvements, and the use of available subcontract services.

#### 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.

#### 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 2001.

Executive Officers of the Company

The following are all the executive officers of the Company as of March 8, 2002.

David A. Roberts, 54, is President and Chief Executive Officer of the Company, a position he has held since June 25, 2001. Prior to joining Graco, from 1996 to 2001 he was Group Vice President of the Marmon Group, where Mr. Roberts had responsibility for a group of companies with approximately \$600 million in revenue and products including grocery store refrigeration, retail store fixtures and fast food restaurant equipment. Mr. Roberts has been a director of Graco since June 2001.

Stephen L. Bauman, 49, was elected Vice President, Human Resources, effective October 25, 2000. Prior to joining Graco in 2000, he held various positions with Alliant Techsystems, Inc. most recently as Vice President of Human Resources, Alliant Integrated Defense Company, a subsidiary.

James A. Graner, 57, was elected Vice President and Controller in February 1994. He was Treasurer from May 1993 to February 1994. Prior to becoming Treasurer, he held various managerial positions in treasury, accounting and information systems departments. He joined the Company in 1974.

Dale D. Johnson, 47, was appointed Vice President, Contractor Equipment Division on March 19, 2001. From January 14, 2000 to March 18, 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, 37, was appointed Vice President, Lubrication Equipment Division effective February 15, 2000. 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. Prior to joining the Company in December 1998, he was employed by H.B. Fuller Company, where he held various positions, including President and Division Manager of TEC Incorporated and Vice President and Business Unit Manager of Foster Products Corporation. (Mr. Koch is not related to David A. Koch, Chairman Emeritus.)

David M. Lowe, 46, became Vice President and General Manager, European Operations effective September 1, 1999. Mr. Lowe was Vice President, Lubrication Equipment Division from December 1996 to September 1999. From February 1995 to December 1996 he was Treasurer. He joined the Company in 1995.

Robert M. Mattison, 54, was first elected Vice President, General Counsel and Secretary, in January 1992, a position which he holds today. He joined the Company in 1992.

Patrick J. McHale, 40, was appointed Vice President of Manufacturing effective March 19, 2001. From February 2000 to March 2001 he served as Vice President, Contractor Equipment Division. Mr. McHale was Vice President, Lubrication Equipment Division from September 1999 to February 2000. He was Contractor Equipment Manufacturing - Distribution Operations Manager from February 1998 to September 1999. From March 1997 to February 1998 he was Director of Michigan Operations. From February 1996 to March 1997 he was Contractor Equipment Manufacturing Operations Manager and from January 1994 to February 1996 he was the Sioux Falls Plant Manager. Mr. McHale joined the Company in 1989.

Charles L. Rescorla, 50, was appointed Vice President of the Industrial/Automotive Equipment Division effective March 19, 2001. From January 1995 through March 2001 he served as Vice President, Manufacturing and Distribution Operations. Prior to becoming the Director of Manufacturing in March 1994, he was the Director of Engineering, Industrial/Automotive Division, a position which he assumed in 1988 when he joined the Company.

Mark W. Sheahan, 37, was elected Vice President and Treasurer on December 11, 1998. Effective December 17, 1996, he was elected Treasurer. He joined the Company in 1995.

Fred A. Sutter, 41, was appointed Vice President, Asia Pacific and Latin America effective March 1, 1999. From March 1995 to February 28, 1999 he was Director of Industrial Marketing. He joined the Company in 1995.

The Board of Directors elected Messrs. Bauman, Graner, Johnson, Koch, Lowe, Mattison, McHale, Rescorla, Sutter, and Sheahan on May 1, 2001, all to hold office until the next annual meeting of directors or until their successors are elected and qualify.

## PART II

### Item 5. Market for the Company's Common Stock and Related Shareholder Matters

Graco Common Stock. Graco common stock is traded on the New York Stock Exchange under the ticker symbol "GGG." As of March 8, 2002, the share price was \$ 41.55 and there were 31,533,255 shares outstanding and 2,600 common shareholders of record, which includes nominees or broker dealers holding stock on behalf of an estimated 5,600 beneficial owners.

#### Quarterly Financial Information (In thousands, except per share amounts)

2001	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	\$109,814	\$130,873	\$118,651	\$113,481
Gross profit	55,138	64,253	59,156	56,215
Net earnings	13,120	18,248	16,760	17,138
Per common share:				

Basic net earnings	0.43	0.59	0.54	0.55
Diluted net earnings	0.42	0.58	0.53	0.54
Dividends declared	0.10	0.10	0.10	0.11
-----				
Stock price (per share)				
High	\$ 29.25	\$ 33.00	\$ 35.26	\$ 39.05
Low	24.35	26.22	28.00	28.89
Close*	28.00	33.00	30.20	39.05
-----				
Volume (# of shares)	2,957	4,143	3,056	4,448
-----				
	First	Second	Third	Fourth
2000	Quarter	Quarter	Quarter	Quarter
-----				
Net sales	\$122,227	\$132,768	\$123,100	\$116,278
Gross profit	62,129	66,102	62,949	59,672
Net earnings	14,975	18,331	18,073	18,729
Per common share:				
Basic net earnings	0.49	0.60	0.60	0.62
Diluted net earnings	0.48	0.59	0.59	0.61
Dividends declared	0.09	0.09	0.09	0.10
-----				
Stock price (per share)				
High	\$ 22.75	\$ 23.33	\$ 23.92	\$ 27.67
Low	19.33	20.00	20.42	20.13
Close*	19.33	21.67	21.67	27.59
-----				
Volume (# of shares)	4,532	4,880	2,223	2,904
-----				

\* As of the last trading day of the calendar quarter.

#### Item 6. Selected Financial Data

Graco Inc. & Subsidiaries					
(In thousands, except per share amounts)	2001	2000	1999	1998	1997
-----					
Net sales	\$472,819	\$494,373	\$450,474	\$440,585	\$423,897
Net earnings	65,266	70,108	59,341	47,263	44,716
=====					
Per common share:					
Basic net earnings	\$ 2.11	\$ 2.31	\$ 1.95	\$ 1.37	\$ 1.17
Diluted net earnings	2.07	2.27	1.90	1.34	1.14
-----					
Total assets	\$276,113	\$238,544	\$236,033	\$233,702	\$264,532
Long-term debt (including current portion)	550	19,360	66,910	115,739	7,959
Cash dividends declared per common share	0.41	0.38	0.31	0.29	0.25
=====					

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

##### MANAGEMENT'S REVIEW AND DISCUSSION

##### 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.

The table below reflects sales by segment and geography for the three most recent fiscal years and the percentage changes in those sales for such years.

(In millions)	2001	2000	1999	% Increase (Decrease)	
				2001	2000
-----					
Segment Sales:					
Industrial/Automotive Equipment	\$199.5	\$228.0	\$227.8	(12)	--
Contractor Equipment	225.1	221.5	178.6	2	24
Lubrication Equipment	48.2	44.9	44.1	7	2
-----					
Consolidated	\$472.8	\$494.4	\$450.5	(4)	10
=====					
Geographic Sales:					
Americas	\$341.0	\$359.9	\$313.9	(5)	15
Europe	82.4	84.7	90.1	(3)	(6)
Asia Pacific	49.4	49.8	46.5	(1)	7
-----					
Consolidated	\$472.8	\$494.4	\$450.5	(4)	10
=====					

The table below reflects the percentage relationship between income and expense items included in the Consolidated Statements of Earnings for the three most recent fiscal years and the percentage changes in those items for such years.



	2001	2000	1999	2001	2000
Net Sales	100.0	100.0	100.0	(4)	10
Cost of products sold	50.3	49.3	48.7	(2)	11
Product development	4.5	4.0	4.4	4	2
Selling, marketing and distribution	17.0	17.5	17.7	(7)	8
General and administrative	7.0	6.7	8.5	1	(14)
Operating profit	21.2	22.5	20.7	(10)	19
Interest expense	0.3	0.8	1.6	(70)	(41)
Other expense (income), net	0.3	0.3	(0.6)	22	*
Earnings before income taxes	20.6	21.4	19.7	(8)	19
Income taxes	6.8	7.2	6.5	(10)	21
Net Earnings	13.8	14.2	13.2	(7)	18

\* Not a meaningful figure.

2001 Compared to 2000. The Company reported net sales in 2001 of \$472.8 million, a decrease of 4 percent from the prior year. The decline in sales for 2001 was the result of poor economic conditions in North America. This had an adverse impact on the Industrial/Automotive Equipment segment, whose worldwide sales of \$199.5 million were 12 percent lower than last year. The Contractor Equipment segment reported sales of \$225.1 million, a 2 percent increase over last year. This increase was due to a strong North American housing market despite the general economic downturn, the acquisition of ASM Company, Inc., and new product introductions. Sales for the Lubrication Equipment segment were \$48.2 million, up 7 percent over last year. This increase was due to gaining market share in a mature North American market, particularly with two large customers. Consolidated backlog at year-end 2001 was the same as last year at \$12 million. The Company's backlog is typically small and is not a good indicator of future business levels.

Sales outside of the Americas represented 28 percent of total sales in 2001, up from 27 percent in 2000. In the Americas, sales were \$341.0 million, a decrease of 5 percent from last year. European sales decreased 3 percent to \$82.4 million and Asia Pacific sales were \$49.4 million, a 1 percent decrease from last year. The decrease in the Americas sales was primarily due to poor economic conditions that resulted in lower sales for the Industrial/Automotive Equipment segment. When compared to 2000 exchange rates, 2001 exchange rates had a \$7 million negative impact on 2001 sales. Measured in local currencies, European sales were flat compared to last year while Asia Pacific sales were 6 percent higher.

The gross profit margin of 49.7 percent for 2001 decreased 1.0 percentage point from the prior year. This reduction resulted from lower sales of Industrial/Automotive products, product mix that included a greater percentage of sales from lower duty paint sprayers, lower production levels and the negative impact of exchange rates. The reduction was partially offset by a \$1.6 million favorable impact from liquidation of LIFO inventory quantities carried at lower costs from prior years.

Operating expense was down 4 percent from the prior year. Lower selling and marketing expenses, reflecting lower sales results in 2001, were responsible for the decline, while product development and general and administrative expenses increased slightly versus last year. As a percentage of sales, operating expense was 28.5 percent, up slightly from last year's 28.2 percent. The Company aggressively managed operating expense throughout the year to more closely match spending with sales. In particular, the rate of product development spending declined in the second half of the year as a result of management actions.

The Company recorded pension income of \$2.6 million in 2001 versus \$3.8 million in 2000. These amounts resulted from recognition of investment gains attributable to pension plan assets. Pension expense/income is recorded in cost of products sold and operating expense based on salaries and wages.

Operating earnings in 2001 decreased \$11.1 million, or 10 percent, from the prior year. This was a result of several factors, including lower sales in the Industrial/Automotive segment, restructuring charges and adverse exchange rates. By segment, before unallocated corporate expense, operating earnings for the Industrial/Automotive Equipment segment decreased 16 percent, and declined slightly as a percentage of sales due to the fixed nature of some expenses and higher product development spending. Contractor Equipment segment operating earnings decreased 1 percent and declined slightly as a percentage of sales. The decline in profitability was primarily due to the mixture of products sold, including a greater percentage of sales from lower duty paint sprayers, as well as increased selling, general and administrative spending. Operating earnings for the Lubrication Equipment segment increased 14 percent and increased by 1.5 percentage points as a percent of sales. This improvement was due to higher sales revenues and disciplined spending. 2001 operating earnings include restructuring costs totaling approximately \$1.4 million before income taxes. These restructuring costs are related to closing a facility and relocating production to Maasmechelen, Belgium and Minneapolis, MN. The costs are for items such as severance, lease termination and legal fees.

Approximately 27 percent of the Company's sales in 2001, and 4 percent of its product costs are in currencies other than the U.S. dollar. The strong U.S. dollar in 2001 versus currencies in Europe and Asia reduced the Company's net earnings by approximately \$3 million.

Interest expense in 2001 was \$1.2 million versus \$4.1 million in 2000. This decrease was primarily the result of reductions in debt from the prior year. In 2001, other expense was \$1.5 million compared to \$1.2 million in 2000. Other

expense (income) includes, among other things, cash discounts, foreign currency translation gains/losses and gains/losses from the sale of fixed assets. Other expense in 2000 includes a \$2.2 million gain from the sale of the Company's former headquarters building in Golden Valley, MN. Foreign currency translation losses decreased by \$1.5 million in 2001.

The Company's net effective tax rate of 33 percent in 2001 and 34 percent in 2000 is 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.

2000 Compared to 1999. The Company reached record sales of \$494.4 million in 2000, a 10 percent increase over 1999. By segment, Contractor Equipment net sales increased by 24 percent to \$221.5 million. Net sales in the Lubrication Equipment segment rose by 2 percent to \$44.9 million. Net sales in Industrial/Automotive Equipment were \$228.0 million, which was virtually flat versus 1999. The large sales increase in the Contractor Equipment segment was due primarily to the introduction of a new line of lower duty paint sprayers sold mainly through the home center channel. After experiencing sales growth in the first half of the year, the Industrial/Automotive Equipment segment sales declined in the second half of the year due to a slowing North American economy. Lubrication Equipment sales were relatively flat versus 1999, in a market that is mature and well served. Consolidated total backlog at the end of 2000 was \$12 million versus backlog at the end of 1999 of \$21 million. The decrease in the 2000 backlog reflected a return to normal order levels from the large backlog that resulted from orders in later 1999 for the home center channel products that were shipped in the first quarter of 2000.

Sales outside of the Americas represented 27 percent of total sales in 2000, down from 30 percent in 1999. In the Americas sales were \$359.9 million, an increase of 15 percent from 1999. European sales decreased 6 percent to \$84.7 million and Asia Pacific sales increased 7 percent to \$49.8 million. The increase in the Americas was primarily due to strong sales of a new product line for the Contractor Equipment segment sold through the home center channel. Overall, when compared to 1999 exchange rates, 2000 exchange rates had a \$9 million negative impact on 2000 sales. Measured in local currencies, sales in Europe increased by 6 percent over the prior year while sales in the Asia Pacific Region increased 3 percent.

Gross profit margin, expressed as a percentage of sales, was 50.7 percent in 2000 compared with 51.3 percent in 1999. The effects of higher production levels, enhanced pricing and improved manufacturing efficiencies were offset by the mix of products sold, including sales of new home center products, and the negative impact of foreign exchange rates.

