

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended **March 26, 2004**

Commission File Number: 001-9249

GRACO INC.

(Exact name of Registrant as specified in its charter)

Minnesota

(State of incorporation)

41-0285640

(I.R.S. Employer Identification Number)

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

(Address of principal executive offices)

55413

(Zip Code)

(612) 623-6000

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

Yes ☒ No ☐

69,411,000 common shares were outstanding as of April 26, 2004.

GRACO INC. AND SUBSIDIARIES

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PART I

Item I. GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)
(In thousands, except per share amounts)

	Thirteen Weeks Ended	
	<u>March 26, 2004</u>	<u>March 28, 2003</u>
Net Sales	\$ 134,982	\$ 119,660
Cost of products sold	61,578	56,657
Gross Profit	73,404	63,003
Product development	5,122	4,473
Selling, marketing and distribution	24,397	22,897
General and administrative	10,443	8,512
Operating Earnings	33,442	27,121
Interest expense	171	128
Other expense (income), net	(56)	(101)
Earnings before Income Taxes	33,327	27,094
Income taxes	11,000	8,900
Net Earnings	\$ 22,327	\$ 18,194
Basic Net Earnings per Common Share	\$.32	\$.26
Diluted Net Earnings per Common Share	\$.32	\$.25
Cash Dividends Declared per Common Share	\$.09	\$.06

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

(Unaudited)
(In thousands)

	<u>March 26, 2004</u>	<u>Dec. 26, 2003</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 23,688	\$ 112,118

Accounts receivable, less allowances of \$6,200 and \$5,700	100,305	98,853
Inventories	32,944	29,018
Deferred income taxes	15,776	14,909
Other current assets	1,242	1,208
	<hr/>	<hr/>
Total current assets	173,955	256,106
Property, Plant and Equipment:		
Cost	222,022	221,233
Accumulated depreciation	(128,090)	(126,916)
	<hr/>	<hr/>
	93,932	94,317
Prepaid Pension	25,943	25,444
Goodwill	9,199	9,199
Other Intangible Assets, net	10,035	10,622
Other Assets	2,638	1,702
	<hr/>	<hr/>
	\$ 315,702	\$ 397,390
	<hr/>	<hr/>

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities		
Notes payable to banks	\$ 9,678	\$ 4,189
Trade accounts payable	19,462	15,752
Salaries, wages and commissions	11,448	16,384
Accrued insurance liabilities	9,987	9,939
Accrued warranty and service liabilities	9,290	9,227
Income taxes payable	14,021	5,981
Dividends payable	6,459	110,304
Other current liabilities	14,326	16,171
	<hr/>	<hr/>
Total current liabilities	94,671	187,947
Retirement Benefits and Deferred Compensation	31,139	30,567
Deferred Income Taxes	8,828	9,066
Shareholders' Equity		
Common stock	46,166	46,040
Additional paid-in capital	91,410	81,405
Retained earnings	44,695	43,295
Other, net	(1,207)	(930)
	<hr/>	<hr/>
Total shareholders' equity	181,064	169,810
	<hr/>	<hr/>
	\$ 315,702	\$ 397,390
	<hr/>	<hr/>

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

	Thirteen Weeks Ended	
	<u>March 26, 2004</u>	<u>March 28, 2003</u>
Cash Flows from Operating Activities		
Net Earnings	\$ 22,327	\$ 18,194
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	4,602	4,401
Deferred income taxes	(901)	(966)
Tax benefit related to stock options exercised	2,500	500
Change in:		
Accounts receivable	(1,550)	388
Inventories	(3,949)	(5,561)
Trade accounts payable	3,717	(142)
Salaries, wages and commissions	(4,911)	(5,142)
Retirement benefits and deferred compensation	(424)	640
Other accrued liabilities	6,361	5,124
Other	83	30
	<hr/>	<hr/>

27,855

17,466

Cash Flows from Investing Activities

Property, plant and equipment additions	(3,838)	(3,276)
Proceeds from sale of property, plant and equipment	14	76
Capitalized software additions	(785)	--
	<u>(4,609)</u>	<u>(3,200)</u>

Cash Flows from Financing Activities

Borrowings on notes payable and lines of credit	7,592	5,826
Payments on notes payable and lines of credit	(2,123)	(10,977)
Common stock issued	8,652	5,216
Common stock retired	(15,202)	(55,258)
Cash dividends paid	(110,590)	(3,922)
	<u>(111,671)</u>	<u>(59,115)</u>
Effect of exchange rate changes on cash	(5)	(315)
Net increase (decrease) in cash and cash equivalents	(88,430)	(45,164)
Cash and cash equivalents		
Beginning of year	112,118	103,333
End of period	<u>\$ 23,688</u>	<u>\$ 58,169</u>

See notes to consolidated financial statements.

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

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of March 26, 2004 and the related statements of earnings and cash flows for the thirteen weeks then ended have been prepared by the Company without being audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of March 26, 2004, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2003 Form 10-K.

