

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

FORM 10-K

☒ Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 26, 1997 or

☐ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File No. 1-9249

Graco Inc.  
(Exact name of Registrant as specified in its charter)

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

4050 Olson Memorial Highway  
Golden Valley, Minnesota 55422-2332  
(Address of principal executive offices) (Zip Code)

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

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

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

As of March 6, 1998, 25,790,412 shares of Common Stock were outstanding.

Indicate by a check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No .

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

The aggregate market value of approximately 16,506,833 shares held by non-affiliates of the registrant was approximately \$492 million on March 6, 1998.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on May 5, 1998, are incorporated by reference into Part III, as specifically set forth in said Part III.

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GRACO INC.

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ON FORM 10-K

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NOTE: Certain exhibits listed in the Index to Exhibits beginning on page 32, and filed with the Securities and Exchange Commission, have been omitted. Copies of such exhibits may be obtained upon written request directed to:

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

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## PART I

### Item 1. Business

**General Information.** Graco Inc. ("Graco" or "the Company") supplies technology and expertise for the management of fluids in both industrial and commercial settings. Based in Minneapolis, Minnesota, Graco serves customers around the world in the manufacturing, processing, construction and maintenance industries. It designs, manufactures and markets systems, products and technology to move, measure, control, dispense and apply a wide variety of fluids and viscous materials. The Company helps customers solve difficult manufacturing problems, increase productivity, improve quality, conserve energy, save expensive material, control environmental emissions and reduce labor costs. Primary uses of the Company's equipment include the application of coatings and finishes to various industrial and commercial products; the mixing, metering, dispensing and application of adhesive, sealant and chemical bonding materials; the application of paint and other materials to architectural structures; the lubrication and maintenance of vehicles and industrial machinery; and the transferring and dispensing of various fluids. Graco is the successor to Gray Company, Inc., which was incorporated in 1926 as a manufacturer of auto lubrication equipment, and became a public company in 1969.

It is Graco's strategic objective to be the highest quality, lowest cost, most responsive supplier in the world for its principal products. In working to achieve its goal to be a world-class manufacturer, Graco has organized its manufacturing operations around focused factories which contain product-based cells. The Company continues to refine these cells as new products are introduced and new equipment is purchased with the ultimate goal of creating cells which function independently of each other. Substantial investments in new manufacturing technology have reduced cycle time and improved quality.

The Company operates in one industry segment, namely the design, manufacture, marketing, sale and installation of systems and equipment for the handling of fluids. Financial information concerning geographic operations and export sales for the last three fiscal years is set forth in Note B of the Notes to Consolidated Financial Statements.

**Recent Developments.** The David A. Koch Center, a world-class manufacturing and global distribution facility, which opened in November 1996 in Rogers, Minnesota, finished its first full year of operation in 1997. The Koch Center provides additional production capacity, enhanced build-to-order capability for projected growth and expanded space for warehousing and distribution. During 1997, the Company's product development efforts resulted in the introduction of approximately 250 new products and pre-engineered system packages. During 1997, Graco completed construction of a laboratory in its Riverside facility to support the consolidation of product development activities in Minneapolis and to provide world-class demonstration, training, test and display capabilities.

**Products.** Graco manufactures a wide array of specialized pumps, applicators, regulators, valves, meters, atomizing devices, replacement parts, and accessories, both individually and in system configurations which are used in industrial and commercial applications in the movement, measurement, control, dispensing and application of many fluids and semi-solids, including paints, adhesives, sealants, and lubricants. In addition, it offers an extensive line of portable equipment which is used in construction and maintenance businesses for the application of paint and other materials.

Commercial and industrial equipment offered by Graco includes specialized pumps, air and airless spray units, manual finishing equipment and fluid handling systems. A variety of pumps provide fluid pressures ranging from 20 to more than 6,000 pounds per square inch and flow rates from under 1 gallon to 275 gallons per minute.

The Company sells accessories for use with its equipment, including hoses, couplings, regulators, valves, filters, reels, meters, and gauges, as well as a complete line of spray guns, tips and applicators. These accessories increase the flexibility, efficiency and effectiveness of Graco equipment. Packings, seals, hoses and other parts, which must be replaced periodically in order to maintain efficiency and prevent loss of material, are also sold by the Company.

Graco introduced a family of sophisticated plural component electronic proportioners in 1996 and 1997. These proportioners, which provide high ratio accuracy, on-line diagnostics and an electronic display panel, proportion, mix and apply two-component materials. One of these proportioners is targeted at the application of hem flange adhesive by automotive customers. The first in a line of sealant and adhesive devices for manual bead dispense applications in the automotive industry was introduced in 1997. These application devices possess substantially reduced size, weight and trigger pull. In 1997, the Company launched the Delta Spray(TM) family of air and high volume low pressure spray guns designed for the application of paints and coatings. Two electronic meters for automotive service applications were introduced in 1997. These streamlined meters have a digital display and dispense up to five gallons per minute.



Sales of replacement parts and accessories have averaged 46 percent of the Company's consolidated net sales and approximately 52 percent of gross profits during the last three years. The following table summarizes the consolidated net sales and gross profits (net sales less cost of products sold) by the Company's principal product groups for that same period.

Product Group Sales and Gross Profit  
(In thousands)

	1997		1996		1995	
	\$	%	\$	%	\$	%
<b>NET SALES</b>						
Commercial and industrial equipment	\$226,198	54.7%	\$207,327	52.9%	\$206,558	53.5%
Accessories and replacement parts	187,699	45.3	184,429	47.1	179,756	46.5
	-----	-----	-----	-----	-----	-----
	\$413,897	100.0%	\$391,756	100.0%	\$386,314	100.0%
	=====	=====	=====	=====	=====	=====
<b>GROSS PROFIT</b>						
Commercial and industrial equipment	\$ 99,063	48.8%	\$ 92,480	47.2%	\$ 90,526	47.7%
Accessories and replacement parts	103,925	51.2	103,501	52.8	99,101	52.3
	-----	-----	-----	-----	-----	-----
	\$202,988	100.0%	\$195,981	100.0%	\$189,627	100.0%
	=====	=====	=====	=====	=====	=====

Marketing and Distribution. Graco's operations are organized to allow its full line of products and systems to be offered in each of its major geographic markets: the Americas (North, Central and South America), Europe (includes the Middle East and Africa), and Asia Pacific. The Industrial Equipment Division, the Automotive Equipment Division, the Contractor Equipment Division, and the Lubrication Equipment Division provide worldwide marketing direction and product design and application assistance to each of these geographic markets.