Operating expenses, expressed as a percentage of net sales, decreased 2.4 percentage points in 2000 versus 1999. Product development expense was \$20.0 million in 2000 versus \$19.7 million in 1999. Selling, marketing, distribution and general and administrative expenses were higher in 2000 due to higher sales, but decreased as a percentage of sales to 24.2 percent in 2000 from 26.2 percent in 1999. In 2000, selling, marketing and distribution expenses were higher than in 1999 due to higher sales and expenses related to the launch of the home center products. General and administrative expenses were lower than in 1999 due to corporate expense reduction initiatives and lower information systems expenditures.

Operating earnings increased by \$18.1 million in 2000 as a result of several factors, including higher sales, expense reduction initiatives and improved manufacturing efficiencies. By segment, before unallocated corporate expense, operating earnings for Industrial/Automotive increased by 20.1 percent versus 1999 and by 4.3 percentage points as a percentage of net sales primarily as a result of improved gross margin rates along with lower product development, marketing and sales-related expenses. Contractor Equipment operating profit increased by 14.9 percent over the prior year but decreased 1.8 percentage points as a percentage of net sales due to the mixture of products sold. Lubrication Equipment operating profit increased by 2.8 percent versus 1999 and increased by 0.2 percentage points as a percent of net sales.

Approximately 27 percent of the Company's sales in 2000 and 5 percent of its product costs were in currencies other than the U.S. dollar. The strong U.S. dollar versus currencies in Europe reduced the Company's net earnings by approximately \$3 million in 2000.

In 2000, interest expense decreased to \$4.1 million from \$7.0 million in 1999. The decrease was due to the significant reduction in borrowings throughout the year. Other expense, net of other income, was \$1.2 million in 2000 compared to other income of \$2.6 million in 1999. In 2000, other expense included \$1.6 million of foreign currency translation losses. In addition, other expense (income) included gains from property sales of \$2.2 million and \$3.2 million in 2000 and 1999, respectively.

The Company's net effective income tax rate of 34 percent in 2000 and 33 percent in 1999 was lower than the U.S. federal tax rate of 35 percent due primarily to earnings from sales outside the U.S. being taxed at rates lower than the federal statutory rate.

#### Liquidity and Capital Resources

The following table highlights several key measures of asset performance.

(In thousands)	2001	2000
Cash and cash equivalents	\$26,531	\$11,071
Working capital	\$82,244	\$61,901
Current ratio	2.1	1.8
Average days receivables outstanding	66	63
Inventory turnover	7.8	7.4

Working capital increased \$20.3 million, in 2001, to \$82.2 million. As a result of strong cash flow from operations, the Company reduced its total debt by \$25.0 million in 2001. Total debt at the end of 2001 was \$10.1 million. Inventories decreased \$2.7 million in 2001, compared to 2000, primarily as a result of inventory reduction initiatives in response to lower sales volumes.

Cash provided by operations was \$89.2 million in 2001, versus \$82.2 million in 2000. Significant uses of cash in 2001 included capital expenditures with two plant expansions totaling \$18.0 million, the acquisition of the ASM Company, Inc. for \$15.9 million, dividends, share repurchases and the retirement of debt. Significant uses of cash in 2000 included the retirement of debt, capital expenditures, dividends and share repurchases.

At year-end 2001 the Company's capital structure included \$10.6 million of short-term debt, no long-term debt and \$173.7 million of shareholders' equity. The ratio of total debt to total capital decreased to 5 percent at the end of 2001 from 24 percent at the end of 2000. The decrease was a result of the elimination of all long-term debt in 2001 through continued strong cash flow from operations.

At December 28, 2001, Graco had various lines of credit totaling \$74 million, of which \$68 million was unused. The Company believes that the combination of present capital resources, internally generated funds and unused financing sources are adequate to meet cash requirements for 2002.

In addition to the commitments described in Note K to the Consolidated Financial Statements, the Company could be required to perform under standby letters of credit totaling \$3.6 million at December 28, 2001. The Company has also guaranteed the debt of its subsidiaries for up to \$14.9 million.

#### Shareholder Actions

Periodically, the Company initiates measures aimed at enhancing shareholder value, broadening common stock ownership, improving the liquidity of its common shares and effectively managing its cash balances. A summary of recent actions follows:

- o a ten percent increase in the regular dividend in 2002;
- o a seven percent increase in the regular dividend in 2001;
- o a 27 percent increase in the regular dividend in 2000;
- o three-for-two stock splits in 2001, 1998 and 1996;
- o repurchase of 5.8 million shares in 1998

#### Critical Accounting Policies

The Company believes that the selection and application of its accounting policies are appropriately reasoned. The following are the accounting policies that management believes require the most difficult, subjective or complex judgments about matters that are inherently uncertain.

**Sales Returns.** An allowance is established for expenses and losses related to possible returns of products. The amount of the allowance is based on historical ratios of returns to sales, the historical average length of time between the sale and the return and other factors. 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.

**Warranty Claims.** A liability is established for estimated warranty claims to be paid in the future that relate to current and prior period sales. The amount of the warranty liability is based on historical ratios of warranty claims to sales, the historical average length of time between a sale and the resulting warranty claim and other factors. 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.

**Inventory Valuation.** A reserve is established for estimated surplus and discontinued inventory items. The amount of the reserve is determined by analyzing historical and projected sales information, plans for discontinued products and other factors. 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.

**Doubtful Accounts Receivable.** An allowance is established for estimated uncollectible accounts receivable. The required allowance is determined by reviewing customer accounts and making estimates of the amounts that may be uncollectible. Factors considered in determining the amount of the reserve include the age of the receivable, the financial condition of the customer, general business, economic and political conditions, and other relevant facts and circumstances. Unexpected changes in the aforementioned factors would result in materially different amounts for this item.

**Product Liability.** The Company carries third-party insurance for what it believes to be a substantial amount of potential product liability exposures. The Company has established a liability for potential uninsured claims. The Company employs a third-party to evaluate 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 liability. A substantial change in the number and/or severity of claims would result in materially different amounts for this item.

#### Accounting Changes

In 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets", which is effective for the Company at the beginning of 2002. Upon adoption of SFAS No. 142, the Company will stop amortization of goodwill, which would have

been \$900,000 of general and administrative expense in 2002. Results of initial goodwill impairment testing indicate no impairment.

See Note A to Consolidated Financial Statements for discussion of other recent and pending accounting changes that were not, or are not expected to be significant to the Company's financial position or operating results.

#### Quantitative and Qualitative Disclosure About Market Risk

Graco 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.

Graco uses foreign exchange contracts to reduce risks associated with foreign currency net monetary asset and liability positions. These contracts typically have maturities of 90 days or less, and gains or losses from changes in market value of these contracts offset foreign exchange gains and losses on the underlying balance sheet items. At December 28, 2001, the foreign currencies to which the Company had the most significant balance sheet exchange rate exposure were the European euro, Canadian dollar, Japanese yen, British pound, and Korean won. The Company does not hold or issue derivative financial instruments for trading purposes.

To evaluate its currency exchange rate risks on its foreign exchange contracts, the Company uses sensitivity analysis, which measures the impact on earnings of hypothetical changes in the value of foreign currencies of its monetary assets and liabilities. At December 28, 2001, due to the short-term nature of the Company's hedging instruments, reasonably likely fluctuations in foreign currency exchange rates in the near term would not materially affect Graco's consolidated operating results, financial position or cash flows.

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. The amount of such debt was not significant at December 28, 2001.

For further discussion of the Company's foreign currency hedging strategy and position, see Note A to the Consolidated Financial Statements.

#### Outlook

Management believes that the tough economic environment will continue in 2002. The length and severity of the soft market conditions in North America, and the risk that it will spread, directly impacts the willingness and ability of Graco's customers to purchase its equipment. Sales growth will be difficult as long as the weakness continues in North America, and management is concerned about continued softness in Europe and Japan. Nonetheless, management remains committed to improved profitability while funding the Company's long-term growth strategies of introducing new products, entering new markets, expanding distribution coverage and pursuing strategic acquisitions.

#### Cautionary Statement Regarding 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 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 Exhibit 99 to the Company's Annual Report on Form 10-K for fiscal year 2001 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 may 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	Page
o Selected Quarterly Financial Data (See Part II, Item 5, Market for the Company's Common Stock and Related Shareholder Matters)	9
o Responsibility for Financial Reporting	15
o Independent Auditors' Report	16
o Consolidated Statements of Earnings for fiscal years 2001, 2000 and 1999	17
o Consolidated Balance Sheets for fiscal years 2001 and 2000	18
o Consolidated Statements of Cash Flows for fiscal years 2001, 2000 and 1999	19
o Consolidated Statements of Changes in Shareholders' Equity for fiscal years 2001, 2000 and 1999	20
o Consolidated Statements of Comprehensive Income for fiscal years 2001, 2000 and 1999	20
o Notes to Consolidated Financial Statements	21

## Responsibility for Financial Reporting

Management is responsible for the accuracy, consistency, and integrity of the information presented in this Annual Report on Form 10-K. The consolidated financial statements and financial statement schedule have been prepared in accordance with generally accepted accounting principles and, where necessary, include estimates based upon management's informed judgment.

In meeting this responsibility, management believes that its comprehensive systems of internal control provide reasonable assurance that the Company's assets are safeguarded and transactions are executed and recorded by qualified personnel in accordance with approved procedures. Internal auditors periodically review these accounting and control systems. Deloitte & Touche LLP, independent certified public accountants, are retained to audit the consolidated financial statements and express an opinion thereon. Their opinion is included below.

The Audit Committee of the Board is responsible for providing independent, objective oversight of the Company's accounting functions and internal controls. In performing its oversight function, the Audit Committee has relied upon advice and information which it has received in its discussions with the Company's management and independent auditors.

Independent Auditors' Report

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 28, 2001 and December 29, 2000 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 28, 2001. Our audits also included the financial statement schedule listed in the Index at Item 14. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit 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, such consolidated financial statements present fairly, in all material respects, the financial position of Graco Inc. and Subsidiaries as of December 28, 2001 and December 29, 2000 and the results of their operations and cash flows for each of the three years in the period ended December 28, 2001, 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.

/s/Deloitte & Touche LLP  
Deloitte & Touche LLP  
Minneapolis, Minnesota  
January 21, 2002

CONSOLIDATED STATEMENTS OF EARNINGS

Graco Inc. and Subsidiaries

Years Ended

(In thousands, except per share amounts)

	December 28, 2001	December 29, 2000	December 31, 1999
Net Sales	\$472,819	\$494,373	\$450,474
Cost of products sold	238,057	243,521	219,339
Gross Profit	234,762	250,852	231,135
Product development	20,808	19,998	19,688
Selling, marketing and distribution	80,528	86,598	79,922
General and administrative	33,244	33,014	38,334
Operating Earnings	100,182	111,242	93,191
Interest expense	1,247	4,127	7,016
Other expense (income), net	1,469	1,207	(2,666)
Earnings before Income Taxes	97,466	105,908	88,841
Income taxes	32,200	35,800	29,500
Net Earnings	\$ 65,266	\$ 70,108	\$ 59,341
Basic Net Earnings per Common Share	\$ 2.11	\$ 2.31	\$ 1.95
Diluted Net Earnings per Common Share	\$ 2.07	\$ 2.27	\$ 1.90

See Notes to Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEETS

Graco Inc. and Subsidiaries

(In thousands, except share amounts)

December 28, 2001      December 29, 2000

ASSETS		
Current Assets		
Cash and cash equivalents	\$ 26,531	\$ 11,071
Accounts receivable, less allowances of \$4,500 and \$4,700	85,440	85,836
Inventories	30,333	33,079
Deferred income taxes	11,710	11,574
Other current assets	1,483	2,182
	-----	-----
Total current assets	155,497	143,742
Property, Plant and Equipment, net	98,944	83,989
Intangible Assets, net	14,274	5,576
Other Assets	7,398	5,237
	-----	-----
Total Assets	\$276,113	\$238,544
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable to banks	\$ 9,512	\$ 15,713
Current portion of long-term debt	550	1,310
Trade accounts payable	10,676	12,899
Salaries, wages and commissions	10,620	14,532
Accrued insurance liabilities	10,380	10,622
Accrued warranty and service liabilities	6,091	5,320
Income taxes payable	6,014	4,642
Other current liabilities	19,410	16,803
	-----	-----
Total current liabilities	73,253	81,841
Long-Term Debt, less current portion	--	18,050
Retirement Benefits and Deferred Compensation	27,359	27,230
Deferred Income Taxes	1,761	568
Commitments and Contingencies (Note K)		
Shareholders' Equity		
Common stock, \$1 par value; 45,000,000 shares authorized'		
31,113,144 and 20,273,561 shares outstanding in 2001 and 2002	31,113	20,274
Additional paid-in capital	54,269	39,954
Retained earnings	89,155	50,233
Accumulated comprehensive income (loss) and other	(797)	394
	-----	-----
Total shareholders' equity	173,740	110,855
	-----	-----
Total Liabilities and Shareholders' Equity	\$276,113	\$238,544
	=====	=====

See Notes to Consolidated Financial Statements.