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

2. On February 20, 2004, the Board of Directors declared a three-for-two split of the Company's common stock. The split was distributed on March 30, 2004 to shareholders of record on March 16, 2004. Share and per share amounts for all periods presented reflect the stock split.
3. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	<u>Thirteen Weeks Ended</u> <u>March 26, 2004</u>	<u>March 28, 2003</u>
Net earnings available to common shareholders	\$22,327	\$18,194
Weighted average shares outstanding for basic earnings per share	69,082	70,850
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,160	999
Weighted average shares outstanding for diluted earnings per share	70,242	71,849

Basic earnings per share	\$.32	\$.26
Diluted earnings per share	\$.32	\$.25

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

Had compensation cost been determined based upon fair value (using the Black-Scholes option-pricing method) 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):

	<u>Thirteen Weeks Ended</u>	
	<u>March 26, 2004</u>	<u>March 28, 2003</u>
Net earnings		
As reported	\$ 22,327	\$ 18,194
Stock-based compensation, net of related tax effects	873	1,037
Pro forma	<u>\$ 21,454</u>	<u>\$ 17,157</u>
Net earnings per common share		
Basic as reported	\$.32	\$.26
Basic pro forma	.31	.24
Diluted as reported	.32	.25
Diluted pro forma	.31	.24

5. Total comprehensive income for the quarter was \$22.0 million in 2004 and \$18.4 million in 2003. There have been no significant changes to the components of comprehensive income from those noted on the 2003 Form 10-K.

6. The Company has three reportable segments; Industrial/Automotive, Contractor and Lubrication. The Company does not identify assets by segment. Sales and operating earnings by segment for the thirteen weeks ended March 26, 2004 and March 28, 2003 were as follows (in thousands):

	<u>Thirteen Weeks Ended</u>	
	<u>March 26, 2004</u>	<u>March 28, 2003</u>
Net Sales		
Industrial/Automotive	\$ 63,251	\$ 52,417
Contractor	58,975	54,838
Lubrication	12,756	12,405
Consolidated	<u>\$ 134,982</u>	<u>\$ 119,660</u>
Operating Earnings		
Industrial/Automotive	\$ 20,761	\$ 13,988
Contractor	12,017	10,757
Lubrication	3,002	3,147
Unallocated corporate expenses	(2,338)	(771)
Consolidated	<u>\$ 33,442</u>	<u>\$ 27,121</u>

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

	<u>March 26, 2004</u>	<u>Dec. 26, 2003</u>
Finished products and components	\$ 27,307	\$ 25,548
Products and components in various stages of completion	18,077	16,464
Raw materials and purchased components	<u>15,591</u>	<u>15,408</u>
	60,975	57,420
Reduction to LIFO cost	(28,031)	(28,402)

	\$ 32,944	\$ 29,018
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8. Information related to other intangible assets follows (in thousands):

	<u>Gross Carrying Value</u>		<u>Accumulated Amortization</u>	
	<u>March 26, 2004</u>	<u>Dec. 26, 2003</u>	<u>March 26, 2004</u>	<u>Dec. 26, 2003</u>
Subject to Amortization:				
Customer lists and distribution network	\$ 8,336	\$ 8,336	\$ 5,397	\$ 4,980
Trademarks, trade names and non-compete agreements	2,803	2,803	1,749	1,622
Patents and other	1,241	1,241	479	436
	<u>12,380</u>	<u>12,380</u>	<u>\$ 7,625</u>	<u>\$ 7,038</u>
Not Subject to Amortization:				
Brand name	5,280	5,280		
	<u>\$17,660</u>	<u>\$17,660</u>		

Amortization of intangibles during the first quarter of 2004 was \$.6 million. Estimated annual amortization is as follows: \$1.7 million in 2004, \$1.1 million in 2005, \$.9 million in 2006, \$.9 million in 2007, \$.4 million in 2008 and \$.3 million thereafter.

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

	<u>Thirteen Weeks Ended March 26, 2004</u>	<u>Year Ended Dec. 26, 2003</u>
Balance, beginning of year	\$ 9,227	\$ 6,294
Charged to expense	2,065	9,490
Margin on parts sales reversed	795	4,697
Reductions for claims settled	(2,797)	(11,254)
Balance, end of period	<u>\$ 9,290</u>	<u>\$ 9,227</u>

Item 2. GRACO INC. AND SUBSIDIARIES MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

The following table sets forth items from the Company's Consolidated Statements of Earnings as percentages of net sales:

	<u>Thirteen Weeks Ended March 26, 2004</u>	<u>March 28, 2003</u>
Net Sales	100.0%	100.0%
Cost of products sold	45.6	47.3
Gross Profit	54.4	52.7
Product development	3.8	3.8
Selling, marketing and distribution	18.1	19.1
General and administrative	7.7	7.1
Operating Earnings	24.8	22.7
Interest expense	0.1	0.1
Other (income) expense, net	--	(0.1)
Earnings Before Income Taxes	24.7	22.7
Income taxes	8.2	7.5
Net Earnings	<u>16.5%</u>	<u>15.2%</u>