Graco sells its equipment worldwide principally through independent distributors. In Canada, Japan, Korea, and Europe, Graco equipment is sold to distribution through sales subsidiaries. In the Americas and Europe, the Company maintains a specialized direct sales force, which handles sales of large systems and sales to certain corporate accounts. Manufacturers' representatives are used with some product lines.

In 1997, Graco's net sales in the Americas were \$276,410,000 or approximately 67 percent of the Company's consolidated net sales; in Europe net sales were \$82,028,000 or approximately 20 percent; and in the Asia Pacific region, net sales were \$55,459,000 or approximately 13 percent.

Consolidated backlog at December 26, 1997, was \$22 million compared to \$19 million at the end of 1996.

Research, Product Development and Technical Services. Graco's research, development and engineering activities focus on new product design, product improvements, applied engineering and strategic technologies. A dedicated support group of application engineers and technicians also provides specialized technical assistance to customers in the design and evaluation of fluid transfer and application systems. It is one of Graco's goals to generate 30 percent of each year's sales from products introduced in the prior three years. With the exception of an automotive design group based at the Plymouth, Michigan facility, all major research and development activities are now conducted in facilities located in Minneapolis, and Rogers, Minnesota. Total research and development expenditures were \$17,817,000, \$17,909,000, and \$15,715,000 for the 1997, 1996, and 1995 fiscal years, respectively.

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

Competition. Graco faces substantial competition in all of its markets. The nature and extent of this competition varies in different markets due to the diversity of the Company's products. Product quality, reliability, design, customer support and service, specialized engineering and pricing are the major competitive factors. Although no competitor duplicates all of Graco's products, some competitors are larger than the Company, both in terms of sales of directly competing products and in terms of total sales and financial resources. Graco believes it is one of the world's leading producers of high-quality specialized fluid management equipment and systems. It is impossible, because of the absence of reliable industry-wide third-party data, to determine its exact relative market position.

Environmental Protection. During the fiscal year ending December 26, 1997, the amounts incurred to comply with federal, state and local legislation pertaining to environmental standards did not have a material effect upon the capital expenditures or earnings of the Company.

Employees. As of December 26, 1997, the Company employed approximately 2,086 persons on a full-time basis. Of this total, approximately 352 were employees based outside the United States, and 843 were hourly factory workers in the United States.

## Item 2. Properties

As of December 31, 1997, the Company's principal operations that occupy more than 10,000 square feet were conducted in the following facilities:

Type of Facility - - - - -	Location - - - - -	Gross Square Footage - - - - -
Owned - - - - -		
Distribution/Manufacturing/Office	Rogers, Minnesota	333,000
Manufacturing/Office	Minneapolis, Minnesota	242,300
Manufacturing/Office	Minneapolis, Minnesota	202,300
Engineering/Research & Development	Minneapolis, Minnesota	138,700
Engineering/Manufacturing/Office	Plymouth, Michigan	106,000
Assembly/European Headquarters/Warehouse	Maasmechelen, Belgium	75,800
Corporate Headquarters	Golden Valley, Minnesota	73,800
Manufacturing/Office	Sioux Falls, South Dakota	55,100
Sales Office/Warehouse	Los Angeles, California	21,000
Office/Warehouse	Mississauga, Ontario, Canada	20,000
Leased - - - - -		
Engineering/Office/Warehouse	Yokohama, Japan (4 facilities)	48,724
Sales Office	Rungis, France	12,626
Assembly/Engineering/Office/Warehouse	Neuss, Germany	41,765
Sales Office	West Midlands, United Kingdom	16,320
Warehouse	Gwangju-Gun, Korea	10,549

The lease of the Graco Communications Center, (18,200 square foot facility in Minneapolis, Minnesota) where technical publication, mail and literature operations were previously performed, was terminated on February 28, 1997. These operations were transferred to the David A. Koch Center in Rogers, Minnesota and the Riverside facility in Minneapolis, Minnesota.

The sales office in Rungis, France was moved in February, 1997, to a smaller facility within the same industrial park. The previous lease was terminated effective March 31, 1997.

Manufacturing operations previously conducted in the facility in Franklin Park, Illinois (82,000 square feet) were relocated to the Riverside facility and the facility was sold.

A world-class demonstration laboratory in the Riverside facility was completed during the second quarter of 1997. This laboratory is used for product training and product demonstrations to customers.

The Company leases space for subsidiary sales or liaison offices around the world, some of which have demonstration areas and/or warehouse space.

Graco's facilities are in satisfactory condition, suitable for their respective uses and are sufficient and adequate to meet current needs, with the recent expansions. Manufacturing capacity met business demand in 1997. Future production requirements are expected to be met through existing production capabilities, efficiency and productivity improvement and the use of available subcontract services.

### Item 3. Legal Proceedings

The Company is engaged in routine litigation incident to its business, which management believes will not have a material adverse effect upon its operations or consolidated financial position.

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

No issues were submitted to a vote of security holders during the fourth quarter of 1997.

### Executive Officers of the Company

The following are all the executive officers of the Company as of March 6, 1998.