CONSOLIDATED STATEMENTS OF CASH FLOWS

Graco Inc. and Subsidiaries

Years Ended

(In thousands)

	December 28, 2001	December 29, 2000	December 31, 1999
Cash Flows from Operating Activities			
Net earnings	\$ 65,266	\$ 70,108	\$ 59,341
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	18,494	15,452	14,701
Deferred income taxes	762	1,644	1,152
Tax benefit related to stock options exercised	3,365	1,503	1,890
(Gain) loss on sale of fixed assets	424	(1,561)	(2,936)
Change in:			
Accounts receivable	309	(8,287)	2,097
Inventories	5,329	4,161	3,309
Trade accounts payable	(2,402)	(516)	1,551
Salaries, wages and commissions	(4,311)	1,921	(946)
Retirement benefits and deferred compensation	(2,624)	(3,999)	(2,112)
Other accrued liabilities	3,062	1,416	(3,147)
Other	1,507	367	1,248
Net cash provided by operating activities	89,181	82,209	76,148
Cash Flows from Investing Activities			
Property, plant and equipment additions	(30,203)	(14,523)	(9,140)
Proceeds from sale of property, plant and equipment	267	4,845	9,695
Acquisition of business, net of cash acquired	(15,949)	--	(18,388)
Net cash used in investing activities	(45,885)	(9,678)	(17,833)
Cash Flows from (for) Financing Activities			
Borrowing on notes payable and lines of credit	160,274	188,552	118,900
Payments on notes payable and lines of credit	(165,937)	(187,144)	(119,201)
Borrowings on long-term debt	21,000	43,665	25,001
Payments on long-term debt	(39,810)	(91,215)	(73,711)
Common stock issued	11,932	8,127	6,760
Common stock retired	(3,761)	(19,182)	(5,077)
Cash dividends paid	(12,339)	(11,361)	(8,927)
Net cash used in financing activities	(28,641)	(68,558)	(56,255)
Effect of exchange rate changes on cash	805	510	973
Net increase in cash and cash equivalents	15,460	4,483	3,033
Cash and cash equivalents			
Beginning of year	11,071	6,588	3,555
End of year	\$ 26,531	\$ 11,071	\$ 6,588

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

Graco Inc. and Subsidiaries

(In thousands)	Years Ended		
	December 28, 2001	December 29, 2000	December 31, 1999
<b>Common Stock</b>			
Balance, beginning of year	\$ 20,274	\$ 20,416	\$ 20,097
Stock split	10,148	--	--
Shares issued	817	475	466
Shares repurchased	(126)	(617)	(147)
Balance, end of year	31,113	20,274	20,416
<b>Additional Paid-In Capital</b>			
Balance, beginning of year	39,954	31,755	23,892
Shares issued	11,115	7,652	6,294
Tax benefit related to stock options exercised	3,365	1,503	1,890
Shares repurchased	(165)	(956)	(321)
Balance, end of year	54,269	39,954	31,755
<b>Retained Earnings</b>			
Balance, beginning of year	50,233	9,279	(35,878)
Net income	65,266	70,108	59,341
Dividends declared	(12,721)	(11,545)	(9,575)
Stock split	(10,148)	--	--
Shares repurchased	(3,470)	(17,609)	(4,609)
Change in accounting period	(5)	--	--
Balance, end of year	89,155	50,233	9,279
<b>Accumulated Other Comprehensive Income (Loss)</b>			
Balance, beginning of year	394	1,490	1,817
Current period change	(1,114)	(1,096)	(327)
Balance, end of year	(720)	394	1,490
<b>Unearned Compensation</b>			
Balance, beginning of year	--	--	(615)
Restricted stock issued	(93)	--	--
Charged to operations	16	--	615
Balance, end of year	(77)	--	--
<b>Total Shareholders' Equity</b>	<b>\$173,740</b>	<b>\$110,855</b>	<b>\$ 62,940</b>

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Graco Inc. and Subsidiaries

(In thousands)	Years Ended		
	December 28, 2001	December 29, 2000	December 31, 1999
<b>Net Earnings</b>	<b>\$65,266</b>	<b>\$70,108</b>	<b>\$59,341</b>
Other comprehensive income, net of tax:			
Foreign currency translation adjustments	(759)	(1,096)	(327)
Minimum pension liability adjustment	(355)	16	(90)
<b>Comprehensive Income</b>	<b>\$64,152</b>	<b>\$69,028</b>	<b>\$58,924</b>

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 Graco Inc. and Subsidiaries  
 Years Ended December 28, 2001, December 29, 2000 and December 31, 1999

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. Years ended December 28, 2001 and December 29, 2000 were 52-week years. The year ended December 31, 1999 was a 53-week year.

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 28, 2001, all subsidiaries are 100 percent owned. In 2000 and 1999, subsidiaries in Japan and Korea were included on the basis of fiscal years ended November 30. In 2001, the one-month reporting lag in Japan and Korea was eliminated and net earnings for December 2000 were recorded as adjustments to equity. Certain prior year amounts have been reclassified to conform with 2001 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 except Graco Verfahrenstechnik (GV) in Germany, whose functional currency is the euro. Accordingly, adjustments resulting from the translation of GV's financial statements into U.S. dollars are charged or credited to a separate component of shareholders' equity. Gains and losses from the translation of foreign currency balances and transactions of other foreign subsidiaries are included in other expense (income).

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 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	5 to 10 years
Manufacturing equipment	5 to 10 years
Office, warehouse and automotive equipment	3 to 10 years

Intangible Assets. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," which requires the purchase method of accounting for all business combinations after June 30, 2001, and specifies criteria for recognizing intangible assets apart from goodwill. The Company's historical practices for recording intangible assets separately from goodwill are consistent with the new standard.

Also in 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets," which is effective for the Company at the beginning of 2002. Upon adoption of SFAS No. 142, the Company will stop amortization of goodwill, which would have been \$900,000 of general and administrative expense in 2002. Results of initial goodwill impairment testing indicate no impairment.

Components of intangible assets were:

(In thousands)	2001	2000
Goodwill, net of accumulated amortization of \$650 in 2001	\$ 7,939	\$ --
Other identifiable intangibles, net of accumulated amortization of \$6,400 and \$4,100	6,335	5,576
Total intangible assets, net	\$14,274	\$5,576

Other identifiable intangibles includes values assigned to patents, trademarks, trade names, customer lists and noncompete agreements, which are being amortized on a straight-line basis over useful lives ranging from 2 to 10 years.

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.

Restructuring. During the third quarter of 2001, the Company announced plans to relocate the operations of its German subsidiary, Graco Verfahrenstechnik, to other Company facilities in Belgium and the U.S. This included termination of approximately 50 employees, termination of leases and consolidation of product lines. General and administrative expense in 2001 includes a \$1.4 million charge to establish a restructuring accrual for costs associated with termination of

employees and lease termination. There were no significant payments charged against the accrual in 2001, but the Company expects that all amounts accrued will be paid in 2002.

**Self-Insurance.** The Company is self-insured for certain losses 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.

**Revenue Recognition.** The Company recognizes revenue when title passes, which is usually upon shipment. 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.

**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.** As allowed under SFAS No. 123 "Accounting for Stock-Based Compensation," the Company has elected to apply Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock option and purchase plans and adopt the "disclosure only" provisions of SFAS No. 123.

**Derivative Instruments and Hedging Activities.** At the beginning of fiscal 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that all derivatives, including those embedded in other contracts, be recognized as either assets or liabilities and that those financial instruments be measured at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation. The adoption of SFAS No. 133 resulted in no transition adjustment.

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 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 (income). 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 on the forward contract 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 2001, and there were no such transactions outstanding as of December 28, 2001.

**Other Recent Accounting Pronouncements.** In 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," which requires the cost of legal obligations (as defined) associated with the retirement of long-lived assets to be recorded as liabilities in the period in which they are incurred. The FASB also issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which provides for a single accounting model to be used for long-lived assets to be disposed of, and broadens the presentation of discontinued operations to include more disposal transactions. The Company does not expect the adoption of these standards to have a material effect on its financial position or operating results.

## 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. 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.

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	2001	2000	1999
-----			
Sales			
Industrial / Automotive	\$199,508	\$227,963	\$227,772
Contractor	225,110	221,538	178,616
Lubrication	48,201	44,872	44,086
	-----	-----	-----
Total	\$472,819	\$494,373	\$450,474
	=====	=====	=====
Segment operating earnings			
Industrial / Automotive	\$ 48,820	\$ 57,798	\$ 48,143
Contractor	47,297	47,935	41,736
Lubrication	12,119	10,600	10,307
Unallocated corporate expenses	(8,054)	(5,091)	(6,995)
	-----	-----	-----
Total	\$100,182	\$111,242	\$ 93,191
	=====	=====	=====

Geographic Information	2001	2000	1999
-----			
Sales (based on customer location)			
United States	\$308,535	\$322,792	\$280,685
Other countries	164,284	171,581	169,789
	-----	-----	-----
Total	\$472,819	\$494,373	\$450,474
	-----	-----	-----
Long-lived assets			
United States	\$109,819	\$ 80,811	\$ 80,259
Belgium	8,954	10,437	11,298
Other countries	1,843	3,554	5,972
	-----	-----	-----
Total	\$120,616	\$ 94,802	\$ 97,529
	=====	=====	=====

#### Sales to Major Customers

In 2001, sales to a home center retailer in the Contractor segment totaled 11 percent of consolidated sales. No customer represented 10 percent or more of consolidated sales in 2000. In 1999, sales to a paint manufacturer and retailer in the Contractor segment totaled 11 percent of consolidated sales.

#### C. Inventories

Major components of inventories were as follows:

(In thousands)	2001	2000
-----		
Finished products and components	\$23,863	\$26,812
Products and components in various stages of completion	18,827	20,153
Raw materials and purchased components	18,899	19,259
	-----	-----
Reduction to LIFO cost	(31,256)	(33,145)
	-----	-----
Total	\$30,333	\$33,079
	=====	=====

Inventories valued under the LIFO method were \$18,249,000 and \$20,585,000 for 2001 and 2000. All other inventory was valued on the FIFO method.

In 2001 and 2000, certain inventory quantities were reduced, resulting in liquidation of LIFO inventory quantities carried at lower costs from prior years. The effect in 2001 was to increase net earnings by approximately \$1,000,000. In 2000, the effect on net earnings was not significant.

#### D. Property, Plant and Equipment

Property, plant and equipment were as follows:

(In thousands)	2001	2000
-----		
Land	\$ 5,815	\$ 4,062
Buildings and improvements	65,648	50,512
Manufacturing equipment	114,605	105,509
Office, warehouse and automotive equipment	23,998	22,652
Construction in progress	1,457	4,137
	-----	-----
Total property, plant and equipment	211,523	186,872
Accumulated depreciation	(112,579)	(102,883)
	-----	-----

Net property, plant and equipment	\$ 98,944	\$ 83,989
	=====	=====

E. Income Taxes

Earnings before income tax expense consist of:

(In thousands)	2001	2000	1999
-----	-----	-----	-----
Domestic	\$81,731	\$ 95,440	\$87,292
Foreign	15,735	10,468	1,549
	-----	-----	-----
Total	\$97,466	\$105,908	\$88,841
	=====	=====	=====

Income tax expense consists of:

(In thousands)	2001	2000	1999
-----	-----	-----	-----
Current:			
Domestic:			
Federal	\$23,725	\$ 28,532	\$23,081
State and local	2,105	2,164	2,323
Foreign	5,349	3,018	2,867
	-----	-----	-----
	31,179	33,714	28,271
	-----	-----	-----
Deferred:			
Domestic	55	2,414	1,778
Foreign	466	(328)	(549)
	-----	-----	-----
	1,021	2,086	1,229
	-----	-----	-----
Total	\$32,200	\$ 35,800	\$29,500
	=====	=====	=====

Income taxes paid were \$25,888,000, \$30,919,000 and \$31,272,000 in 2001, 2000 and 1999.

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

	2001	2000	1999
-----	-----	-----	-----
Statutory tax rate	35%	35%	35%
Earnings from non-U.S. sales at lower tax rates	(2)	(1)	(2)
State taxes, net of federal effect	1	1	2
U.S. general business tax credits	(1)	(1)	(2)
	-----	-----	-----
Effective tax rate	33%	34%	33%
	=====	=====	=====

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)	2001	2000
-----	-----	-----
Inventory valuations	\$ 2,126	\$ 2,847
Insurance accruals	2,842	3,247
Warranty reserve	2,030	1,089
Vacation accruals	1,331	1,435
Bad debt reserves	1,329	1,321
Net operating loss carryforward	509	334
Other	1,543	1,301
	-----	-----
Current	11,710	11,574
	-----	-----
Unremitted earnings of consolidated foreign subsidiaries	(1,950)	(1,950)
Excess of tax over book depreciation	(7,094)	(7,494)
Postretirement benefits	5,739	5,721
Pension and deferred compensation	741	1,880
Other	803	1,275
	-----	-----
Non-current	(1,761)	(568)
	-----	-----
Net deferred tax assets	\$ 9,949	\$11,006
	=====	=====

Total deferred tax assets were \$19,141,000 and \$20,923,000 and total deferred tax liabilities were \$9,192,000 and \$9,917,000 on December 28, 2001 and December 29, 2000.

F. Debt

(In thousands)	2001	2000
-----	-----	-----
Reducing revolving credit facility	--	\$17,500
Other	\$550	1,860
	-----	-----
Total long-term debt	550	19,360
Less current portion	550	1,310
	-----	-----
Long-term portion	--	\$18,050
	=====	=====

Interest paid on debt during 2001, 2000 and 1999 amounted to \$1,288,000, \$4,171,000 and \$6,843,000. The fair value of the Company's long-term debt at December 28, 2001 and December 29, 2000 is not materially different than its recorded value.

In July 1998, the Company entered into a five-year \$190 million reducing revolving credit facility (the Revolver) with a syndicate of ten banks including the lead bank, U.S. Bank National Association. Available credit under the Revolver was subsequently reduced to \$72 million by December 29, 2000, and was further reduced to \$50 million by December 28, 2001. Outstanding balances bear interest at the London Interbank Offered Rate plus a spread of 0.45 percent. This spread changes as the ratio of total debt to earnings before interest, taxes and depreciation and amortization declines. The Revolver specifies quarterly reductions of the maximum amount of the credit line, and requires the Company to maintain certain financial ratios as to net worth, cash flow leverage and fixed charge coverage. The Revolver effectively restricts dividend payments that would cause a violation of the tangible net worth covenant. At December 28, 2001, the Company could have paid up to \$74 million of dividends without violating the tangible net worth covenant.

On December 28, 2001, the Company had lines of credit with U.S. and foreign banks of \$74 million, including the \$50 million Revolver. The unused portion of these credit lines was \$68 million at December 28, 2001. 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 5.2 percent, 6.2 percent and 5.4 percent for the years ended December 28, 2001, December 29, 2000, and December 31, 1999. The Company pays commitment fees of up to 0.175 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

A three-for-two stock split was declared on December 8, 2000 and distributed February 6, 2001 for shares outstanding on January 15, 2001. All stock option, share and per share data reflects this split.

At December 28, 2001, 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 of 966,914 common shares have been made to certain key employees under the plans, of which 3,000 shares remain restricted as of December 28, 2001. Compensation cost charged to operations for the restricted share awards was \$16,000 in 2001, zero in 2000 and \$615,000 in 1999.