Net Sales

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

	Thirteen Weeks Ended	
	March 26, 2004	March 28, 2003
By Segment		
Industrial/Automotive	\$ 63,251	\$ 52,417
Contractor	58,975	54,838
Lubrication	12,756	12,405
	<hr/>	<hr/>
Consolidated	\$134,982	\$119,660
	<hr/>	<hr/>
By Geographic Area		
Americas ¹	\$ 89,275	\$ 82,191
Europe ²	27,914	23,564
Asia Pacific	17,793	13,905
	<hr/>	<hr/>
Consolidated	\$134,982	\$119,660
	<hr/>	<hr/>

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

²Europe, Africa and Middle East

Consolidated sales increased by 13 percent compared to the first quarter last year; 9 percent when translated at consistent exchange rates. All operating segments and geographic regions had increases. Most of the translation effect came from the strengthening of the European euro. Sales in Europe increased 3 percent in local currencies, 18 percent when translated into U.S. dollars.

Industrial/Automotive sales increased by 21 percent, 14 percent translated at consistent exchange rates. Volume was higher in all three regions with double-digit increases in both the Americas and Asia Pacific. Demand for this segment's products strengthened in the fourth quarter of 2003 and continued to be strong in the first quarter of 2004.

Contractor segment sales increased by 8 percent, 5 percent translated at consistent exchange rates. In the Americas, sales were higher in both the professional paint store channel and the home center channel. In the professional paint store channel, sales increased in nearly every product category, with strong increases in larger paint sprayers. Home center channel sales posted strong gains over the first quarter of last year.

Lubrication segment sales increased by 3 percent, 1 percent translated at consistent exchange rates. Increases from successful sales promotions offset a decrease in control system sales. Sales in the first quarter of 2003 included \$1 million from the Matrix fluid dispensing system. Sales of the Matrix system have been suspended pending completion of design changes and successful field-testing.

Gross Profit

Gross profit as a percentage of sales increased to 54.4 percent from 52.7 percent primarily due to favorable currency translation rates. Changes in exchange rates have less impact on the cost of products sold than on sales because most product costs are incurred in U.S. dollars, which had the effect of increasing gross profit rate in the first quarter of 2004 when compared to the same period last year.

Manufacturing productivity and process improvements, savings from the closing of the old Main Plant facility in Minneapolis, Minnesota and segment sales mix (higher proportion of sales from Industrial/Automotive) also had a favorable impact on the gross profit rate.

Operating Expenses

Higher product development expenses reflect the Company's plans to increase development activity. Such expenses did not change as a percentage of sales.

Selling, marketing and distribution expenses increased by 7 percent, but decreased as a percentage of sales. Changes in exchange rates used to translate expenses incurred in foreign currencies, routine salary rate increases, Sharpe expenses (acquired in the second quarter of 2003) and higher warranty costs all contributed to the increase in selling, marketing and distribution expenses.

General and administrative expenses in 2004 included a \$1 million contribution to the Graco Foundation – no contribution was made in the first quarter of 2003. General and administrative expenses also include \$.5 million in 2004 for the demolition of the Company's Main Plant facility. Amortization of intangibles and expenses related to Sharpe operations also contributed to the increase in general and administrative expenses.

Liquidity and Capital Resources

During the quarter, significant uses of cash included \$111 million of dividends paid (including \$104 million for a one-time special dividend) and \$15 million for purchases and retirement of Company common stock.

The Company had unused lines of credit available at March 26, 2004 totaling \$47 million. Cash balances of \$24 million at March 26, 2004, internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

Outlook

Management is encouraged by the increased demand for its Industrial/Automotive products over the last six months. In addition to the large increase in Industrial/Automotive, the Contractor segment continues to show higher sales. These increases are evidence that the economy is strengthening and management continues to look for higher sales and net earnings this year.

SAFE HARBOR CAUTIONARY STATEMENT

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, 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 2003 for a more comprehensive discussion of these and other risk factors.

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

Item 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

As of the end of the fiscal quarter covered by this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures. This evaluation was done under the supervision and with the participation of the Company's President and Chief Executive Officer, Vice President and Controller, Vice President and Treasurer, and Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

Changes in internal controls

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

PART II

Item 2 Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

Issuer Purchases of Equity Securities¹

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

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

Information on issuer purchases of equity securities follows:

<u>Period</u>	<u>(a) Total Number of Shares Purchased</u>	<u>(b) Average Price Paid per Share</u>	<u>(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period)</u>
Dec 27, 2003 - Jan 23, 2004	--	--	--	2,360,850
Jan 24, 2004 - Feb 20, 2004	294,782	\$27.42	293,550	3,000,000
Feb 21, 2004 - Mar 26, 2004	258,201	\$27.57	234,000	2,766,000