George Aristides, 62, was elected Chief Executive Officer on January 1, 1996. From 1993 to 1997 he was President. From 1993 to 1996 he was Chief Operating Officer. From March 1993 to June 1993, he was Executive Vice President, Industrial/Automotive Equipment Division, Manufacturing, Distribution and Eurafican Operations. From 1985 until 1993, he was Vice President, Manufacturing Operations and Controller. He joined the Company in 1973 as Corporate Controller and became Vice President and Controller in 1980. He has served as a director of the Company since 1993.

Charles M. Osborne, 44, was elected President and Chief Operating Officer on May 6, 1997. From 1989 to 1997, he was Senior Vice President and Chief Financial Officer, Deluxe Corporation, a printer of checks and business forms and a supplier of electronic processing services to the financial payments industry. He has been a director of Graco since 1995. Dale Johnson, a Vice President of the Company, is a brother-in-law to Mr. Osborne.

Clayton R. Carter, 59, was elected Vice President, Industrial Equipment Division, effective December 17, 1996. From January 1, 1995, he was Vice President, Lubrication Equipment Division. He became Director, Vehicle Services Division, in February 1994. He joined the Company in 1962 and has held various sales management positions.

James A. Graner, 53, was elected Vice President and Controller in February 1994. He became Treasurer in May 1993. Prior to becoming Assistant Treasurer in 1988, he held various managerial positions in the treasury, accounting and information systems departments. He joined Graco in 1974.

Clyde W. Hansen, 65, was elected Vice President, Human Resources and Quality Management Systems, in December 1993. He joined the Company in 1984 as Employee Relations Director, a position he held until December 1993.

John L. Heller, 61, was elected Vice President, Asia Pacific, Latin America & Developing Markets in 1997. From 1996 to 1997 he was Vice President, Latin America & Developing Markets. From July 1993 to December 1995, he was Senior Vice President and General Manager - Contractor Equipment Division. He became Vice President, Far East Operations and Latin America, in 1992. Prior to becoming Vice President, Far East Operations in 1984, he held various management and staff positions in sales and human resources. He joined the Company in 1972.

Dale D. Johnson, 43, was appointed Vice President, Contractor Equipment Division, on December 17, 1996. Prior to becoming the Director of Marketing in June 1996, he held various marketing and sales positions in the Contractor Equipment Division. He joined the Company in 1976. Charles Osborne, President and Chief Operating Officer of the Company, is a brother-in-law to Mr. Johnson.

Roger L. King, 52, was named Vice President & General Manager, European Operations, effective January 4, 1996. From July 1993 to December 1995, he was Senior Vice President and General Manager - International Operations. He was Senior Vice President and Chief Financial Officer from March 1993 to July 1993, and Vice President and Treasurer from 1987 to March 1993. Prior to becoming Vice President, Treasurer and Secretary in 1980, he held the position of Treasurer and Secretary and various treasury management positions with Graco. He joined the Company in 1970.

David M. Lowe, 42, was elected to the position of Vice President, Lubrication Equipment Division, in December 1996. From February 1995 to December 1996, he was Treasurer. Prior to joining the Company, he was employed by Ecolab Inc., where he held various positions in the Treasury Department, including Manager-Corporate Finance; Director, Corporate Finance and most recently Director, Corporate Development.

Robert M. Mattison, 50, was elected Vice President, General Counsel and Secretary, in January 1992, a position which he holds today. Prior to joining the Company, he held various legal positions with Honeywell Inc., most recently as Associate General Counsel.

Charles L. Rescorla, 46, is Vice President, Manufacturing & Distribution Operations, a position to which he was appointed on January 1, 1995. Prior to becoming the Director of Manufacturing in March 1994, he was the Director of Engineering, Industrial Division, a position which he assumed in 1988 when he joined the Company.

Mark W. Sheahan, 33, was elected Treasurer, effective December 17, 1996. He joined the Company as Treasury Operations Manager in 1995. Prior to joining the Company, he was a Senior Manager with KPMG Peat Marwick llp.

The Board of Directors elected Messrs. Aristides, Osborne, Carter, Graner, Hansen, Heller, King, Lowe, Mattison and Sheahan on May 6, 1997, all to hold office until the next annual meeting of directors or until their successors are elected and qualify. Messrs. Johnson and Rescorla were appointed to their positions by management effective December 17, 1996 and January 1, 1995, respectively.



## PART II

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

Graco Common Stock. Graco common stock is traded on the New York Stock Exchange under the ticker symbol "GGG." As of March 6, 1998, there were 25,790,412 shares outstanding and 2,426 common shareholders of record, which includes nominees or broker dealers holding stock on behalf of an estimated 3,950 beneficial owners.

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

1997	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Sales	\$92,099	\$111,721	\$101,920	\$108,157
Gross Profit	44,533	53,399	51,362	53,694
Net Earnings	6,181	10,418	12,879	15,238
Per Common Share:				
Basic Net Earnings	0.24	0.41	0.50	0.60
Diluted Net Earnings	0.24	0.40	0.49	0.58
Dividends Declared	0.09	0.09	0.09	0.11
Stock Price (per share)				
High	\$ 24.08	\$ 21.25	\$ 23.25	\$ 26.46
Low	16.17	15.67	19.42	22.17
Close*	19.17	20.08	23.83	24.87
Volume (# of shares)	2,958	4,030	1,577	2,307
1996				
Net Sales	\$90,153	\$ 97,099	\$ 97,680	\$106,824
Gross Profit	44,837	49,422	49,976	51,746
Net Earnings	5,585	10,032	10,157	10,395
Per Common Share:				
Basic Net Earnings	0.22	0.39	0.39	0.41
Diluted Net Earnings	0.21	0.38	0.39	0.40
Dividends Declared	0.08	0.08	0.08	0.09
Stock Price (per share)				
High	\$ 13.83	\$ 14.42	\$ 13.59	\$ 17.33
Low	11.83	11.92	12.17	12.33
Close*	13.00	13.42	12.50	16.33
Volume (# of shares)	2,693	2,832	2,270	2,269

(1) All share and per share data has been restated for the three-for-two stock split declared on December 12, 1997 and paid February 4, 1998.