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

	Options	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 25, 1998	1,772,682	\$10.86	766,329	\$ 6.59
Granted	706,748	14.57		
Exercised	(424,580)	4.82		
Canceled	(55,705)	15.69		
Outstanding, December 31, 1999	1,999,145	\$12.69	1,117,539	\$10.00
Granted	438,000	20.59		
Exercised	(387,597)	10.69		
Canceled	(87,258)	15.39		
Outstanding, December 29, 2000	1,962,290	\$14.74	943,151	\$11.46
Granted	657,889	27.54		
Exercised	(571,655)	12.94		
Canceled	(58,557)	20.09		
Outstanding, December 28, 2001	1,989,967	\$19.30	602,267	\$12.88

The following table summarizes information for options outstanding and exercisable at December 28, 2001:

Options Outstanding	Options Outstanding	Options Exercisable
---------------------	---------------------	---------------------

Range of Prices	Options Outstanding	Weighted Avg. Remaining Life	Weighted Avg. Exercise Price	Options Exercisable	Weighted Avg. Exercise Price
\$ 4-10	275,163	2	\$ 6.17	275,163	\$ 6.17
11-18	460,985	7	14.16	100,276	13.63
19-25	624,430	7	20.44	219,628	20.47
26-32	629,389	9	27.67	7,200	27.90
\$ 4-32	1,989,967	7	\$19.30	602,267	\$12.88

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 Nonemployee Director Stock Plan enables individual nonemployee directors of the Company to elect to receive or defer all or part of a director's 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 6,006, 6,927 and 6,161 shares under this Plan during 2001, 2000 and 1999. The expense related to this Plan is not significant.

Reserved Shares. Shares reserved for issuance under the various stock option and purchase plans are shown below:

	Total Shares Reserved	Remaining Reserved as of December 28, 2001
Long-term Stock Incentive Plan	7,818,750	2,996,996
Employee Stock Incentive Plan	1,500,000	1,488,150
Stock Incentive Plan	1,500,000	1,497,000
Nonemployee Director Stock Option Plan	450,000	434,811
Employee Stock Purchase Plan	8,775,000	919,689
Nonemployee Director Stock Plan	337,500	304,331
Total	20,381,250	7,640,977

Stock-Based Compensation. 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 the stock option 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)	2001	2000	1999
Net earnings			
As reported	\$65,266	\$70,108	\$59,341
Pro forma	60,998	66,582	56,712
Net earnings per common share			
Basic as reported	\$ 2.11	\$ 2.31	\$ 1.95
Diluted as reported	2.07	2.27	1.90
Pro forma basic	1.97	2.19	1.87
Pro forma diluted	1.94	2.15	1.81

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:

	2001	2000	1999
Expected life in years	5.1	6.1	5.3
Interest rate	5.1%	6.4%	5.1%
Volatility	37.4%	44.5%	43.5%
Dividend yield	1.4%	1.8%	1.9%

Based upon these assumptions, the weighted average fair value at grant date of options granted in 2001, 2000 and 1999 was \$8.96, \$8.16 and \$5.19.

The fair value of the employees' purchase rights under the Employee Stock Purchase Plan was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	2001	2000	1999
Expected life in years	1.0	1.0	1.0
Interest rate	5.1%	6.4%	5.2%
Volatility	37.4%	45.2%	43.8%
Dividend yield	1.5%	1.9%	2.0%

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 Black-Scholes. The weighted average fair value of each purchase right per common share was \$7.14, \$5.95 and \$4.08 in 2001, 2000 and 1999.

#### I. Earnings per Share

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

(In thousands, except per share amounts)	2001	2000	1999
--	------	------	------



Numerator			
Net earnings available to common shareholders	\$65,266	\$70,108	\$59,341
	-----	-----	-----
Denominators			
Denominator for basic earnings per share - weighted average shares	30,903	30,407	30,372
Dilutive effect of stock options computed based on the treasury stock method using the average market price	578	498	927
	-----	-----	-----
Denominator for diluted earnings per share	31,481	30,905	31,299
	=====	=====	=====
Basic earnings per share	\$ 2.11	\$ 2.31	\$ 1.95
	=====	=====	=====
Diluted earnings per share	\$ 2.07	\$ 2.27	\$ 1.90
	=====	=====	=====

#### J. Retirement Benefits

The Company has a defined contribution plan, under Section 401(k) of the Internal Revenue Code, which provides additional 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 \$2,187,000, \$2,162,000 and \$2,008,000 in 2001, 2000 and 1999.

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

The Company has noncontributory defined benefit pension plans covering substantially all U.S. employees, certain directors and some of the employees of the Company's non-U.S. subsidiaries. For the U.S. plans, the benefits are based on years of service and the highest five consecutive years' earnings in the ten years preceding retirement. The Company funds these plans annually in amounts consistent with minimum funding requirements and maximum tax deduction limits and invests primarily in common stocks and bonds, including the Company's common stock. The market value of the plans' investment in the common stock of the Company was \$19,460,000 and \$16,090,000 at December 28, 2001 and December 29, 2000. The following tables provide a reconciliation of the changes in the plans' benefit obligations and fair value of assets over the periods ending December 28, 2001 and December 29, 2000, and a statement of the funded status as of the same dates.

(In thousands)	Pension Benefits		Postretirement Medical Benefits	
	2001	2000	2001	2000
Reconciliation of benefit obligation				
Obligation, beginning of year	\$109,582	\$102,040	\$ 16,298	\$ 15,430
Service cost	3,825	3,733	493	459
Interest cost	7,452	6,961	1,126	1,063
Assumption changes	--	--	3,058	--
Actuarial loss	10	211	707	537
Benefit payments	(3,977)	(3,363)	(1,381)	(1,191)
Obligation, end of year	\$116,892	\$109,582	\$ 20,301	\$ 16,298
Reconciliation of fair value of plan assets				
Fair value, beginning of year	\$136,816	\$135,997	\$ --	\$ --
Actual return on assets	(3,813)	3,770	--	--
Employer contribution	438	412	1,381	1,191
Benefit payments	(3,977)	(3,363)	(1,381)	(1,191)
Fair value, end of year	\$129,464	\$136,816	\$ --	\$ --
Funded status				
Funded status over (under), end of year	\$ 12,572	\$ 27,234	\$(20,301)	\$(16,298)
Unrecognized transition obligation (asset)	(55)	(64)	--	--
Unrecognized prior service cost	1,559	1,734	--	--
Unrecognized loss (gain)	(17,516)	(35,946)	4,410	645
Net	\$ (3,440)	\$ (7,042)	\$(15,891)	\$(15,653)

The following table provides the amounts included in the consolidated balance sheets as of December 28, 2001 and December 29, 2000.

(In thousands)	Pension Benefits		Postretirement Medical Benefits	
	2001	2000	2001	2000
Accrued benefit liability	\$(9,282)	\$(10,018)	\$(15,891)	\$(15,653)
Other assets	5,842	2,976	--	--
Net	\$(3,440)	\$(7,042)	\$(15,891)	\$(15,653)

The components of net periodic benefit cost for the plans for 2001, 2000 and 1999 were as follows:

(In thousands)	Pension Benefits			Postretirement Medical Benefits		
	2001	2000	1999	2001	2000	1999
Service cost-benefits earned during the period	\$ 3,825	\$ 3,733	\$ 3,517	\$ 493	\$ 459	\$ 482
Interest cost on projected benefit obligation	7,452	6,961	6,267	1,126	1,063	995
Expected return on assets	(12,139)	(12,086)	(11,189)	--	--	--
Amortization of transition obligation (asset)	(10)	(3)	(4)	--	--	--
Amortization of prior service cost	174	220	231	--	--	--
Amortization of net loss (gain)	(2,041)	(2,707)	(629)	--	--	--
Cost of pension plans which are not significant and have not adopted SFAS No. 87	163	130	266	N/A	N/A	N/A
Curtailement gain	--	--	(541)	--	--	--
Net periodic benefit cost (credit)	\$(2,576)	\$(3,752)	\$(2,082)	\$1,619	\$1,522	\$1,477

The Company'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 12 percent for 2002, 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. The other assumptions used in the measurement of the Company's benefit obligation are shown below:

(In thousands)	Pension Benefits			Postretirement Medical Benefits		
	2001	2000	1999	2001	2000	1999
Discount rate	7.0%	7.0%	6.5%	7.0%	7.0%	6.5%
Expected return on assets	9.0%	9.0%	11.0%	N/A	N/A	N/A
Rate of compensation increase	3.8%	3.6%	3.6%	N/A	N/A	N/A

At December 28, 2001, 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	\$ 259	\$ (210)
Effect on the health care component of the accumulated postretirement benefit obligation	189	(1,369)

#### K. Commitments and Contingencies

Lease Commitments. Aggregate annual rental commitments at December 28, 2001, under operating leases with noncancelable terms of more than one year, were \$4,936,000, payable as follows:

(In thousands)	Buildings	Vehicles & Equipment	Total
2002	\$ 931	\$1,002	\$1,933
2003	865	779	1,644
2004	791	335	1,126
2005	82	49	131
2006	87	15	102
Thereafter	--	--	--
Total	\$2,756	\$2,180	\$4,936

Total rental expense was \$2,416,000 for 2001, \$2,499,000 for 2000 and \$3,492,000 for 1999.

Other Commitments. 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. The Company estimates that the maximum commitment amount under such agreements does not exceed \$5,000,000.

Contingencies. The Company is party to various legal proceedings arising in the normal course of business activities, none of which, in management's opinion, is expected to have a material adverse impact on the Company's consolidated results of operations or its financial position.

#### L. Acquisition

On March 19, 2001, the Company purchased ASM Company, Inc. (ASM) for \$16 million cash. ASM manufactures and markets spray tips, guns, poles and other accessories for the professional painter, and had sales of approximately \$11 million in 2000.

The Company used the purchase method to account for the acquisition. Based on the results of an independent appraisal, the purchase price was allocated to net tangible assets of \$4 million (net of assumed liabilities totaling \$2 million), identifiable intangible assets of \$3 million and goodwill of \$9 million. Identifiable intangible assets include patents, proprietary technologies, trade names, trademarks, customer list and a noncompete agreement. Intangibles and goodwill were amortized in 2001 on a straight-line basis, with useful lives ranging from 2 to 10 years.

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

None.

### 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 2001 Annual Report on Form 10-K and the information under the headings "Election of Directors, Nominees and Other Directors" on pages 2 through 4 and under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" on page 16, of the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders, to be held on May 7, 2002 (the "Proxy Statement"), is incorporated herein by reference.

#### Item 11. Executive Compensation

The information contained under the heading "Executive Compensation" on pages 6 through 8 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" on pages 14 through 15 of the Proxy Statement is incorporated herein by reference.

#### Item 13. Certain Relationships and Related Transactions

The information under the heading "Certain Business Relationships" on page 14 of the Company's Proxy Statement for its 2001 Annual Meeting of Shareholders, to be held on May 7, 2002 (the "Proxy Statement"), is incorporated herein by reference.

PART IV

Item 14. Exhibits, Financial Statement Schedule, and Reports on Form 8-K

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

(1)	Financial Statements See Part II	
(2)	Financial Statement Schedule	Page
	o Schedule II - Valuation and Qualifying Accounts.....	33
	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) .....	35
	Those entries marked by an asterisk are Management Contracts, Compensatory Plans or Arrangements.	

(b) Reports on Form 8-K

There were no reports on Form 8-K for the thirteen weeks ended December 28, 2001.

(c) Exhibit Index .....35

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	Change Add (Deduct)	Balance at end of year
Year ended December 28, 2001					
Allowance for doubtful accounts	\$2,300	\$ 100	\$ 500	\$100	\$2,000
Allowance for returns and credits	2,400	7,000	7,000	100	2,500
	<u>\$4,700</u>	<u>\$7,100</u>	<u>\$7,500</u>	<u>\$200</u>	<u>\$4,500</u>
Year ended December 29, 2000:					
Allowance for doubtful accounts	\$2,500	\$ 100	\$ 300		\$2,300
Allowance for returns and credits	2,000	8,100	7,700		2,400
	<u>\$4,500</u>	<u>\$8,200</u>	<u>\$8,000</u>		<u>\$4,700</u>
Year ended December 31, 1999:					
Allowance for doubtful accounts	\$2,600	\$ 300	\$ 600	\$200	\$2,500
Allowance for returns and credits	1,800	6,000	5,800		2,000
	<u>\$4,400</u>	<u>\$6,300</u>	<u>\$6,400</u>	<u>\$200</u>	<u>\$4,500</u>

- 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.

/s/DAVID A. ROBERTS March 22, 2002  
-----

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.

/s/DAVID A. ROBERTS March 22, 2002  
-----

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

/s/MARK W. SHEAHAN March 22, 2002  
-----

Mark W. Sheahan  
Vice President and Treasurer  
(Principal Financial Officer)

/s/JAMES A. GRANER March 22, 2002  
-----

James A. Graner  
Vice President and Controller  
(Principal Accounting Officer)

G. Aristides	Director, Chairman of the Board
D. A. Koch	Chairman Emeritus
R. O. Baukol	Director
R. G. Bohn	Director
W. J. Carroll	Director
J. Kevin Gilligan	Director
L. R. Mitau	Director
J. H. Moar	Director
M. A.M. Morfitt	Director
M. H. Rauenhorst	Director
D. A. Roberts	Director
W. G. Van Dyke	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.

/s/DAVID A. ROBERTS March 22, 2002  
-----

David A. Roberts  
(For himself and as attorney-in-fact)

Exhibit Index

Exhibit Number -----	Description -----
3.1	Restated Articles of Incorporation as amended December 8, 2000. (Incorporated by reference to Exhibit 3.1 to the Company's 2000 Annual Report on Form 10-K.)
3.2	Restated Bylaws as amended September 29, 2000. (Incorporated by reference to Exhibit 3.2 to the Company's 2000 Annual Report on Form 10-K.)
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 July 2, 1998, between the Company and U.S. Bank National Association, as Agent for a combination of banks. (Incorporated by reference to Exhibit 4 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 25, 1998.)
*10.1	2001 Corporate and Business Unit Annual Bonus Plan. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended March 30, 2001.)
*10.2	Executive Officer Annual Incentive Bonus Plan. (Incorporated by reference to Exhibit 10.35 to the Company's 1999 Annual Report on Form 10-K.)
*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	Nonemployee Director Stock Plan, as amended and restated June 18, 1999. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 25, 1999.)
*10.5	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.)
*10.6	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.)
*10.7	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.)
*10.8	Chairman's Award Plan. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 7, 1988.)
*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.)
*10.10	Restoration Plan 1998 Restatement. (Incorporated by reference to Exhibit 10.8 to the Company's 1997 Annual Report on Form 10-K.)
*10.11	Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Nonemployee Director Stock Option Plan with schedule of awards current as of December 28, 2001.
*10.12	Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Long Term Stock Incentive Plan with schedule of awards current as of December 28, 2001.
*10.13	Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Graco Inc. Stock Incentive Plan with schedule of awards current as of December 28, 2001.
*10.14	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.)
*10.15	Key Employee Agreement. Form of agreement with officers and other key employees relating to change of control.