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

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

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- 3.1 Restated Articles of Incorporation as amended February 20, 2004
- 10.1 2004 Corporate & SBU Bonus Plan
- 10.2 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Graco Inc. Stock Incentive Plan. Amended form of agreement for awards made to executive officers in 2004.
- 10.3 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Graco Inc. Stock Incentive Plan. Amended form of agreement for award made to nonemployee directors in 2004.
- 10.4 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Graco Inc. Stock Incentive Plan. Amended form of agreement for awards made to Chief Executive Officer in 2004.
- 31.1 Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a)
- 31.2 Certification of Vice President and Controller pursuant to Rule 13a-14(a)
- 31.3 Certification of Vice President and Treasurer pursuant to Rule 13a-14(a)
- 32 Certification of President and Chief Executive Officer, Vice President and Controller, and Vice President and Treasurer pursuant to Section 1350 of Title 18, U.S.C.

(b) Reports on Form 8-K

The following Current Report on Form 8-K was furnished during the quarter ended March 26, 2004: On January 23, 2004, Graco Inc. furnished a current report on Form 8-K to furnish its earnings release for the year ended December 26, 2003.

SIGNATURES

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

GRACO INC.

Date: April 27, 2004

By: /s/David A. Roberts

David A. Roberts
President & Chief Executive Officer

Date: April 27, 2004

By: /s/James A. Graner

James A. Graner
Vice President & Controller
Chief Accounting Officer

Date: April 27, 2004

By: /s/Mark W. Sheahan

Mark W. Sheahan
Vice President & Treasurer
Principal Financial Officer

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

ARTICLE I

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

ARTICLE 2

2. Corporation Service Company, is this corporation's registered agent in the State of Minnesota, and Multifoods Tower, 33 South Sixth Street, Minneapolis, Minnesota 55402, the business office address of Corporation Service Company, is the registered office of this corporation.

ARTICLE 3

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

ARTICLE 4

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

(b) Preferred Shares may be issued from time to time in one or more series as the Board of Directors may determine, as hereinafter provided. The Board of Directors is hereby authorized by resolution or resolutions, to provide from time to time for series of Preferred Shares out of the unissued Preferred Shares not then allocated to any series of Preferred Shares. Before any shares of any such series are issued, the Board of Directors shall fix and determine, and is hereby expressly empowered to fix and determine, by resolution or resolutions, the designations and the relative rights and preferences thereof, of the shares of such series. Preferred Shares will be senior to the Cumulative Preferred Shares in terms of dividend and liquidation rights unless the Board of Directors specifically provides otherwise in the resolution or resolutions establishing a series of Preferred Shares.

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

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

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

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

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

(c) *Dividends.* The holders of Cumulative Preferred Shares shall be entitled to receive out of any assets legally available therefor, when and as declared by the Board of Directors, fixed cumulative dividends at the rate of five percent (5%) per annum upon the par value thereof, and no more, payable semiannually on January 1 and July 1 of each year. Such dividends shall be cumulative from January 1, 1969.

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

Subject to the provisions of this Article 5 and not otherwise, dividends may be declared by the Board of Directors and paid from time to time, out of any funds legally available therefor, upon the Common Shares, and the holders of Cumulative Preferred Shares shall not be entitled to participate in any such dividends.

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

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

If notice of redemption shall have been duly given as aforesaid and if on or before the redemption date specified in the notice, all funds necessary for the redemption shall have been deposited in trust with a bank or trust company in good standing and doing business at any place within the United States, and designated in the notice of redemption, for the pro rata benefit of the shares so called for redemption, so as to be and continue to be available therefor, then, from and after the date of such deposit, notwithstanding that any certificate for Cumulative Preferred Shares so called for redemption shall not have been surrendered for cancellation, the shares represented thereby shall no longer be deemed outstanding, and the dividends thereon shall cease to accumulate from and after the date fixed for redemption, and all rights with respect to the Cumulative Preferred Shares so called for redemption shall forthwith, on the date of such deposit, cease and terminate except only the right of the holders thereof to receive the redemption price of the shares so redeemed, including accrued cumulative dividends to the redemption date, but without interest. Any funds deposited by the corporation pursuant to this paragraph and unclaimed at the end of six (6) years after the date fixed for redemption shall be repaid to the corporation upon its request expressed in a resolution of its Board of Directors, after which repayment the holders of the shares so called for redemption shall look only to the corporation for the payment thereof.

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

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

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

(ii) After an amount equivalent to three (3) full semi-annual dividend installments of the Cumulative Preferred Shares shall be in default, the holders of Cumulative Preferred Shares at the time outstanding, voting separately as a class shall, at any annual meeting of the shareholders or any special meeting of the shareholders called as herein provided occurring during such period, elect two (2) members of the Board of Directors, and the holders of the Common Shares, voting separately as a class, shall elect the remaining directors of the corporation.