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

# Item 6. Selected Financial Data

## Graco Inc. & Subsidiaries

(In thousands, except per share amounts)	1997	1996	1995	1994	1993
Net Sales	\$413,897	\$391,756	\$386,314	\$360,013	\$322,602
Net Earnings	44,716	36,169	27,706	15,326	9,493
Per Common Share:					
Basic Net Earnings	\$ 1.75	\$ 1.40	\$ 1.07	\$ .59	\$ .37
Diluted Net Earnings	1.71	1.38	1.06	.59	.37
Total Assets	\$264,532	\$247,814	\$217,833	\$228,385	\$216,365
Long-term Debt (including current portion)	7,959	9,920	12,009	32,483	19,480
Redeemable Preferred Stock	--	--	--	1,474	1,485
Cash Dividends Declared per Common Share	\$ 0.38	\$ 0.33	\$ 0.30	\$ 0.26	\$ 1.43

(1) Includes the special one-time dividend of \$1.20 per share declared December 17, 1993.

(2) All per share data has been restated for the three-for-two stock split declared on December 12, 1997 and paid February 4, 1998.

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

### MANAGEMENT'S REVIEW AND DISCUSSION

The following is Management's Review and Discussion and is not covered by the Independent Auditors' Report.

Graco's net earnings of \$44.7 million in 1997 are 24 percent higher than the \$36.2 million earned in 1996 and are significantly higher than the \$27.7 million recorded in 1995. The large increases in 1997 and 1996 are due largely to enhanced profit margins, lower effective tax rates and higher net sales.

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

	Revenue & Expense Item As a Percentage of Net Sales			Revenue & Expense Item Percentage Increase (Decrease)	
	1997	1996	1995	1997/96	1996/95
Net Sales	100.0	100.0	100.0	6	1
Cost of Products Sold	51.0	50.0	50.9	8	--
Product Development	4.3	4.6	4.1	--	14
Selling	21.1	21.8	22.4	3	(2)
General & Administrative	7.8	10.1	10.9	(19)	(5)
Operating Profit	15.8	13.5	11.7	23	17
Interest Expense	(0.2)	(0.2)	(0.6)	4	(64)
Other (Expense) Income, Net	(0.3)	0.1	0.2	*	*
Earnings Before Income Taxes	15.3	13.4	11.3	20	21
Income Taxes	4.5	4.2	4.1	13	5
Net Earnings	10.8	9.2	7.2	24	31

\* Not a Meaningful Figure

## NET SALES

In 1997, Graco recorded its fifth consecutive year of record net sales, posting a 6 percent increase over 1996 to \$413.9 million. The 1997 increase was due to higher sales in all regions except Asia Pacific. Geographically, net sales in the Americas of \$276.4 million in 1997 increased by 9 percent when compared to 1996. European sales increased 4 percent in 1997 to \$82.0 million, a 13 percent increase, offset by a 9 percent decline due to exchange rates. Sales in Asia Pacific declined 8 percent in 1997 to \$55.5 million, a 1 percent decrease and a 7 percent decline due to exchange rates. For the past two years, declines in Asia Pacific have been primarily due to exchange rates.

In 1996, sales increased 1 percent over 1995, due primarily to higher sales in North America, somewhat offset by declines in Europe and Asia Pacific.

Periodic price increases have contributed to net sales increases. The Company's most recent U.S. price increase was effective in March 1997 and represented an average 0.4 percent increase from its January 1996 price lists. The January 1996 U.S. price change was an average 2.5 percent increase from January 1995 prices.

Consolidated backlog at December 26, 1997, was \$22 million compared to \$19 million at the end of 1996, and \$20 million at the end of 1995.

(In thousands)	1997	1996	1995	% Increase (Decrease)	
				1997/96	1996/95
Division Sales:					
Industrial Equipment	\$162,557	\$154,866	\$151,016	5	3
Automotive Equipment	63,557	69,910	75,637	(9)	(8)
Contractor Equipment	142,400	124,392	118,818	15	5
Lubrication Equipment	45,383	42,588	40,843	7	4
Consolidated	\$413,897	\$391,756	\$386,314	6	1
Geographic Sales:					
Americas	\$276,410	\$252,615	\$238,874	9	6
Europe	82,028	78,666	82,552	4	(5)
Asia Pacific	55,459	60,475	64,888	(8)	(7)
Consolidated	\$413,897	\$391,756	\$386,314	6	1

## COST OF PRODUCTS SOLD

The cost of products sold, as a percentage of net sales, increased in 1997 to 51.0 percent from 50.0 percent in 1996. This increase was the result of several factors, including material cost increases and exchange rates, partially offset by improved manufacturing efficiencies. The cost of products sold as a percentage of net sales of 50.0 percent in 1996 decreased from 50.9 percent in 1995, due to a combination of factors including modest price increases and improved manufacturing efficiencies, partially offset by material and manufacturing cost increases.

## OPERATING EXPENSES

Operating expenses in 1997 declined 4 percent from 1996, primarily due to the impact of lower general and administrative expenses, partially offset by higher selling expenses resulting from increased net sales. The lower expense level is the result of the ongoing benefits of restructuring, exchange rates, higher investment returns on employee retirement plan assets, and elimination of discretionary contributions. Operating expenses in 1996 declined 1 percent from 1995, due primarily to lower selling and general and administrative expenses as well as lower non-recurring charges in 1996 when compared to 1995.

Product development expenses in 1997 were virtually unchanged from 1996 levels. In 1996, product development costs were 14 percent higher than 1995 expenditures. Graco is committed to expanding its sales by making significant investments in product development.