- \*10.16 Executive Long Term Incentive Agreement. Form of agreement used for award of restricted stock to one executive officer, dated June 25, 2001. (Incorporated by reference to Exhibit 10.3 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2001.)
  - \*10.17 Trust Agreement 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.)
  - \*10.18 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.)
  - \*10.19 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.)
- 11 Statement of Computation of Earnings per share included in Note I on page 29.
  - 21 Subsidiaries of the Registrant included herein on page 38.
  - 23 Independent Auditors' Consent included herein on page 38.
  - 24 Power of Attorney included herein on page 39.
  - 99 Cautionary Statement Regarding Forward-Looking Statements included herein on page 40.

\*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:

Subsidiary	Jurisdiction of Organization	Percentage of Voting Securities Owned by the Company
Equipos Graco Argentina S.A.	Argentina	100%*
Graco Barbados FSC Limited	Barbados	100%
Graco Canada Inc.	Canada	100%
Graco do Brasil Limitada	Brazil	100%*
Graco Europe N.V.	Belgium	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 Inc.	United States	100%**
Graco Verfahrenstechnik GmbH	Germany	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.

\*\*\* Shares 100% held by Graco N.V.

Exhibit 23

Independent Auditors' Consent

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 January 21, 2002, appearing in this Annual Report on Form 10-K of Graco Inc. for the year ended December 28, 2001.

/s/Deloitte & Touche LLP  
 Deloitte & Touche LLP  
 Minneapolis, Minnesota  
 March 22, 2002

## 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 28, 2001, 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
/s/G. ARISTIDES ----- G. Aristides	February 22, 2002 -----
/s/R. O. BAUKOL ----- R. O. Baukol	February 22, 2002 -----
/s/R. G. BOHN ----- R. G. Bohn	February 22, 2002 -----
/s/W. J. CARROLL ----- W. J. Carroll	February 22, 2002 -----
/s/J. K. GILLIGAN ----- J. K. Gilligan	February 22, 2002 -----
/s/D. A. KOCH ----- D. A. Koch	February 22, 2002 -----
/s/L. R. MITAU ----- L. R. Mitau	February 22, 2002 -----
/s/J. H. MOAR ----- J. H. Moar	February 22, 2002 -----
/s/M. A.M. MORFITT ----- M. A.M. Morfitt	February 22, 2002 -----
/s/M. H. RAUENHORST ----- M. H. Rauenhorst	February 22, 2002 -----
/s/D. A. ROBERTS ----- D. A. Roberts	February 22, 2002 -----
/s/W. G. VAN DYKE ----- W. G. Van Dyke	February 22, 2002 -----

## 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 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:

- o With respect to the Company's business as a whole, the Company's prospects and operating results may be affected by:
  - changing economic conditions in the United States and other major world economies, including economic expansions, downturns or recessions; fluctuations in capital goods investment activity, interest rates, and foreign currency exchange rates;
  - 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; successfully conclude and integrate acquisitions; realize productivity and product quality improvements; and continue to control expenses.
  - disruption in operations, transportation, communication, customer operations, distribution, payment or sources of supply, including the cost and availability of skilled labor, raw materials and energy, caused by political or economic instability, acts of God, labor disputes, war, embargo, fire or other cause beyond its reasonable control.
  - changes in the markets in which the Company participates, including consolidation of competitors and major customers, price competition, and alteration in mix of products desired;
  - changes in accounting standards or in the application by the Company of critical accounting policies; and
  - changes in the return on investments in the Company's retirement plan.
- o The prospects and operating results of the Company's Contractor Equipment Division may be affected by: variations in the level of residential, commercial and institutional building and remodeling activity; the availability and cost of 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 application; changes in the buying and channel preferences of the end user; 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.
- o The prospects and operating results of the Company's Industrial/Automotive Equipment Division may be affected by: the capital equipment spending levels of industrial customers; the availability and cost of customer financing; changes in the environmental regulation of coatings; changes in the technical characteristics of materials; changes in application technology; the ability of the Company to meet changing customer requirements; consolidation in the distribution channels; consolidation in the fluid handling equipment manufacturing industry; the equipment purchase plans of major automobile manufacturers worldwide (which are in turn impacted by the level of automotive sales worldwide); changes in automotive manufacturing processes; the pricing strategies of competitors; significant penetration of the North American market by low cost foreign manufacturers of competitive equipment; and consolidation in the automobile manufacturing industry worldwide.
- o The prospects and operating results of the Company's Lubrication Equipment Division 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; significant penetration of the North American market by low cost foreign manufacturers of competitive equipment; consolidation of automotive dealerships; trends in spending by state and local governments, and variations in the equipment spending levels of the major oil companies.

NONEMPLOYEE DIRECTOR  
NONSTATUTORY STOCK OPTION AGREEMENT  
(NSO)

THIS AGREEMENT, made this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_ by and between Graco Inc., a Minnesota corporation (the "Company") and \_\_\_\_\_ (the "Nonemployee Director").

WITNESSETH THAT:

WHEREAS, the Company pursuant to its Nonemployee Director Stock Option Plan wishes to grant this stock option to Nonemployee Director.

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

1. Grant of Option  
-----

The Company hereby grants to Nonemployee Director, the right and option (the "Option") to purchase all or any part of an aggregate of \_\_\_\_\_ common shares, par value \$1.00 per share, at the price of \$ \_\_\_\_\_ per share on the terms and conditions set forth herein. This is a nonstatutory stock Option which does not qualify for special tax treatment under Sections 421 or 422 of the Internal Revenue Code.

2. Duration and Exercisability

a. This Option may not be exercised by Employee until the expiration of one (1) year from the date of grant, and this Option shall in all events terminate ten (10) years after the date of Grant. During the first year from the date of grant of this Option, no portion of this Option may be exercised. Thereafter this Option shall become exercisable in four cumulative installments of 25% as follows:

Date	Total Portion of Option Which is Exercisable
One Year after Date of Grant	25%
Two Years after Date of Grant	50%
Three Years after Date of Grant	75%
Four Years after Date of Grant	100%

In the event that Nonemployee Director does not purchase in any one year the full number of shares of common stock of the Company to which he/she is entitled under this Option, he/she may, subject to the terms and conditions of Section 3 hereof, purchase such shares of common stock in any subsequent year during the term of this Option.

b. During the lifetime of the Nonemployee Director, the Option shall be exercisable only by him/her and shall not be assignable or transferable by him/her otherwise than by will or the laws of descent and distribution.

3. Effect of Termination of Membership on the Board

a. In the event a Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in section 3b below, the Nonemployee Director shall have the right to exercise the Option as follows, subject to the condition that no Option shall be exercisable after the expiration of the term of the Option:

- (1) If the Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, the option becomes immediately exercisable upon the date the Nonemployee Director ceases being a director. The Nonemployee Director may exercise the Option for a period of thirty six (36) months from the date the Nonemployee Director ceased being a director, provided that if the Nonemployee Director dies before the thirty-six (36) month period has expired, the Option may be exercised by the Nonemployee Director's legal representative or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death for a period of twelve (12) months from the date of the Nonemployee Director's death.
- (2) If the Nonemployee Director was a member of the Board of Directors of the Company for less than five (5) years, the Nonemployee Director may exercise the Option, to the extent the Option was exercisable at the date the Nonemployee Director ceases being a member of the Board, for a period of thirty (30) days following the date the Nonemployee Director ceased being a director, provided that, if the Nonemployee Director dies before the thirty (30) day period has expired, the Option may be exercised by the Nonemployee Director's legal representative, or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death, for a period of twelve (12) months from the date of the Nonemployee Director's death.
- (3) If the Nonemployee Director dies while a member of the Board of Directors of the Company, the Option, to the extent exercisable

by the Nonemployee Director at the date of death, may be exercised by the Nonemployee Director's legal representative, or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death, for a period of twelve (12) months from the date of the Nonemployee Director's death.

(4) In the event 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 thereunder unless and until the Company is satisfied that the person or persons exercising the Option are the duly appointed legal representatives of the deceased optionee's estate or the proper legatees or distributees thereof.

b. If a Nonemployee Director ceases being a director of the Company due to an act of (a) fraud or intentional misrepresentation or (b) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any Affiliate of the Company or (c) any other gross or willful misconduct, as determined by the Board, in its sole and conclusive discretion, the Option granted to such Nonemployee Director shall immediately be forfeited as of the date of the misconduct.

#### 4. Manner of Exercise

a. The Option can be exercised only by Nonemployee Director or other proper party within the Option period by delivering 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 4b(3) below, accompanied by payment in full of one hundred percent (100%) of the Option price.

b. The Nonemployee Director may, at his/her election, pay the Option price as follows:

(1) by cash or by certified check,

(2) by delivery of shares of common stock to the Company, which shall have been owned for at least six (6) months and have a fair market value per share on the date of surrender equal to the exercise price, or

(3) by delivery to Company of a properly executed exercise notice together with irrevocable instructions to a broker to promptly deliver to the Company from sale or loan proceeds the amount required to pay the exercise price.

For purposes of subsection 4b(2) hereunder, the fair market value per share is the last sale price reported on the composite tape by the New York Stock Exchange on the business day immediately preceding the date as of which fair market value is being determined or, if there were no sales of shares of the Company's common stock reported on the composite tape on such day, on the most recently preceding day on which there were sales, or if the shares of the Company's stock are not listed or admitted to trading on the New York Stock Exchange on the day as of which the determination is made, the amount determined by the Board or its delegate to be the fair market value of a share on such day.

c. Such Option price shall be subject to adjustment as provided in Section 6 hereof.

#### 5. Change of Control

a. Notwithstanding Section 2(a) hereof, all outstanding Options not yet exercisable 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 their 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 9, a Trust Person shall not be deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

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

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

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

the extent that such ownership existed prior to the Business Combination, and

(c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

b. A Change of Control shall not be deemed to have occurred with respect to a Nonemployee Director if:

(1) the acquisition of the 25% or greater interest referred to in subsection a(1) of this Section 5 is by a group, acting in concert, that includes the Nonemployee Director or

(2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in subsections (4) or (5) of this section by a group, acting in concert, that includes that Nonemployee Director.

#### 6. Adjustments and Changes in the Stock

a. If Nonemployee Director exercises all or any portion of the Option subsequent to any change in the common stock of the Company by reason of any stock dividend, stock split, spin-off, split-up, merger, consolidation, recapitalization, reclassification, combination or exchange of shares, or any other similar corporate event, the aggregate number of shares available under the Plan, and the number and the price of shares of common stock subject to outstanding Options shall be appropriately adjusted automatically.

b. No right to purchase fractional shares shall result from any adjustment in the Option pursuant to subsection 6a of this Agreement. In case of any such adjustment, the shares subject to the Option shall be rounded down to the nearest whole share.

c. Notice of any adjustment shall be given by the Company to Nonemployee Director for the Option which shall have been so adjusted and such adjustment (whether or not such notice is given) shall be effective and binding for all purposes of the Plan.

#### 7. Miscellaneous

a. This Option is issued pursuant to the Company's Nonemployee Director Stock Option Plan and is subject to its terms. A copy of the Plan has been given to the Nonemployee Director. The terms of the Plan are also available for inspection during business hours at the principal offices of the Company.

b. This Agreement shall not confer on Nonemployee Director or other person any claim or right to be granted an Option under the Plan, except as expressly provided in the Plan. Neither the Plan nor any action taken hereunder shall be construed as giving Nonemployee Director any right to be retained in the service of the Company.

c. Neither Nonemployee Director, the Nonemployee Director's legal representative, nor any person who acquires the right to exercise this Option by reason of the Nonemployee Director's death 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 certificates for 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. This Agreement will be governed by and constructed exclusively in accordance with the laws of the State of Minnesota.

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

GRACO INC.

By:

-----  
Its  
Vice President, General  
Counsel and Secretary



-----  
Name  
Nonemployee Director

Nonemployee Director Stock Option Plan  
Schedule Identifying Non-Statutory Stock Option Agreements Executed and  
Material Details in which Executed Agreements Differ from Agreement Copy Filed  
Current as of December 28, 2001

DATE	NAME	SHARES	PRICE
-----	-----	-----	-----
*May 7, 1996	Ronald Baukol	4,500	\$ 8.39
*May 7, 1996	Lee Mitau	4,500	\$ 8.39
*May 7, 1996	Martha Morfitt	4,500	\$ 8.39
*May 7, 1996	William VanDyke	4,500	\$ 8.39
*May 6, 1997	Ronald Baukol	3,375	\$11.78
*May 6, 1997	Lee Mitau	3,375	\$11.78
*May 6, 1997	Martha Morfitt	3,375	\$11.78
*May 6, 1997	William VanDyke	3,375	\$11.78
*May 5, 1998	Ronald Baukol	3,375	\$23.21
*May 5, 1998	Lee Mitau	3,375	\$23.21
*May 5, 1998	Martha Morfitt	3,375	\$23.21
*May 5, 1998	William VanDyke	3,375	\$23.21
*May 4, 1999	Ronald Baukol	3,375	\$21.04
*May 4, 1999	Lee Mitau	3,375	\$21.04
*May 4, 1999	Martha Morfitt	3,375	\$21.04
*May 4, 1999	William VanDyke	3,375	\$21.04
*June 1, 1999	Robert Bohn	4,500	\$21.79
*June 1, 1999	William Carroll	4,500	\$21.79
*May 2, 2000	Ronald Baukol	3,375	\$22.67
*May 2, 2000	Robert Bohn	3,375	\$22.67
*May 2, 2000	William Carroll	3,375	\$22.67
*May 2, 2000	Lee Mitau	3,375	\$22.67
*May 2, 2000	Martha Morfitt	3,375	\$22.67
*May 2, 2000	William VanDyke	3,375	\$22.67
*September 28, 2000	Mark Rauenhorst	4,500	\$21.00
February 23, 2001	J. Kevin Gilligan	3,000	\$26.35
May 1, 2001	Ronald Baukol	2,500	\$27.40
May 1, 2001	Robert Bohn	2,500	\$27.40
May 1, 2001	William Carroll	2,500	\$27.40
May 1, 2001	J. Kevin Gilligan	2,500	\$27.40
May 1, 2001	Lee Mitau	2,500	\$27.40
May 1, 2001	Martha Morfitt	2,500	\$27.40
May 1, 2001	Mark Rauenhorst	2,500	\$27.40
May 1, 2001	William VanDyke	2,500	\$27.40
May 1, 2001	James Moar	3,000	\$27.40

\*Share data has been adjusted to reflect stock splits.