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

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

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

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

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

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

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

ARTICLE 5

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

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

(b) The Business Combination is a merger, consolidation, exchange of shares or sale of all or substantially all of the assets of the corporation and the cash or fair market value (determined as of the effective date of such Business Combination or, in the case of a sale of assets as of the date of the distribution of the proceeds of the sale to the shareholders of the corporation) of the property, securities or other consideration to be received per share by holders of common stock of the corporation other than the Related Person is not less than the highest per share price (with appropriate adjustments for recapitalizations, stock splits, stock dividends and like distributions), paid by the Related Person in acquiring any of its holdings of the corporation's common stock during the two-year period prior to the effective date of the Business Combination or the distribution of the proceeds of a sale of assets.

5.2 For the purposes of this Article 6:

(a) The term "Business Combination" shall mean

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

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

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

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

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

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

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

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

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

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

Related Person.

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

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

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

5.3 For the purposes of this Article 6 the Continuing Directors by a majority vote shall have the power to make a good faith determination, on the basis of information known to them, of: (i) the number of shares of Voting Stock of the corporation that any person or entity Beneficially Owns, (ii) whether a person or entity is an Affiliate or Associate of another, (iii) whether the assets subject to any Business Combination constitute a Substantial Part, (iv) whether any business transaction is one in which a Related Person has an interest, (v) whether the cash or fair market value of the property, securities or other consideration to be received per share by holders of capital stock of the corporation other than the Related Person in a Business Combination is an amount at least equal to the highest per share price paid by the Related Person and (vi) such other matters with respect to which a determination is required under this Article 6.

5.4 The provisions set forth in this Article 6 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of Voting Stock of the corporation.

ARTICLE 6

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

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

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

6.4 The provisions of this Article 7 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of the capital stock of the corporation entitled to vote generally in the election of directors, voting together as a single class.

ARTICLE 7

7. No director of the corporation shall be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty by such director as a director; provided, however, that this Article 8 shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 302A.559 of the Minnesota Business Corporation Act or Section 80A.23 of the Minnesota Securities Law, or (iv) for any transaction from which the director derived an improper personal benefit. No amendment to or repeal of this Article 8 shall apply to or have any effect on the liability or alleged liability of any director of the corporation for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

ARTICLE 8

8. The Board of Directors of the corporation (the "Board"), when evaluating any offer of another party, (a) to make a tender or exchange offer for any Voting Stock (as defined in Article 6) of the corporation or (b) to effect a Business Combination (as defined in Article 6), shall, in connection with the exercise of its judgment in determining what is in the best interests of the corporation as a whole, be authorized to give due consideration to such factors as the Board determines to be relevant, including, without limitation:

- (i) the interests of the corporation's shareholders;
- (ii) the social, legal and economic effects upon employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its business;
- (iii) whether the proposed transaction might violate federal or state laws; and
- (iv) not only the consideration being offered in the proposed transaction, in relation to the then current market price for the outstanding capital stock of the corporation, but also the market price for the capital stock of the corporation over a period of

years, the estimated price that might be achieved in a negotiated sale of the corporation as a whole or in part of through orderly liquidation, the premiums over market price for the securities of other corporations in similar transactions, current political, economic or other factors bearing on securities prices and the corporation's financial condition and future prospects.

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

2004 CORPORATE & SBU BONUS PLAN

Objectives

- To create shareholder value through achievement of annual financial objectives.
- To motivate and retain those key executives and managers who work in positions where they can impact the Company's annual financial objectives.

Plan Design

The Plan links the size of each individual's award to specific financial objectives. These objectives are tailored for the Corporation and for each Business Unit. These objectives are:

- Corporation
 - Corporate Sales and/or Net Earnings objectives
- Business Units
 - Sales and/or Contribution Growth objectives

Eligibility Requirements

Only those positions which carry clear managerial responsibility for directly contributing to Graco's Corporate Sales and/or Net Earnings objective and Business Unit Sales and/or Contribution Growth objectives are eligible to be included in this Plan.

Only those individuals in eligible positions who have demonstrated and are maintaining a performance level that meets the supervisor's normal expectations for that position are eligible for annual participation in this Plan as well as the receipt of any annual Bonus Payments.

Participation

The top executive in each organizational unit may nominate managers for participation in this Plan when the established position and individual eligibility requirements have been met.

The Management Organization and Compensation Committee of the Graco Inc. Board of Directors has sole authority to approve the participation of the Chief Executive Officer in the Plan.

The Chief Executive Officer of Graco Inc. has sole authority to select and approve all other Plan participants.

Bonus Maximum

Taken in conjunction with base salary market comparisons, bonus maximum for all positions will be:

- Commensurate with the position's ability to impact the annual Corporate Sales and/or Net Earnings objective and Business Unit Sales and/or Contribution Growth objectives.
- Consistent with total compensation levels prevalent for similar positions in the market place.

Based on these criteria, bonus maximums ranging from 10% to 90% have been established for each individual.

Bonus Payment

The determination of a participant's annual Bonus Payment will be calculated by adding the bonus results attained for Corporate Sales and/or Net Earnings performance (expressed in percent) to the bonus results attained for any applicable Business Unit's Sales and/or Contribution Growth performance (expressed in percent). These bonus results are then multiplied by the participant's Maximum Bonus Percentage and then multiplied by the participant's Base Salary for the Plan Year, to determine the total Bonus Payment.