## FOREIGN CURRENCY EFFECTS

Foreign currency translations negatively impacted 1997 earnings before income taxes by \$6.2 million when compared to 1996, and decreased earnings before income taxes by \$2.7 million in 1996 when compared to 1995. The reduced profits in both years were due to a strong U.S. dollar versus other foreign currencies. Since approximately 34 percent of the Company's sales and 12 percent of its product costs are in currencies other than the U.S. dollar, a strong U.S. dollar reduces the Company's profits. A weakening of the U.S. dollar has the reverse impact on the Company's profits. Gains and losses attributable to translating the financial statements for all non-U.S. subsidiaries, and the gains and losses on the forward and option contracts used to hedge these exposures, which are non-speculative, are in Other (expense) income.

## OTHER (EXPENSE) INCOME

The Company's interest expense rose 4 percent in 1997, primarily reflecting an increase in the average levels of debt during the year. This increase in debt levels resulted from higher short-term debt during portions of 1997.

Other expense of \$1.1 million in 1997, other income of \$0.5 million in 1996, and \$0.7 million for 1995, include, among other things, the foreign currency translation gains and losses discussed above, a \$1.2 million gain from the sale of real estate in 1997, a \$0.8 million favorable settlement of a legal dispute in 1997, a \$1.5 million favorable settlement of a legal dispute in 1996, and a \$0.9 million gain from the sale of real estate in 1995.

## INCOME TAXES

The Company's net effective tax rate of 30 percent in 1997 is five percentage points lower than the 1997 U.S. federal tax rate of 35 percent. The decrease from the 31 percent rate in 1996 is due primarily to foreign earnings being taxed at effective rates lower than the U.S. rate as foreign subsidiary earnings permitted recognition of previously reserved deferred tax benefits and previous tax filings were validated. The effective tax rate of 31 percent in 1996 was lower than the 1995 rate of 36 percent principally due to foreign earnings being taxed at lower effective rates than the U.S. rate from the utilization of previously reserved net operating losses. Detailed reconciliations of the U.S. federal tax rate to the effective rates for 1997, 1996, and 1995 are included in Note D to the Consolidated Financial Statements.

## EARNINGS

In 1997, earnings increased by 24 percent to \$44.7 million, or \$1.71 per diluted share as compared to 1996, when earnings increased by 31 percent to \$36.2 million or \$1.38 per diluted share as compared to 1995.

## ACCOUNTING CHANGES

The Company adopted Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share" in 1997. Refer to notes A and K to the Consolidated Financial Statements for more detailed information.

## YEAR 2000 INFORMATION SYSTEMS DISCLOSURES

The Year 2000 issue is the result of a computer program being written using two digits rather than four to define the applicable year, which could cause potential failure or miscalculation in date-sensitive software that recognizes "00" as 1900, rather than 2000.

The Company is continuing its program, begun in 1996, to ensure that all hardware and software will be year 2000 compliant. A dedicated project team is expected to complete the conversion of core business applications in 1998. Additional teams have initiated year 2000 compliance projects on the Company's network, operating system software, and distributed systems.

The Company has incurred costs totaling \$1 million during 1997, and estimates a total of an additional \$5 to \$8 million to be spent in 1998 and 1999 to resolve year 2000 issues. These costs are charged to expense as incurred and include software license fees and allocation of internal staff time. Incremental costs associated with year 2000 compliance are not anticipated to result in significant increases in future operating expenses and will not have a material adverse effect on the results of operations, liquidity and capital resources. Rather, existing resources are being redeployed and other projects are being delayed to accommodate year 2000 related projects. A contingency plan is being

developed in 1998 for critical business applications to mitigate potential problems or delays associated with either new system replacements or established vendor delivery dates. Additionally, the Company is working with customers and suppliers to assess the potential impact of their year 2000 compliance issues on Graco. Although all companies have risks associated with the year 2000, management believes that sufficient resources have been allocated and project plans are in place which will result in uninterrupted business activity with no material impact on operations or operating results.

#### OUTLOOK

Overall we expect improved financial results in 1998. We anticipate higher sales, driven by continued new product introductions, an improved and expanding worldwide distribution network and good economic conditions in North America and Europe, despite weakness in Asia Pacific, including Japan, South Korea and Southeast Asia.

Graco has undertaken a number of restructuring efforts in recent years that have improved its effectiveness in the markets it serves, and have increased the Company's operating margins and net profits. These efforts will continue to favorably impact margins and profits in 1998. We are implementing additional measures to improve operating efficiency.

We anticipate that the strength of the U.S. dollar relative to other major currency will negatively impact operating margins in 1998. We also anticipate a higher tax rate in 1998.

#### SAFE HARBOR CAUTIONARY STATEMENT

This annual report on Form 10-K contains "forward-looking statements" about the Company's expectations of the future, which are subject to certain risk factors that could cause actual results to differ materially from those expectations. Risk factors include economic conditions in the United States and other major world economies, currency exchange fluctuations, and additional factors identified in Exhibit 99 to the Company's Report on Form 10-K for fiscal year 1997.

#### SHAREHOLDER ACTIONS

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

- o three-for-two stock splits paid in 1998 and in 1996;
- o share repurchases of approximately 1 million shares over the last two years;
- o a 18 percent increase in the regular dividend in 1997;
- o a 17 percent increase in the regular dividend in 1996;
- o a 13 percent increase in the regular dividend in 1995.

#### ASSETS

The following table highlights several key measures of asset performance.

(In thousands)	1997	1996
-----	-----	-----
Cash and Cash Equivalents	\$13,523	\$ 6,535
Working Capital	\$87,312	\$63,884
Current Ratio	2.3	1.8
Average Days Receivables Outstanding	75	75
Inventory Turnover	4.9	4.7

Average inventory balances and inventory turnover increased during 1997 when compared to 1996, and year-end inventory was higher at \$43.9 million to accommodate increased sales activity. Accounts receivable at year end increased 3 percent to \$86.1 million.