STOCK OPTION AGREEMENT  
(NON-ISO)

THIS AGREEMENT, made this \_\_\_\_\_ day of \_\_\_\_\_, 2\_\_\_\_, by and between Graco Inc., a Minnesota corporation (the "Company") and (the "Employee").

WITNESSETH THAT:

WHEREAS, the Company pursuant to its Long-Term Stock Incentive Plan wishes to grant this stock option to Employee;

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

1. Grant of Option

The Company hereby grants to Employee, the right and option (hereinafter called the "option") to purchase all or any part of an aggregate of \_\_\_\_\_ shares of Common Stock of the Company, par value \$1.00 per share, at the price of \$ \_\_\_\_\_ per share on the terms and conditions set forth herein.

2. Duration and Exercisability

A. This option may not be exercised by Employee until the expiration of one (1) year from the date of grant, and this option shall in all events terminate ten (10) years after the date of grant. During the first year from the date of grant of this option, no portion of this option may be exercised. Thereafter this option shall become exercisable in four cumulative installments of 25% as follows:

Date	Total Portion of Option Which is Exercisable
One Year after Date of Grant	25%
Two Years after Date of Grant	50%
Three Years after Date of Grant	75%
Four Years after Date of Grant	100%

In the event that 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 hereof, purchase such shares of Common Stock in any subsequent year during the term of this option.

B. During the lifetime of the 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.

3. Effect of Termination of Employment

A. In the event that Employee shall cease to be employed by the Company or its subsidiaries for any reason other than his/her gross and willful misconduct, death, retirement (as defined in Section 3. D. below), or disability (as defined in Section 3. D. below), Employee shall have the right to exercise the option at any time within one month after such termination of employment to the extent of the full number of shares he/she was entitled to purchase under the option on the date of termination, subject to the condition that no option shall be exercisable after the expiration of the term of the option.

B. In the event that Employee shall cease to be employed by the Company or its subsidiaries by reason of his/her gross and willful misconduct during the course of his/her employment, including but not limited to wrongful appropriation of Company funds or the commission of a felony, the option shall be terminated as of the date of the misconduct.

C. If the Employee shall die while in the employ of the Company or a subsidiary or within one month after termination of employment for any reason other than gross and willful misconduct and shall not have fully exercised the option, all remaining shares shall become immediately exercisable and such option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

D. If the Employee's termination of employment is due to retirement (either after attaining age 55 with 10 years of service, or attaining age 65), or due to disability within the meaning of the provisions of the Graco Long-Term Disability Plan subject to the conditions that no option shall be exercisable after the expiration of the terms of the option, all remaining shares shall

become immediately exercisable and the option may be exercised by the Employee at any time within three years of the Employee's retirement, subject to the condition that no option shall be exercisable after the expiration of the term of the option. In the event of the death of the Employee within the three-year period after retirement, the option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, to the extent of the full number of shares he/she was entitled to purchase under the option on the date of death, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

- E. Notwithstanding anything to the contrary contained in this Section 3, if the Employee chooses to terminate his/her employment by retirement (as defined in Section 3. D. above) and has not given the Company written notice, by correspondence to his/her immediate supervisor and the Chief Executive Officer, of said 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 said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3. A. above, provided, however, that in the event that the Chief Executive Officer, in his/her sole discretion and judgement, determines that termination of employment by retirement of the Employee without six (6) months prior written notice is in the best interests of the Company, then such retirement shall be subject to Section 3. D. above.

#### 4. Manner of Exercise

- A. The option can be exercised only by Employee or other proper party within the option period delivering 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 Section 4. C., 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 either by check (bank check, certified check, or personal check) or 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 these purposes, the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the date of exercise on the New York Stock Exchange (the "NYSE") or on the principal national securities exchange on which such shares are traded if the shares are not then traded on the NYSE. 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 arranging for the immediate sale of some or all of the shares issued upon exercise of the option by a securities dealer and the payment to the Company by the securities dealer of the option 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. If the Committee, as defined in the Company's Long Term Stock Incentive Plan, has in its discretion determined that the Employee may do so, such amount may be paid by the Employee 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 common shares otherwise to be delivered with a fair market value equal to the amount of such tax obligation, or (ii) electing to surrender to the Company previously owned common shares with a fair market value equal to the amount of such minimum tax obligation.

#### 6. Change of Control

- A. Notwithstanding Section 2(a) 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 subsection (4) below; 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 subparagraph A.(1) of this Section 6 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 subsections (4) or (5) of this section 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 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 Company's Long-Term Incentive Stock Plan and is subject to its terms. A copy of the Plan has been given to the Employee. The terms of the Plan are also 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. Employee shall have none of the rights of a shareholder with respect to shares subject to this option until such shares shall have been issued to him/her upon exercise of this option.

C. 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.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be

executed on the day and year first above written.

GRACO INC.

By:

-----  
Its Chief Executive Officer

-----  
Employee

Long Term Stock Incentive Plan  
Schedule Identifying Non-ISO Stock Option Agreements Executed and  
Material Details in which Executed Agreements Differ from Agreement Copy Filed  
Current as of December 28, 2001

DATE	NAME	SHARES	PRICE
*December 17, 1992	Dale Johnson	4,050	\$ 4.59
*December 17, 1992	Charles Rescorla	6,075	\$ 4.59
*May 2, 1994	David Koch	22,370	\$ 6.70
*May 2, 1994	Robert Mattison	3,672	\$ 6.70
*December 15, 1994	Dale Johnson	6,750	\$ 5.59
*December 15, 1994	Robert Mattison	10,125	\$ 5.59
*December 15, 1994	Patrick McHale	10,125	\$ 5.59
*December 15, 1994	Charles Rescorla	16,875	\$ 5.59
*February 23, 1995	David Lowe	16,875	\$ 7.00
*March 1, 1995	David Koch	22,370	\$ 6.96
*March 1, 1995	Robert Mattison	3,672	\$ 6.96
*March 1, 1996	James Graner	11,250	\$ 8.89
*March 1, 1996	Robert Mattison	2,460	\$ 8.89
*February 28, 1997	James Graner	11,250	\$13.83
*February 28, 1997	Dale Johnson	6,750	\$13.83
*February 28, 1997	David Lowe	22,500	\$13.83
*February 28, 1997	Robert Mattison	11,250	\$13.83
*February 28, 1997	Charles Rescorla	6,750	\$13.83
*February 28, 1997	Mark Sheahan	6,750	\$13.83
*February 18, 1998	Fred Sutter	6,000	\$19.71
*February 18, 1998	Patrick McHale	4,500	\$19.71
*February 27, 1998	James Graner	7,500	\$19.67
*February 27, 1998	Dale Johnson	15,000	\$19.67
*February 27, 1998	David Lowe	7,500	\$19.67
*February 27, 1998	Robert Mattison	7,500	\$19.67
*February 27, 1998	Charles Rescorla	7,500	\$19.67
*February 27, 1998	Mark Sheahan	5,250	\$19.67
*February 22, 1999	James Graner	7,500	\$14.33
*February 22, 1999	Dale Johnson	15,000	\$14.33
*February 22, 1999	David Lowe	11,250	\$14.33
*February 22, 1999	Robert Mattison	7,500	\$14.33
*February 22, 1999	Charles Rescorla	11,250	\$14.33
*February 22, 1999	Mark Sheahan	7,500	\$14.33
*February 22, 1999	Fred Sutter	7,500	\$14.33
*February 9, 2000	Dale Johnson	30,000	\$20.46
*February 23, 2000	James Graner	7,500	\$20.46
*February 23, 2000	David Lowe**	11,250	\$20.46
*February 23, 2000	Robert Mattison	7,500	\$20.46
*February 23, 2000	Patrick McHale	11,250	\$20.46
*February 23, 2000	Charles Rescorla	11,250	\$20.46
*February 23, 2000	Mark Sheahan	7,500	\$20.46
*February 23, 2000	Fred Sutter	11,250	\$20.46
*October 23, 2000	Stephen Bauman	7,500	\$22.33
February 22, 2001	George Aristides	40,000	\$26.35
February 22, 2001	George Aristides	60,000	\$26.35
February 22, 2001	Stephen Bauman	5,000	\$26.35
February 22, 2001	James Graner	5,000	\$26.35
February 22, 2001	Dale Johnson	20,000	\$26.35
February 22, 2001	David Lowe**	7,500	\$26.35
February 22, 2001	Robert Mattison	5,000	\$26.35
February 22, 2001	Patrick McHale	7,500	\$26.35
February 22, 2001	Charles Rescorla	10,000	\$26.35
February 22, 2001	Mark Sheahan	5,000	\$26.35
February 22, 2001	Fred Sutter	7,500	\$26.35
April 19, 2001	Robert Mattison	5,000	\$27.85
April 19, 2001	Mark Sheahan	5,000	\$27.85

\* Share data has been adjusted to reflect stock splits.

\*\*The stock option becomes exercisable in one installment, three years after the date of the grant

NOTE:

(1) All options granted prior to 2000 become exercisable in four equal annual

installments, commencing two years after the date of the grant. Options granted in 2000 and later become exercisable in four equal annual installments, commencing one year after the date of the grant.

(2) Option agreements prior to 1999 did not contain Section 3. E.

STOCK OPTION AGREEMENT  
(NON-ISO)

THIS AGREEMENT, made this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_, by and between  
Graco Inc., a Minnesota corporation (the "Company") and \_\_\_\_\_  
(the "Employee").

WITNESSETH THAT:

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

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

1. Grant of Option

The Company hereby grants to Employee, the right and option (hereinafter called the "option") to purchase all or any part of an aggregate of \_\_\_\_\_ shares of Common Stock of the Company, par value \$1.00 per share, at the price of \$ \_\_\_\_\_ per share on the terms and conditions set forth herein.

2. Duration and Exercisability

A. This option may not be exercised by Employee until the expiration of one (1) year from the date of grant, and this option shall in all events terminate ten (10) years after the date of grant. During the first year from the date of grant of this option, no portion of this option may be exercised. Thereafter this option shall become exercisable in four cumulative installments of 25% as follows:

Date ----	Total Portion of Option Which is Exercisable -----
One Year after Date of Grant	25%
Two Years after Date of Grant	50%
Three Years after Date of Grant	75%
Four Years after Date of Grant	100%

In the event that 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 hereof, purchase such shares of Common Stock in any subsequent year during the term of this option.

B. During the lifetime of the 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.

3. Effect of Termination of Employment

A. In the event that Employee shall cease to be employed by the Company or its subsidiaries for any reason other than his/her gross and willful misconduct, death, retirement (as defined in Section 3. D. below), or disability (as defined in Section 3. D. below), Employee shall have the right to exercise the option at any time within one month after such termination of employment to the extent of the full number of shares he/she was entitled to purchase under the option on the date of termination, subject to the condition that no option shall be exercisable after the expiration of the term of the option.

B. In the event that Employee shall cease to be employed by the Company or its subsidiaries by reason of his/her gross and willful misconduct during the course of his/her employment, including but not limited to wrongful appropriation of Company funds or the commission of a felony, the option shall be terminated as of the date of the misconduct.

C. If the Employee shall die while in the employ of the Company or a subsidiary or within one month after termination of employment for any reason other than gross and willful misconduct and shall not have fully exercised the option, all remaining shares shall become immediately exercisable and such option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

D. If the Employee's termination of employment is due to retirement (either after attaining age 55 with 10 years of service, or attaining age 65), or due to disability within the meaning of the provisions of the Graco Long-Term Disability Plan subject to the conditions that no option shall be exercisable after the expiration of the terms of the option, all remaining shares shall become immediately exercisable and the option may be exercised by



the Employee at any time within three years of the Employee's retirement, subject to the condition that no option shall be exercisable after the expiration of the term of the option. In the event of the death of the Employee within the three-year period after retirement, the option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, to the extent of the full number of shares he/she was entitled to purchase under the option on the date of death, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

- E. Notwithstanding anything to the contrary contained in this Section 3, if the Employee chooses to terminate his/her employment by retirement (as defined in Section 3. D. above) and has not given the Company written notice, by correspondence to his/her immediate supervisor and the Chief Executive Officer, of said 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 said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3. A. above, provided, however, that in the event that the Chief Executive Officer, in his/her sole discretion and judgement, determines that termination of employment by retirement of the Employee without six (6) months prior written notice is in the best interests of the Company, then such retirement shall be subject to Section 3. D. above.

#### 4. Manner of Exercise

- A. The option can be exercised only by Employee or other proper party within the option period delivering 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 Section 4. C., 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 either by check (bank check, certified check, or personal check) or 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 these purposes, the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the date of exercise on the New York Stock Exchange (the "NYSE") or on the principal national securities exchange on which such shares are traded if the shares are not then traded on the NYSE. 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 arranging for the immediate sale of some or all of the shares issued upon exercise of the option by a securities dealer and the payment to the Company by the securities dealer of the option 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. Such amount may be paid by the Employee 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 common 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 common shares with a fair market value equal to the amount of such minimum tax obligation.

#### 6. Change of Control

- A. Notwithstanding Section 2(a) 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 subsection (4) below; 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 subparagraph A.(1) of this Section 6 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 subsections (4) or (5) of this section 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 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. A copy of the Plan has been given to the Employee. The terms of the Plan are also 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. Employee shall have none of the rights of a shareholder with respect to shares subject to this option until such shares shall have been issued to him/her upon exercise of this option.

C. 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.

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

GRACO INC.

By: \_\_\_\_\_

-----  
Employee

Stock Incentive Plan  
Schedule Identifying Non-ISO Stock Option Agreements Executed and  
Material Details in which Executed Agreements Differ from Agreement Copy Filed  
Current as of December 28, 2001

DATE	NAME	SHARES	PRICE
----- June 25, 2001	----- David A. Roberts	----- 50,000	----- \$31.20

## GRACO INC. KEY EMPLOYEE AGREEMENT

AGREEMENT, by and between Graco Inc., a Minnesota corporation (the "Company") and \_\_\_\_\_ (the "Executive"), dated as of the \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_.

The Board of Directors of the Company (the "Board"), has determined that it is in the best interests of the Company and its shareholders to assure that the Company will have the continued dedication of the Executive, notwithstanding the possibility, threat or occurrence of a Change of Control (as defined in Section 2 below) of the Company. The Board believes it is imperative to diminish the inevitable distraction of the Executive by virtue of the personal uncertainties and risks created by a pending or threatened Change of Control, to encourage the Executive's full attention and dedication to the Company currently and in the event of any threatened or pending Change of Control, to provide inducement for the Executive to remain an employee of the Company in the event of any threatened or pending Change of Control, and to facilitate an orderly transition in the event of a Change of Control. Therefore, in order to accomplish these objectives, the Board has caused the Company to enter into this Agreement.