Example:

Annual Corporate Performance Results	+	Annual Business Unit Performance Results (if applicable)	x	Participant's Maximum Bonus Salary	x	Participant's Annual Base Salary	=	Bonus
%		%		\$		\$		\$

The following rules have been established to ensure equitable administration of Graco's Annual Bonus Plan (the Plan):

- 1. The Plan will be administered by the Management Organization and Compensation Committee of the Board of Directors. The Committee may cancel the Plan and interpret the Plan.**
- 2. The Management Organization and Compensation Committee shall establish the Annual Corporate Bonus Plan financial objectives. Within the basic framework of the Plan, the Chief Executive Officer may establish the annual bonus plan financial objectives for individual Business Units. The CEO may also establish deadlines for filing administrative forms and adopt other administrative rules.**

The CEO has established the Bonus Administrative Committee consisting of the CEO, the Vice President, Human Resources, and the Compensation Manager. This Committee is responsible for making approval recommendations on all Annual Bonus Program administrative matters, such as participation award payments, performance measures, and performance results. All requests for adjustments or exceptions are to be formally submitted to this Committee for review through the Compensation Manager.

- 3. Key executives and managers selected to participate in the Plan after its annual effective date (January 1st) may be included on a pro-rata basis.**
- 4. Participation in the Plan one year does not necessarily assure participation in subsequent years. Eligibility requirements for both the position and individual performance must be met continually.**
- 5. Participation continues during any paid time off such as short-term disability (up to six months). Participation ceases with retirement, death, or long-term disability (over six months). In the event participation ceases due to retirement, death, or long term disability, the Participant will be eligible for a Bonus Payment, calculated using the Maximum Bonus Percent and Base Salary up to the time of retirement, death, or long-term disability and the annual performance results for the year in which retirement, death, or long-term disability occurs.**
- 6. A participant who transfers to a position (e.g. through job posting or job elimination) that is not eligible for inclusion in the Plan will be eligible for a pro-rata award based on the actual time employed in the eligible position during the year.**

If, due to unique skills possessed by a participant, the company requests that the participant accept a transfer to a non-bonus eligible position, the participant will remain on the Plan. The participant's eligibility will be reviewed annually as noted in Administrative Rule #4.

- 7. A participant must be an employee in good standing on 12/31 of the Plan Year in order to receive a bonus. A participant who resigns or is terminated effective during the Plan Year is ineligible for a bonus.**

Participants must maintain satisfactory performance throughout the Plan year in order to be eligible to receive a bonus award payment.

In addition, a participant whose employment termination has been requested due to job elimination, performance or otherwise for cause will be ineligible for a bonus payment even though the participant is still employed at year-end.

- 8. Targets and actual performance for Corporate and Division measures will be at actual exchange rates. Targets and actual performance for international measures where business is conducted in foreign currency will be at prior year's actual rates.**
- 9. Acquisitions and divestitures not included in the annual business plan for the Plan Year will be excluded from the Corporate Sales and/or Net Earnings calculations.**
- 10. Significant changes in historical FASB accounting practices or income tax rates will be included in corporate earnings calculations at the discretion of the Management Organization and Compensation Committee of the Board of Directors.**
- 11. Payments will be made by March 15th of the year following each successive Corporate and Business Unit performance year.**

These Administrative Rules indicate Graco's intent. Situations may arise which are not specifically covered by these rules and will require the use of judgment and discretion. Final responsibility for interpretation of these Administrative Rules rests solely with the Vice President, Human Resources.

**STOCK OPTION AGREEMENT
(NON-ISO)**

THIS AGREEMENT, made this ____ day of _____, 2____, by and between Graco Inc., a Minnesota corporation (the "Company") and «Name» (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 agree as follows:

1. Grant of Option

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

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:

<u>Date</u>	<u>Total Portion of Option Which is Exercisable</u>
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.
- C. Under no circumstances may the Option granted by this Agreement be exercised after the term of the Option expires.