## LIABILITIES

At the end of 1997, the Company's long-term debt (including the current portion thereof) was 5 percent of total capital (long-term debt plus shareholders' equity) compared to 7 percent in 1996. The Company's total debt (notes payable to banks plus long-term debt including the current portion thereof) as a percentage of total capital fell to 7 percent at the end of 1997, down from 10 percent in 1996. The Company had \$67.7 million in unused credit lines available at December 26, 1997. The Company believes that available credit lines plus operating cash flows are adequate to fund its short and long-term initiatives.

## SHAREHOLDERS' EQUITY

Shareholders' equity totaled \$157.5 million on December 26, 1997, \$31.5 million higher than 1996.

## CASH FLOWS FROM OPERATING ACTIVITIES

During 1997, the Company's operating cash flow of \$36.3 million was lower than 1996 due to changes in working capital requirements. Cash flow from operating activities in 1996 was \$48.6 million, slightly lower than the \$51.7 million recorded in 1995.

The Company's operating cash flows have been, and are expected to be, the principal source of funds required for future additions to property, plant, and equipment, and working capital, as well as for other corporate purposes.

## CASH FLOWS FROM INVESTING ACTIVITIES

Capital expenditures were \$20.1 million in 1997, \$30.0 million in 1996, and \$19.8 million in 1995. These expenditures have enhanced the Company's engineering and manufacturing capabilities, improved product quality, increased capacity, and lowered costs. Substantial expenditures in 1997 included the addition of manufacturing equipment and the construction of a demonstration laboratory in the Riverside facility.

The Company expects to spend in excess of \$20 million on capital improvements in 1998. Capital expenditures in 1998 will include manufacturing equipment, and cellular manufacturing and information systems initiatives.

## CASH FLOWS FROM FINANCING ACTIVITIES

The amount of common stock issued represents the funds received for shares sold through the Company's Dividend Reinvestment Plan, its Employee Stock Purchase Plan, and the distribution of shares pursuant to its Long Term Stock Incentive Plan, more fully described in Note H to the Consolidated Financial Statements.

Graco offers an Automatic Dividend Reinvestment Plan, which gives shareholders a simple and convenient way to reinvest quarterly cash dividends in additional shares of Graco common stock. Brokerage and service charges are paid by the Company.

From time to time, the Company may make open market purchases of its common shares. On February 20, 1998, the Company's Board of Directors authorized management to repurchase up to 1,200,000 shares for a period ending on February 28, 2000. In 1997, the Company repurchased 389,550 split-adjusted shares at an average split-adjusted price per share of \$17.90.

Graco is currently paying 11 cents per share as its regular quarterly dividend. Annual cash dividends paid on the Company's common and preferred stock were \$9.6 million in 1997, \$8.3 million in 1996, and \$7.5 million in 1995. The Company expects to continue paying regular quarterly dividends to its common shareholders at amounts that will adjust periodically to reflect earning performance and management expectations.

Debt was reduced by \$1.9 million and \$2.4 million in 1997 and 1996, respectively, reflecting strong cash flows from operations attributable to higher net income and lower working capital requirements.

Item 8. Financial Statements and Supplementary Data

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## RESPONSIBILITY FOR FINANCIAL REPORTING

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

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

The Board of Directors pursues its oversight role through its Audit Committee. The Audit Committee, composed of directors who are not employees, meets twice a year with management, internal auditors, and Deloitte & Touche LLP to review the systems of internal control, accounting practices, financial reporting, and the results of auditing activities.

## INDEPENDENT AUDITORS' REPORT

Shareholders and Board of Directors  
Graco Inc.  
Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheets of Graco Inc. and Subsidiaries (the "Company") as of December 26, 1997 and December 27, 1996, and the related statements of earnings and cash flows for each of the three years in the period ended December 26, 1997. Our audit also included the financial statement schedule listed in the Index at Item 14. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and financial statement schedule based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Graco Inc. and Subsidiaries as of December 26, 1997 and December 27, 1996, and the results of their operations and their cash flows for each of the three years in the period ended December 26, 1997 in conformity with generally accepted accounting principles. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Deloitte & Touche llp  
Minneapolis, Minnesota  
January 19, 1998



CONSOLIDATED STATEMENTS OF EARNINGS

GRACO INC. & Subsidiaries

(In thousands, except per share amounts) .....	Years Ended		
	December 26, 1997	December 27, 1996	December 29, 1995
Net Sales .....	\$ 413,897	\$ 391,756	\$ 386,314
Cost of products sold .....	210,909	195,775	196,687
Gross Profit .....	202,988	195,981	189,627
Product development .....	17,817	17,909	15,715
Selling .....	87,479	85,281	86,634
General and administrative .....	32,219	39,734	42,044
Operating Profit .....	65,473	53,057	45,234
Interest expense .....	(866)	(831)	(2,335)
Other (expense) income, net .....	(1,091)	543	657
Earnings before Income Taxes .....	63,516	52,769	43,556
Income taxes .....	18,800	16,600	15,850
Net Earnings .....	\$ 44,716	\$ 36,169	\$ 27,706
Basic Net Earnings per Common Share .....	\$ 1.75	\$ 1.40	\$ 1.07
Diluted Net Earnings per Common Share .....	\$ 1.71	\$ 1.38	\$ 1.06

All per share data has been restated for the three-for-two stock split declared on December 12, 1997, paid February 4, 1998.

See Notes to Consolidated Financial Statement.