NOW, THEREFORE, IT IS HEREBY AGREED AS FOLLOWS:

1. Certain Definitions: "Effective Date;" "Change of Control Period;" "Company;" "Affiliated Companies."

- (a) The "Effective Date" shall mean the first date during the Change of Control Period (as defined in Section 1(b)) on which a Change of Control (as defined in Section 2) occurs. Anything in this Agreement to the contrary notwithstanding, if a Change of Control occurs and if the Executive's employment with the Company is terminated prior to the date on which the Change of Control occurs, and if it is reasonably demonstrated by the Executive that such termination of employment (i) was at the request of a third party who has taken steps reasonably calculated to effect the Change of Control or (ii) otherwise arose in connection with or anticipation of the Change of Control, then for all purposes of this Agreement the "Effective Date" shall mean the date immediately prior to the date of such termination of employment.
- (b) The "Change of Control Period" shall mean the period commencing on the date hereof and ending on the second anniversary of such date, provided, however, that commencing on the date one year after the date hereof, and on each annual anniversary of such date (such date and each annual anniversary thereof shall be hereinafter referred to as the "Renewal Date"), the Change of Control Period shall be automatically extended so as to terminate two years from such Renewal Date, unless at least 60 days prior to the Renewal Date the Company shall give notice to the Executive that the Change of Control Period shall not be so extended.
- (c) The "Company" shall mean the Company as hereinbefore defined and any successor to its business and/or assets which assumes or agrees to perform this Agreement by operation of law or otherwise.
- (d) As used in this Agreement, the term "affiliated companies" shall include any company controlled by, controlling or under common control with the Company.

2. Change of Control. For the purpose of this Agreement

(a) A "Change of Control" means:

- (i) 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:

- (1) an acquisition directly from the Company,
- (2) an acquisition by the Company,
- (3) an acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (4) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned immediately after said acquisition 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 2, 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 limitation the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

(5) an acquisition by the Executive or any group that includes the Executive, or

(6) an acquisition by any corporation pursuant to a transaction that complies with clauses (A), (B) and (C) of Section 2 (a)(iii) below; 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 (1) or (2) 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 (1) or (2) 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

(ii) 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

(iii) 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

(iv) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

3. Employment Period. For purposes of this Agreement, the term "Employment Period" shall mean the period commencing on the Effective Date and ending on the earlier of (i) the termination by the Company or the Executive of the Executive's employment with the Company, or (ii) the second anniversary of the Effective Date." As provided in Section 10(f), nothing stated in this Agreement shall restrict the right of the Company or the Executive at any time to terminate the Executive's employment with the Company, subject to the obligations of the Company provided for in this Agreement in the event of such termination.

4. Terms of Employment.

(a) Position and Duties.

(i) During the Employment Period, (A) the Executive's position (including offices and titles), duties and responsibilities shall be at least commensurate in all material respects with the most significant of those held, exercised and assigned at any time during the 90-day period immediately preceding the Effective Date and (B) the Executive's services shall be performed at the location where the Executive was employed immediately preceding the Effective Date or any office or location less than 50 miles from such location.

(ii) Except as otherwise expressly provided in this Agreement, during the Employment Period, and excluding any periods of vacation and sick leave to which the Executive is entitled, the Executive agrees to devote reasonable attention and time during normal business hours to the business and affairs of the Company. During the Employment Period it shall not be a violation of this Agreement for the Executive to (A) serve on corporate, civic or charitable boards or committees, (B) deliver lectures, fulfill speaking engagements or teach at educational institutions and (C) manage personal investments, so long as such activities do not significantly interfere with the performance of the Executive's responsibilities as an employee of the Company in accordance with this Agreement. To the extent that any such activities have been conducted by the Executive prior to the Effective Date, the continued conduct of such activities (or the conduct of activities similar in nature and scope thereto) subsequent to the Effective Date shall not thereafter be deemed to interfere with the performance of the Executive's responsibilities to the Company.

(b) Compensation.

(i) Base Salary. During the Employment Period, the Executive shall receive an annual base salary ("Annual Base Salary") which shall be paid at a monthly rate, at least equal to twelve times the highest monthly base salary paid or payable to the Executive by the Company and its affiliated companies in respect of the twelve-month period immediately preceding the month in which the Effective Date occurs. During the Employment Period, the Annual Base Salary shall be reviewed at least annually and shall be increased at any time and from time to time as shall be substantially consistent with increases in base salary generally awarded in the ordinary course of business to other peer executives of the Company. The term Annual Base Salary as used in this Agreement shall refer to Annual Base Salary as so increased. The Executive's Annual Base Salary shall not be reduced after any such increase. Any increase in Annual Base Salary shall not serve to limit or reduce any other obligation to the Executive under this Agreement.

(ii) Annual Incentive Payments. In addition to Annual Base Salary, the Executive shall be awarded, for each fiscal year during the Employment Period, an annual bonus ("Annual Bonus") in cash, in accordance with the Company's Annual Bonus Plan, or other plan instituted in lieu of the Annual Bonus Plan which provides for an annual incentive payment in addition to Annual Base Salary ("Substitute Plan"). The Executive shall participate in the Annual Bonus Plan or Substitute Plan at the same level at which the Executive participated immediately prior to the Effective Date, or if more favorable, at the level of other peer executives of the Company and its affiliated companies. Any Substitute Plan instituted by the Company after the Effective Date shall be at least as favorable, in the aggregate, as the most favorable Annual Bonus Plan or Substitute Plan in effect at any time during the 90-day period immediately preceding the Effective Date

(iii) Savings and Retirement Plans. During the Employment Period, the Executive shall be entitled to participate in all savings and retirement plans, practices, policies and programs applicable generally to other peer executives of the Company and its affiliated companies, but in no event shall such plans, practices, policies and programs provide the Executive with savings opportunities and retirement benefit opportunities, in each case, less favorable, in the aggregate, than the most favorable of those provided by the Company and its affiliated companies for the Executive under such plans, practices, policies and programs as in effect at anytime during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, those provided generally at any time after the

Effective Date to other peer executives of the Company and its affiliated companies.

- (iv) Welfare Benefit Plans. During the Employment Period, the Executive and/or the Executive's family, as the case maybe, shall be eligible for participation in and shall receive all benefits under welfare benefit plans, practices, policies and programs provided by the Company and its affiliated companies (including, without limitation, medical, prescription, dental, disability, salary continuance, employee life, group life, accidental death and travel accident insurance plans and programs) to the extent applicable generally to other peer executives of the Company and its affiliated companies, but in no event shall such plans, practices, policies and programs provide the Executive with benefits which are less favorable, in the aggregate, than the most favorable of such plans, practices, policies and programs in effect for the Executive at anytime during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, those provided generally at any time after the Effective Date to other peer executives of the Company and its affiliated companies.
- (v) Expenses. During the Employment Period, the Executive shall be entitled to receive prompt reimbursement for all reasonable expenses incurred by the Executive in accordance with the most favorable policies, practices and procedures of the Company and its affiliated companies in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies.
- (vi) Perquisites. During the Employment Period, the Executive shall be entitled to perquisites in accordance with the most favorable plans, practices, programs and policies of the Company and its affiliated companies in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies.
- (vii) Office and Support Staff. During the Employment Period, the Executive shall be entitled to an office or offices of a size and with furnishings and other appointments, and to secretarial and other assistance, at least equal to the most favorable of the foregoing provided to the Executive by the Company at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as provided generally at any time thereafter with respect to other peer executives of the Company.
- (viii) Vacation. During the Employment Period, the Executive shall be entitled to paid vacations in accordance with the most favorable plans, policies, programs and practices of the Company and its affiliated companies as in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer Executives of the Company and its affiliated companies.

## 5. Termination of Employment.

- (a) Death or Disability. The Executive's employment shall terminate automatically upon the Executive's death during the Employment Period. If the Company determines in good faith that the Disability of the Executive has occurred during the Employment Period (pursuant to the definition of Disability set forth below), it may give to the Executive written notice in accordance with Section 10(b) of this Agreement of its intention to terminate the Executive's employment. In such event, the Executive's employment with the Company shall terminate effective on the 30th day after receipt of such notice by the Executive (the "Disability Effective Date"), provided that, within the 30 days after such receipt, the Executive shall not have returned to full-time performance of the Executive's duties. For purposes of this Agreement, "Disability" shall mean the absence of the Executive from the Executive's duties with the Company on a full-time basis for 180 consecutive days as a result of incapacity due to mental or physical illness which is determined to be total and permanent by a physician selected by the Company or its insurers and acceptable to the Executive or the Executive's legal representative (such agreement as to acceptability not to be withheld unreasonably).
- (b) Cause. The Company may terminate the Executive's employment during the Employment Period for Cause. For purposes of this Agreement, "Cause" shall mean (i) repeated violations by the Executive of the Executive's obligations under Section 4(a) of this Agreement (other than as a result of incapacity due to physical or mental illness) which are demonstrably willful and deliberate on the Executive's part, which are committed in bad faith or without the belief on the part of the Executive that such violations are in the best interests of the Company and which are not remedied in a reasonable period of time after receipt of written notice from the Company specifying such violations or (ii) the conviction of the Executive of a felony involving moral turpitude.
- (c) Good Reason. The Executive's employment may be terminated by the Executive for Good Reason. For purposes of this Agreement, "Good



Reason" shall mean:

- (i) the assignment to the Executive of any duties materially inconsistent in any respect with the Executive's position (including offices and titles), duties or responsibilities as contemplated by Section 4(a) of this Agreement, or any other action by the Company which results in a material diminution in such position, duties or responsibilities, excluding for this purpose an isolated, insubstantial and inadvertent action not taken in bad faith and which is remedied by the Company promptly after receipt of notice thereof given by the Executive;
- (ii) any failure by the Company to comply with any of the provisions of Section 4(b) of this Agreement, other than an isolated, insubstantial and inadvertent failure not occurring in bad faith and which is remedied by the Company promptly after receipt of notice thereof given by the Executive;
- (iii) the Company's requiring the Executive to be based at any office or location other than that described in Section 4(a)(i)(B) hereof or the Company's requiring the Executive to travel on Company business to a substantially greater extent than required immediately prior to the Effective Date;
- (iv) any purported termination by the Company of the Executive's employment otherwise than as expressly permitted by this Agreement; or
- (v) any failure by the Company to comply with and satisfy Section 9(c) of this Agreement.

For purposes of this Section 5(c), any good faith determination of "Good Reason" made by the Executive shall be conclusive.

- (d) Notice of Termination. Any termination by the Company for Cause, or by the Executive for Good Reason, shall be communicated by Notice of Termination to the other party hereto given in accordance with Section 10(b) of this Agreement. For purposes of this Agreement, a "Notice of Termination" means a written notice which (i) indicates the specific termination provision in this Agreement relied upon, (ii) to the extent applicable, sets forth in reasonable detail the facts and circumstances claimed to provide a basis for termination of the Executive's employment under the provision so indicated and (iii) if the Date of Termination (as defined below) is other than the date of receipt of such notice, specifies the termination date (which date shall be not more than fifteen days after the giving of such notice). The failure by the Executive or the Company to set forth in the Notice of Termination any fact or circumstance which contributes to a showing of Good Reason or Cause shall not waive any right of the Executive or the Company hereunder or preclude the Executive or the Company from asserting such fact or circumstance in enforcing the Executive's or the Company's rights hereunder.
- (e) Date of Termination. "Date of Termination" means (i) if the Executive's employment is terminated by the Company for Cause, or by the Executive for Good Reason, the date of receipt of the Notice of Termination or any later date specified therein, as the case may be, (ii) if the Executive's employment is terminated by the Company other than for Cause or Disability or death, the Date of Termination shall be the date on which the Company notifies the Executive of such termination and (iii) if the Executive's employment is terminated by reason of death or Disability, the Date of Termination shall be the date of death of the Executive or the Disability Effective Date, as the case may be.

## 6. Obligations of the Company upon Termination.

- (a) Good Reason; Other Than for Cause, Death or Disability. If, within two years after the Effective Date, the Company shall terminate the Executive's employment other than for Cause, death or Disability, or the Executive shall terminate employment for Good Reason, in lieu of further payments pursuant to Section 4(b) with respect to periods following the Date of Termination:
  - (i) except as provided in Section 6(e) below, the Company shall pay to the Executive, in a lump sum in cash, within 30 days (except as provided in subsection 6(a)(i)A below) after the Date of Termination, the aggregate of the following amounts (such aggregate shall be hereinafter referred to as the "Special Termination Amount"):

- A. the sum of (1) the Executive's Annual Base Salary through the Date of Termination to the extent not theretofore paid, and, (2) the product of (x) the higher of (I) the midpoint between the minimum and the maximum bonus payment under the Annual Bonus Plan or Substitute Plan applicable to the Executive for the fiscal year in which the Date of Termination occurs, or (II) the amount that would be payable to the Executive for the fiscal year in which the Date of Termination occurs under the Annual Bonus Plan or Substitute Plan had the termination not so occurred (which amount shall be payable pursuant to this clause 2 within 30 days after it is calculated), and (y) a fraction, the numerator of which is the number of days in the current fiscal year through the Date of Termination, and the denominator of which is 365 (the sum of the amounts described in clauses (1) and (2) shall be hereinafter referred to as the "Accrued

Obligations"); and

- B. the amount equal to the product of (1) two and (2) the sum of (x) the Executive's Annual Base Salary and (y) the midpoint between the maximum and minimum bonus payment applicable to the Executive for the fiscal year in which the Date of Termination occurs under the Annual Bonus Plan or Substitute Plan; and

(ii) for two years following the Date of Termination or such longer period as any plan, program, practice or policy may provide, the Company shall continue benefits to the Executive and/or the Executive's family at least equal to those which would have been provided to them in accordance with the plans programs, practices and policies described in Section 4(b)(iv) of this Agreement if the Executive's employment had not been terminated, in accordance with the most favorable plans, practices, programs or policies of the Company and its affiliated companies applicable generally to other peer executives and their families during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies and their families, provided, however, that if the Executive becomes re-employed with another employer and is eligible to receive medical or disability welfare benefits under another employer provided plan, the medical and disability welfare benefits described herein shall cease upon the Executive and the Executive's family becoming eligible under such other plan. For purposes of determining eligibility of the Executive for retiree benefits pursuant to such plans, practices, programs and policies, the Executive shall be considered to have remained employed until two years after the Date of Termination and to have retired two years after the Date of Termination.