3. Effect of Termination of Employment

- A. If Employee's employment terminates for any reason other than Employee's gross and willful misconduct, death, retirement (as defined in Section 3D), or disability (as defined in Section 3D), Employee shall have the right to exercise that portion of the Option exercisable upon the date of termination of employment at any time within the period beginning on the day after termination of employment and ending at 5:00 p.m. Central Time thirty (30) days later.
- B. If Employee's employment terminates by reason of Employee's gross and willful misconduct during employment, including, but not limited to, wrongful appropriation of Company funds, serious violations of Company policy, breach of fiduciary duty or the conviction of a felony, the unexercised portion of the Option shall terminate as of the time of the misconduct. If the Company determines subsequent to the termination of Employee's employment for whatever reason, that Employee engaged in conduct during employment that would constitute gross and willful misconduct justifying termination, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Company thereafter determines that Employee engaged in gross and willful misconduct during employment which would have justified termination at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise.
- C. If Employee shall die while employed by the Company or an affiliate or within thirty (30) days after a termination of employment which meets the criteria of Section 3A, and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining shares at any time during a period beginning on the day after the date of Employee's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.
- D. If Employee's termination of employment is due to retirement or disability, all shares remaining under the Option shall become immediately exercisable. Employee shall be deemed to have retired if the termination of employment occurs for reasons other than the Employee's gross and willful misconduct, death, or disability after Employee (i) has attained age 55 and 10 years of service with the Company or an affiliate, or (ii) has attained age 65. Employee shall be deemed to be disabled if the termination of employment occurs because Employee is unable to work due to an impairment which would qualify as a disability under the Company's long term disability program. Employee may exercise the shares remaining unexercised at any time during a period beginning on the day after the date of Employee's termination of employment and ending at 5:00 p.m. Central Time three (3) years later. If Employee should die during this three (3) year period, the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent may exercise the unexercised portion of the

Option at any time during a period beginning the day after the date of Employee's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.

- E. Notwithstanding anything to the contrary contained in this Section 3, if the Employee's employment is terminated by retirement (as defined in Section 3D) and Employee has not given the Company written notice to his/her immediate supervisor and the Chief Executive Officer, of Employee's intention to retire not less than six (6) months prior to the date of his/her retirement, then in such event, for purposes of this Agreement only, said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3A, *provided, however*, that in the event that the Chief Executive Officer determines that said termination of employment without six (6) months prior written notice is in the best interests of the Company, then such termination shall be deemed to be a retirement and shall be subject to Section 3D.
- F. 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(s) exercising the Option is the duly appointed legal representative of the deceased optionee's estate or the proper legatee or distributee thereof.

4. Manner of Exercise

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

For purposes of Section 4B(2), the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the day immediately preceding the date of exercise on the 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 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.

5. Payment of Withholding Taxes

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

6. Change of Control

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

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

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 6, a Trust Person shall not be deemed to have beneficial ownership of

the Company Common Stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

- (v) an acquisition by the Employee or any group that includes the Employee, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of Section 6A(4); and

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

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

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

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

7. Adjustments

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

8. Miscellaneous

- A. This Option is issued pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. This Agreement shall not confer on Employee any right with respect to continuance of employment by the Company or any of its subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time.
- C. Neither Employee, the Employee's legal representative, nor the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.
- D. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- E. This Agreement will be governed by and constructed exclusively in accordance with the laws of the State of Minnesota.

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

GRACO INC.

By _____

Its Chief Executive Officer

<<NAME>>
Employee

**NONEMPLOYEE DIRECTOR
NONSTATUTORY STOCK OPTION AGREEMENT
(NSO)**

THIS AGREEMENT, made this ____ day of _____, 2____ by and between Graco Inc., a Minnesota corporation (the "Company") and «NAME» (the "Nonemployee Director").

WITNESSETH THAT:

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

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

1. Grant of Option

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

2. Duration and Exercisability

- A. This Option may not be exercised by the Nonemployee Director 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:

<u>Date</u>	<u>Total Portion of Option Which is Exercisable</u>
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.
- C. Under no circumstances may the Option granted by this Agreement be exercised after the term of the Option expires.

3. Effect of Termination of Membership on the Board

- A. In the event Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in Section 3B below, the Nonemployee Director shall have the right to exercise the Option as follows:
- (1) If the Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, the portion of the Option not yet exercisable shall become immediately exercisable upon the date the Nonemployee Director ceases being a director. The Nonemployee Director may exercise all or any portion of the Option not yet exercised for a period of three (3) years from the date the Nonemployee Director ceased being a director, provided that if the Nonemployee Director dies before the three (3) year period has expired, the Option may be exercised by the executor(s) or administrator(s) of the Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.
 - (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 executor(s) or administrator(s) of the Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.
 - (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 executor(s) or administrator(s) of the Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.

- (4) In the event the Option is exercised by the executors, administrators, legatees, or distributees of the estate of the Nonemployee Director, the Company shall be under no obligation to issue stock thereunder unless and until the Company is satisfied that the person(s) exercising the Option is the duly appointed legal representative of the Nonemployee Director's estate or the proper legatee or distributee thereof.

- B. If a Nonemployee Director ceases being a director of the Company by reason of Nonemployee Director's gross and willful misconduct, including but not limited to, (i) fraud or intentional misrepresentation; (ii) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any affiliate of the Company; (iii) breach of fiduciary duty, or (iv) any other gross or willful misconduct, as determined by the Board, in its sole and conclusive discretion, the unexercised portion of the Option granted to such Nonemployee Director shall immediately be forfeited as of the time of the misconduct. If the Board determines subsequent to the time Nonemployee Director ceases being a director of the Company for whatever reason, that Nonemployee Director engaged in conduct while a member of the Board of Directors of the Company that would constitute gross and willful misconduct, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Board thereafter determines that Nonemployee Director engaged in gross and willful misconduct while a member of the Board of Directors of the Company at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise.