CONSOLIDATED BALANCE SHEETS

GRACO INC. & Subsidiaries

(In thousands, except share amounts)	December 26, 1997	December 27, 1996
-----	-----	-----
Assets		
Current Assets:		
Cash and cash equivalents.....	\$ 13,523	\$ 6,535
Accounts receivable, less allowances of \$4,100 in 1997 and \$4,700 in 1996.....	86,148	83,474
Inventories.....	43,942	41,531
Deferred income taxes, net.....	11,140	11,633
Other current assets.....	1,539	1,321
	-----	-----
Total current assets.....	156,292	144,494
Property, Plant and Equipment, at Cost:		
Land.....	5,083	5,227
Buildings and improvements.....	63,981	63,213
Manufacturing equipment.....	91,161	82,544
Office, warehouse and automotive equipment.....	30,497	31,049
Construction in progress.....	6,218	1,052
	-----	-----
Total property, plant and equipment, at cost...	196,940	183,085
Accumulated depreciation.....	(96,760)	(88,913)
	-----	-----
Net property, plant and equipment.....	100,180	94,172
Other Assets.....	8,060	9,148
	-----	-----
	\$264,532	\$247,814
	=====	=====
Liabilities and Shareholders' Equity		
Current Liabilities:		
Notes payable to banks.....	\$ 2,911	\$ 3,813
Current portion of long-term debt.....	1,796	1,845
Trade accounts payable.....	12,542	13,854
Salaries, wages and commissions.....	14,903	14,808
Accrued insurance liabilities.....	10,227	10,925
Income taxes payable.....	5,546	4,647
Other current liabilities.....	21,055	30,718
	-----	-----
Total current liabilities.....	68,980	80,610
Long-term Debt, less current portion.....	6,163	8,075
Retirement Benefits and Deferred Compensation....	31,880	33,079
Commitments and Contingencies (Note J)		
Shareholders' Equity		
Common stock, \$1 par value; 33,750,000 shares authorized; shares outstanding, 25,552,694 and 17,047,166, in 1997 and 1996, respectively.....	25,553	17,047
Additional paid-in capital.....	26,085	22,254
Retained earnings.....	105,030	85,232
Other, net.....	841	1,517
	-----	-----
Total shareholders' equity.....	157,509	126,050
	-----	-----
	\$264,532	\$247,814
	=====	=====

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

GRACO INC. &amp; Subsidiaries

(In thousands)	Years Ended		
	December 26, 1997	December 27, 1996	December 29, 1995
Cash Flows from Operating Activities:			
Net earnings .....	\$ 44,716	\$ 36,169	\$ 27,706
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization .....	13,494	12,658	11,082
Deferred income taxes .....	(358)	781	1,938
Change in:			
Accounts receivable .....	(7,804)	(10,192)	4,499
Inventories .....	(3,860)	(394)	9,693
Trade accounts payable .....	(839)	459	(6,193)
Salaries, wages and commissions .....	437	1,081	999
Retirement benefits and deferred compensation .....	(626)	928	2,448
Other accrued liabilities .....	(8,549)	6,963	(3,417)
Other .....	(330)	148	2,955
	36,281	48,601	51,710
Cash Flows from Investing Activities:			
Property, plant and equipment additions .....	(20,109)	(30,038)	(19,848)
Proceeds from sale of property, plant and equipment.....	1,990	1,058	3,036
	(18,119)	(28,980)	(16,812)
Cash Flows from (for) Financing Activities:			
Borrowing on notes payable and lines of credit....	44,033	15,890	44,248
Payments on notes payable and lines of credit....	(44,460)	(16,657)	(50,927)
Payments on long-term debt .....	(1,455)	(1,652)	(20,333)
Common stock issued .....	3,260	2,525	2,485
Retirement of common and preferred stock .....	(6,971)	(8,115)	(1,547)
Cash dividends paid .....	(9,608)	(8,344)	(7,490)
	(15,201)	(16,353)	(33,564)
Effect of exchange rate changes on cash .....	4,027	1,624	(2,135)
Net increase (decrease) in cash and cash equivalents	6,988	4,892	(801)
Cash and cash equivalents			
Beginning of year .....	6,535	1,643	2,444
End of year .....	\$ 13,523	\$ 6,535	\$ 1,643
	=====	=====	=====

See Notes to Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

GRACO INC. & Subsidiaries

Years Ended December 26, 1997, December 27, 1996, and December 29, 1995

### A. Summary of Significant Accounting Policies

**Fiscal Year.** The Company's fiscal year is 52 or 53 weeks, ending on the last Friday in December.

**Basis of Statement Presentation.** The Consolidated Financial Statements include the accounts of the parent company and its subsidiaries after elimination of all significant intercompany balances and transactions. As of December 26, 1997, all subsidiaries are 100 percent owned. Subsidiaries outside North America have been included principally on the basis of fiscal years ended November 30 to effect more timely consolidated financial reporting. The U.S. dollar is the functional currency for all foreign subsidiaries.

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

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

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

**Currency Hedges.** The Company periodically evaluates its monetary asset and liability positions denominated in foreign currencies. The Company enters into forward contracts, borrowings in various currencies or options, in order to hedge its net monetary positions. Consistent with financial reporting requirements, these hedges and net monetary positions are recorded at current market values and the gains and losses are included in Other (expense) income. The Company believes it uses strong financial counterparts in these transactions and that the resulting credit risk under these hedging strategies is not significant. The notional amounts (which may not be indicative of credit or market risk) of such contracts were (in U.S. dollars) \$28,271,000 and \$9,322,000 at December 26, 1997 and December 27, 1996, respectively.

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

Buildings and improvements	10 to 30 years
Leasehold improvements	3 to 10 years
Manufacturing equipment and tooling	3 to 10 years
Office, warehouse and automotive equipment	4 to 10 years

**Revenue Recognition.** Revenue is recognized on large contracted systems using the percentage-of-completion method of accounting. The Company recognizes revenue on other products when title passes, which is usually upon shipment.

**Earnings Per Common Share.** Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share" was issued in February 1997 and requires the presentation of earnings per share on a basic and diluted basis. Basic earnings per share is computed by dividing earnings available to common shareholders by the weighted average number of shares outstanding during the year. Diluted earnings per share is computed after giving effect to the exercise of all dilutive outstanding options grants. The Company adopted SFAS No. 128 in 1997.