(b) Death. If the Executive's employment is terminated by reason of the Executive's death within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive's legal representatives under this Agreement, other than for payment of the Accrued Obligations. The Accrued Obligations shall be paid to the Executive's estate or beneficiary, as applicable, in a lump sum in cash within 30 days of the Date of Termination, or as otherwise provided in Section 6(a)(i)(A). In addition, the Executive's family shall be entitled to receive benefits at least equal to the most favorable benefits provided by the Company and any of its affiliated companies to surviving families of deceased peer executives of the Company and such affiliated companies under such plans, programs, practices and policies relating to family death benefits, if any, as in effect with respect to other deceased peer executives and their families at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive and/or the Executive's family, as in effect on the date of the Executive's death with respect to other deceased peer executives of the Company and its affiliated companies and their families.

(c) Disability. If the Executive's employment is terminated by reason of the Executive's Disability within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive, other than for payment of the Accrued Obligations. The Accrued Obligations shall be paid to the Executive in a lump sum in cash within 30 days of the Date of Termination or as otherwise provided in Section 6(a)(i)(A). In addition, the Executive shall be entitled after the Disability Effective Date to receive disability and other benefits at least equal to the most favorable of those generally provided by the Company and its affiliated companies to disabled executives and/or their families in accordance with such plans, programs, practices, and policies relating to disability, if any, as in effect generally with respect to other disabled peer executives and their families at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive and/or the Executive's family, as in effect at any time thereafter generally with respect to other disabled peer executives of the Company and its affiliated companies and their families.

(d) Cause; Other than for Good Reason. If the Executive's employment shall be terminated for Cause within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive other than the obligation to pay to the Executive Annual Base Salary through the Date of Termination plus the amount of any compensation previously deferred by the Executive, in each case to the extent theretofore unpaid. If the Executive voluntarily terminates employment within two years after the Effective Date, excluding a termination for Good Reason, this Agreement shall terminate without further obligations to the Executive, other than Annual Base Salary through the Date of Termination plus the amount of any compensation previously deferred by the Executive, in each case to the extent theretofore unpaid, and any payment that may be due under the terms of the Annual Bonus Plan or any Successor Plan. In such case, all such amounts shall be paid to the Executive in a lump sum in cash within 30 days of the Date of Termination or, in the case of any payment under the Annual Bonus Plan or any Successor Plan, pursuant to the terms thereof.

(e) Possible Payment Reduction.

(i) Notwithstanding any provision to the contrary contained in this Agreement, if the lump sum cash payment due and the other benefits to which the Executive shall become entitled under

Section 6(a) hereof, either alone or together with other payments in the nature of compensation to the Executive which are contingent on a change in the ownership or effective control of the Company or in the ownership of a substantial portion of the assets of the Company or otherwise, would constitute a "parachute payment" (as defined in Section 280G of the Internal Revenue Code of 1986, as amended (the "Code") or any successor provision thereto), such lump sum payment shall be reduced (but not below zero) to the largest aggregate amount as will result in no portion thereof being subject to the excise tax imposed under Section 4999 of the Code (or any successor provision thereto) or being non-deductible to the Company for Federal Income Tax purposes pursuant to Section 280G of the Code (or any successor provision thereto), provided, however, that no such reduction shall occur, and this Section 6(e) shall not apply, in the event that the amount of such reduction would be more than \$25,000. The Executive in good faith shall determine the amount of any reduction to be made pursuant to this Section 6(e) and shall select from among the foregoing benefits and payments those which shall be reduced. No modification of, or successor provision to, Section 280G or Section 4999 subsequent to the date of this Agreement shall, however, reduce the benefits to which the Executive would be entitled under this Agreement in the absence of this Section 6(e) to a greater extent than they would have been reduced if Section 280G and Section 4999 had not been modified or superseded subsequent to the date of this Agreement, notwithstanding anything to the contrary provided in the first sentence of this Section 6(e)(i).

(f) Certain Additional Payments by the Company.

(i) Anything in this Agreement to the contrary notwithstanding, in the event it shall be determined that Section 6(e) above does not apply and any payment or distribution by the Company to or for the benefit of the Executive (whether paid or payable or distributed or distributable pursuant to the terms of this Agreement, any stock option, restricted stock agreement or otherwise, but determined without regard to any additional payments required under this Section 16(f)) (a "Payment") would be subject to the excise tax imposed by Section 4999 of the Internal Revenue Code of 1986, as amended (the "Code") or any interest or penalties are incurred by the Executive with respect to such excise tax (such excise tax, together with any such interest and penalties, are hereinafter collectively referred to as the "Excise Tax"), then the Executive shall be entitled to receive an additional payment (a "Gross-Up Payment") in an amount such that after payment by the Executive of all taxes (including any interest or penalties imposed with respect to such taxes), including, without limitation, any income taxes (and any interest and penalties imposed with respect thereto) and Excise Tax imposed upon the Gross-Up Payment, the Executive retains an amount of the Gross-Up Payment equal to the Excise Tax imposed upon the Payments.

(ii) Subject to the provisions of Section 6(f)(iii), all determinations required to be made under this Section 6(f), including whether and when a Gross-Up Payment is required and the amount of such Gross-Up Payment and the assumptions to be utilized in arriving at such determination, shall be made by Deloitte and Touche LLP or such other certified public accounting firm as may be designated by the Executive (the "Accounting Firm") which shall provide detailed supporting calculations both to the Company and the Executive within 15 business days of the receipt of notice from the Executive that there has been a Payment, or such earlier time as is requested by the Company. In the event that the Accounting Firm is serving as accountant or auditor for the individual, entity or group effecting the Change of Control, the Executive shall appoint another nationally recognized accounting firm to make the determinations required hereunder (which accounting firm shall then be referred to as the Accounting Firm hereunder). All fees and expenses of the Accounting Firm shall be borne solely by the Company. Any Gross-Up Payment, as determined pursuant to this Section 6(f), shall be paid by the Company to the Executive within five days of the receipt of the Accounting Firm's determination. If the Accounting Firm determines that no Excise Tax is payable by the Executive, it shall furnish the Executive with a written opinion that failure to report the Excise Tax on the Executive's applicable federal income tax return would not result in the imposition of a negligence or similar penalty. Any determination by the Accounting Firm shall be binding upon the Company and the Executive. As a result of the uncertainty in the application of Section 4999 of the Code at the time of the initial determination by the Accounting Firm hereunder, it is possible that Gross-Up Payments which will not have been made by the Company should have been made ("Underpayment"), consistent with the calculations required to be made hereunder. In the event that the Company exhausts its remedies pursuant to Section 6(f)(iii) and the Executive thereafter is required to make a payment of any Excise Tax, the Accounting Firm shall determine the amount of the Underpayment that has occurred and any such Underpayment shall be promptly paid by the Company to or for the benefit of the Executive.

(iii) The Executive shall notify the Company in writing of any claim by the Internal Revenue Service that, if successful, would require the payment by the Company of the Gross-Up Payment. Such notification shall be given as soon as practicable but no later than ten business days after the Executive is informed in writing of such claim (provided that any delay in so informing the Company within such ten business day period shall not affect the obligations of the Company under this Section 6(f) except to the extent that such delay materially and adversely affects the Company) and shall apprise the Company of the nature of such claim and the date on which such claim is requested to be paid. The Executive shall not pay such claim prior to the expiration of the 30-day period following the date on which it gives such notice to the Company (or such shorter period ending on the date that any payment of taxes with respect to such claim is due). If the Company notifies the Executive in writing prior to the expiration of such period that it desires to contest such claim, the Executive shall:

- (A) give the Company any information reasonably requested by the Company relating to such claim,
- (B) take such action in connection with contesting such claim as the Company shall reasonably request in writing from time to time, including, without limitation, accepting legal representation with respect to such claim by an attorney reasonably selected by the Company,
- (C) cooperate with the Company in good faith in order to effectively contest such claim, and
- (D) permit the Company to participate in any proceedings relating to such claim; provided, however, that the Company shall bear and pay directly all costs and expenses (including additional interest and penalties) incurred in connection with such contest and shall indemnify and hold the Executive harmless, on an after-tax basis, for any Excise Tax or income tax (including interest and penalties with respect thereto) imposed as a result of such representation and payment of costs and expenses. Without limitation on the foregoing provisions of this Section 6(f)(iii), the Company shall control all proceedings taken in connection with such contest and, at its sole option, may pursue or forgo any and all administrative appeals, proceedings, hearings and conferences with the taxing authority in respect of such claim and may, at its sole option, either direct the Executive to pay the tax claimed and sue for a refund or contest the claim in any permissible manner, and the Executive agrees to prosecute such contest to a determination before any administrative tribunal, in a court of initial jurisdiction and in one or more appellate courts, as the Company shall determine; provided, however, that if the Company directs the Executive to pay such claim and sue for a refund, the Company shall advance the amount of such payment to the Executive, on an interest-free basis, and shall indemnify and hold the Executive harmless, on an after-tax basis, from any Excise Tax or income tax (including interest or penalties with respect thereto) imposed with respect to such advance or with respect to any imputed income with respect to such advance; and further provided that any extension of the statute of limitations relating to payment of taxes for the taxable year of the Executive with respect to which such contested amount is claimed to be due is limited solely to such contested amount. Furthermore, the Company's control of the contest shall be limited to issues with respect to which a Gross-Up Payment would be payable hereunder and the Executive shall be entitled to settle or contest, as the case may be, any other issue raised by the Internal Revenue Service or any other taxing authority.

(iv) If, after the receipt by the Executive of an amount advanced by the Company pursuant to Section 6(f)(iii), the Executive becomes entitled to receive any refund with respect to such claim, the Executive shall (subject to the Company's complying with the requirements of Section 6(f)(iii)) promptly pay to the Company the amount of such refund (together with any interest paid or credited thereon after taxes applicable thereto). If, after the receipt by the Executive of an amount advanced by the Company pursuant to Section 6(f)(iii), a determination is made that the Executive shall not be entitled to any refund with respect to such claim and the Company does not notify the Executive in writing of its intent to contest such denial of refund prior to the expiration of 30 days after such determination, then such advance shall be forgiven and shall not be required to be repaid and the amount of such advance shall offset, to the extent thereof, the amount of Gross-Up Payment required to be paid.

7. Non-exclusivity of Rights. Nothing in this Agreement shall prevent or limit the Executive's continuing or future participation in any plan, program, policy or practice provided by the Company or any of its affiliated companies and for which the Executive may qualify, nor shall anything herein limit or otherwise affect such rights as the Executive may have

under any contract or agreement with the Company or any of its affiliated companies. Amounts which are vested benefits or which the Executive is otherwise entitled to receive under any plan, policy, practice or program of or any contract or agreement with the Company or any of its affiliated companies at or subsequent to the Date of Termination shall be payable in accordance with such plan, policy, practice or program or contract or agreement except as explicitly modified by this Agreement.

8. Full Settlement; No Mitigation; Legal Fees. The Company's obligation to make the payments provided for in this Agreement and otherwise to perform its obligations hereunder shall not be affected by any set-off, counterclaim, recoupment, defense or other claim, right or action which the Company may have against the Executive or others. In no event shall the Executive be obligated to seek other employment or take any other action by way of mitigation of the amounts payable to the Executive under any of the provisions of this Agreement and such amounts shall not be reduced whether or not the Executive obtains other employment. The Company agrees to pay, to the full extent permitted by law, all legal fees and expenses which the Executive may reasonably incur as a result of any contest (regardless of the outcome thereof) by the Company, the Executive or others of the validity or enforceability of, or liability under, any provision of this Agreement or any guarantee of performance thereof (including as a result of any contest by the Executive about the amount of any payment pursuant to this Agreement), plus in each case interest on any delayed payment at the applicable Federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code").

9. Successors.

(a) This Agreement is personal to the Executive and without the prior written consent of the Company shall not be assignable by the Executive otherwise than by will or the laws of descent and distribution. This Agreement shall inure to the benefit of and be enforceable by the Executive's legal representatives.

(b) This Agreement shall inure to the benefit of and be binding upon the Company and its successors and assigns.

(c) The Company will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Company to assume expressly and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform it if no such succession had taken place.

10. Miscellaneous.

(a) This Agreement shall be governed by and construed in accordance with the laws of the State of Minnesota, without reference to principles of conflict of laws. The captions of this Agreement are not part of the provisions hereof and shall have no force or effect. This Agreement may not be amended or modified otherwise than by a written agreement executed by the parties hereto or their respective successors and legal representatives.

(b) All notices and other communications hereunder shall be in writing and shall be given by hand delivery to the other party or by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

If to the Executive:

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c/o Graco Inc.  
88 11th Ave. N.E.  
Minneapolis, Mn. 55413

If to the Company:

Graco Inc.  
88 11th Ave. N.E.  
Minneapolis, Mn. 55413  
Attention: Vice President, Human Resources

or to such other address as either party shall have furnished to the other in writing in accordance herewith. Notice and communications shall be effective when actually received by the addressee.

(c) The invalidity or unenforceability of any provision of this Agreement shall not affect the validity or enforceability of any other provision of this Agreement.

(d) The Company may withhold from any amounts payable under this Agreement such Federal, state or local taxes as shall be required to be withheld pursuant to any applicable law or regulation.

(e) The Executive's or the Company's failure to insist upon strict compliance with any provision hereof or any other provision of this Agreement or the failure to assert any right the Executive or the Company may have hereunder, including, without limitation, the right of the Executive to terminate employment for Good Reason pursuant to Section 5(c)(i)(v) of this Agreement, shall not be deemed to be a waiver of such provision or right or any other provision or right of this Agreement.

(f) The Executive and the Company acknowledge that, except as may otherwise be provided under any other written agreement between the

Executive and the Company, the employment of the Executive by the Company may be terminated by either the Executive or the Company at any time prior to the Effective Date or, subject to the obligations of the Company provided for in this Agreement in the event of a termination after the Effective Date, at anytime on or after the Effective Date. Moreover, if prior to the Effective Date, the Executive's employment with the Company terminates, then the Executive shall have no further rights under this Agreement. From and after the Effective Date, this Agreement shall supersede any other agreement between the parties with respect to the subject matter hereof.

IN WITNESS WHEREOF, the Executive has hereunto set the Executive's hand and, pursuant to the authorization from its Board of Directors, the Company has caused these presents to be executed in its name on its behalf.

Executive

Graco Inc.

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By: George Aristides,  
Chairman