4. Manner of Exercise

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

For purposes of Section 4B(2), the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the day immediately preceding 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 Nonemployee Director may, with the consent of the Company, pay the Option price 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.

5. Change of Control

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

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

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 5, a Trust Person shall not be deemed to have beneficial ownership of the Company Common Stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

(v) an acquisition by the Nonemployee Director or any group that includes the Nonemployee Director, or

(vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of Section 5A(4); and

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

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

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

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

6. Adjustments and Changes in the Stock

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

7. Miscellaneous

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

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

GRACO INC.

By _____

Its Vice President, General Counsel
and Secretary

<<NAME>>

Nonemployee Director

**STOCK OPTION AGREEMENT
(NON-ISO)**

THIS AGREEMENT, made this ____ day of _____, 2____, by and between Graco Inc., a Minnesota corporation (the "Company") and David A Roberts ("Mr. Roberts" or 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 agree as follows:

1. Grant of Option

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

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:

<u>Date</u>	<u>Total Portion of Option Which is Exercisable</u>
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.
- C. Under no circumstances may the Option granted by this Agreement be exercised after the term of the Option expires.

3. Effect of Termination of Employment

- A. If Employee's employment terminates for any reason other than Employee's gross and willful misconduct, death, retirement (as defined in Section 3D), or disability (as defined in Section 3D), Employee shall have the right to exercise that portion of the Option exercisable upon the date of termination of employment at any time within the period beginning on the day after termination of employment and ending at 5:00 p.m. Central Time ninety (90) days later.
- B. If Employee's employment terminates by reason of Employee's gross and willful misconduct during employment, including, but not limited to, wrongful appropriation of Company funds, serious violations of Company policy, breach of fiduciary duty or the conviction of a felony, the unexercised portion of the Option shall terminate as of the time of the misconduct. If the Company determines subsequent to the termination of Employee's employment for whatever reason, that Employee engaged in conduct during employment that would constitute gross and willful misconduct justifying termination, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Company thereafter determines that Employee engaged in gross and willful misconduct during employment which would have justified termination at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise. Gross and willful misconduct shall not include any action or inaction by Mr. Roberts contrary to the direction of the Board with respect to any initiative, strategy or action of the Company, which action or inaction Mr. Roberts believes is in the best interest of the Company.
- C. If Employee shall die while employed by the Company or an affiliate or within thirty (30) days after a termination of employment which meets the criteria of Section 3A, and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining shares at any time during a period beginning on the day after the date of Employee's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.
- D. If Employee's termination of employment is due to retirement or disability, all shares remaining under the Option shall become immediately exercisable. Employee shall be deemed to have retired if the termination of employment occurs for reasons other than the Employee's gross and willful misconduct, death, or disability after Employee (i) has attained age 55 and 10 years of service with the Company or an affiliate, or (ii) has attained age 65. Employee shall be deemed to be disabled if the termination of employment occurs because Employee is unable to work due to an impairment which would qualify as a disability under the Company's long term disability program. Employee may exercise the shares remaining unexercised at any time during a period beginning on the day after the date of Employee's termination of employment and ending at 5:00 p.m. Central Time three (3) years later. If Employee

should die during this three (3) year period, the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent may exercise the unexercised portion of the Option at any time during a period beginning the day after the date of Employee's death and ending at 5:00 p.m. Central Time on the anniversary of death one (1) year later.

- E. 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(s) exercising the Option is the duly appointed legal representative of the deceased optionee's estate or the proper legatee or distributee thereof.

4. Manner of Exercise

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

For purposes of Section 4B(2), the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the day immediately preceding the date of exercise on the 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 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.

5. Payment of Withholding Taxes

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

6. Change of Control

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

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

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

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

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

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

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

7. Adjustments

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

8. Miscellaneous

- A. This Option is issued pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. This Agreement shall not confer on Employee any right with respect to continuance of employment by the Company or any of its

subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time.

- C. Neither Employee, the Employee's legal representative, nor the executor(s) or administrator(s) of the Employee's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.
- D. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- E. This Agreement will be governed by and constructed exclusively in accordance with the laws of the State of Minnesota.

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

GRACO INC.

By

Lee Mitau
Chairman of the Board

David A. Roberts
Employee

CERTIFICATIONS

I, David A. Roberts, certify that:

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

Date: April 27, 2004

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

CERTIFICATIONS

I, James A. Graner, certify that:

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

Date: April 27, 2004

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

CERTIFICATIONS

I, Mark W. Sheahan, certify that:

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

Date: April 27, 2004

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

CERTIFICATION UNDER SECTION 1350

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

Date: April 27, 2004

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

Date: April 27, 2004

/s/James A. Graner
Vice President and Controller
Chief Accounting Officer

Date: April 27, 2004

/s/Mark W. Sheahan
Vice President and Treasurer
Principal Financial Officer