**Stock Based Compensation.** SFAS No. 123, "Accounting for Stock-Based Compensation," was issued in October 1995 and requires companies to measure employee stock compensation plans based on the fair value method of accounting. However, the statement allows the alternative of continued use of Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," with pro forma disclosure of net income and earnings per share determined as if the fair value method had been applied in measuring compensation cost. The Company adopted SFAS No. 123 in 1996 and elected the continued use of APB No. 25.

Segment Reporting. In June 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 131, Disclosures about Segments of an Enterprise and Related Information, which will be effective for the Company beginning January 1, 1998. SFAS No. 131 redefines how operating segments are determined and requires disclosure of certain financial and descriptive information about a company's operating segments. The Company has not yet completed its analysis of which operating segments it will report on.

#### B. Industry Segment and Foreign Operations

The Company operates in one industry segment, namely, the design, manufacture, marketing, sale and installation of systems and equipment for the management of fluids.

The Company's operations by geographical area for the last three years are shown below.

(In thousands)	1997	1996	1995
-----	-----	-----	-----
Sales to unaffiliated customers:			
Americas	\$ 276,410	\$ 252,615	\$ 238,874
Europe	82,028	78,666	82,552
Asia Pacific	55,459	60,475	64,888
	-----	-----	-----
	413,897	391,756	386,314
Intercompany sales between geographic areas:			
Americas	74,633	54,615	56,703
Europe	5	57	32
Asia Pacific	997	433	1,398
Eliminations	(75,635)	(55,105)	(58,133)
	-----	-----	-----
Total sales	\$ 413,897	\$ 391,756	\$ 386,314
	=====	=====	=====
Operating profit:			
Americas	\$ 86,858	\$ 71,909	\$ 70,037
Europe	7,480	9,153	1,916
Asia Pacific	3,195	6,312	4,384
Eliminations	(1,167)	1,203	1,139
	-----	-----	-----
	96,366	88,577	77,476
General corporate expenses and corporate initiatives	(31,984)	(34,977)	(31,585)
Interest expense	(866)	(831)	(2,335)
	-----	-----	-----
Earnings before income taxes	\$ 63,516	\$ 52,769	\$ 43,556
	=====	=====	=====
Assets:			
Americas	\$ 193,310	\$ 180,467	\$ 152,831
Europe	39,722	40,938	46,618
Asia Pacific	22,499	26,492	26,985
Corporate	13,526	6,536	1,643
Eliminations	(4,525)	(6,619)	(10,244)
	-----	-----	-----
Total assets	\$ 264,532	\$ 247,814	\$ 217,833
	=====	=====	=====

1 Included are U.S. export sales to unaffiliated customers of \$37,477, \$27,989, and \$29,549, in 1997, 1996, and 1995, respectively.

2 Transfers between entities are made at prices which allow appropriate markups to the manufacturing and selling unit.

Net earnings for subsidiaries operating outside the U.S. were \$6,500,000, \$10,468,000, and \$12,506,000 for 1997, 1996, and 1995, respectively.

Retained earnings for subsidiaries operating outside the U.S. were \$8,889,000 and \$8,872,000 for 1997 and 1996, respectively.

Net transaction and translation gains or losses, included in Other (expense) income, were \$(2,825,000), \$(617,000), and \$528,000 for 1997, 1996, and 1995, respectively.

## C. Inventories

Major components of inventories for the last two years were as follows:

(In thousands)	1997	1996
-----	-----	-----
Finished products and components	\$38,290	\$38,707
Products and components in various stages of completion	25,320	24,691
Raw materials	16,715	15,192
	-----	-----
	80,325	78,590
Reduction to LIFO cost	(36,383)	(37,059)
	-----	-----
	\$43,942	\$41,531
	-----	-----

Inventories valued under the LIFO method were \$26,593,000 and \$26,303,000 for 1997 and 1996, respectively. All other inventory was valued on the FIFO method.

In 1997, certain inventory quantities were reduced, resulting in liquidation of LIFO inventory quantities carried at lower costs from prior years. The effect on net earnings in 1997 was not significant.

## D. Income Taxes

Earnings before income tax expense consist of:

(In thousands)	1997	1996	1995
-----	-----	-----	-----
Domestic	\$53,139	\$33,844	\$27,247
Foreign	10,377	18,925	16,309
	-----	-----	-----
Total	\$63,516	\$52,769	\$43,556
	=====	=====	=====

Income tax expense consists of:

(In thousands)	1997	1996	1995
-----	-----	-----	-----
Current:			
Domestic:			
Federal	\$11,729	\$10,518	\$ 9,629
State and local	1,709	1,201	1,591
Foreign	5,281	4,638	3,479
	-----	-----	-----
	18,719	16,357	14,699
	-----	-----	-----
Deferred:			
Domestic	1,994	(227)	227
Foreign	(1,913)	470	924
	-----	-----	-----
	81	243	1,151
	-----	-----	-----
Total	\$18,800	\$16,600	\$15,850
	-----	-----	-----

Income taxes paid were \$17,148,000, \$14,967,000, and \$16,019,000 in 1997, 1996, and 1995, respectively.

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

	1997	1996	1995
	----	----	----
Statutory tax rate	35%	35%	35%
Foreign earnings with (lower) higher tax rates	(3)	(2)	3
Reduction of valuation allowance	(3)	(6)	(4)
State taxes, net of federal effect	2	2	2
U.S. general business tax credits	(1)	(1)	(1)
Other	--	(1)	1
	----	----	----
Effective tax rate	30%	31%	36%
	=====	=====	=====

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

(In thousands)	1997	1996
-----	-----	-----
Inventory valuations	\$ 3,299	\$ 3,307
Insurance accruals	3,445	3,669
Vacation accruals	1,343	1,417
Bad debt reserves	1,109	1,281
Other	1,944	1,959
	-----	-----
Current	11,140	11,633
	-----	-----
Unremitted earnings of consolidated foreign subsidiaries	(3,500)	(3,800)
Excess of tax over book depreciation	(5,594)	(4,906)
Postretirement benefits	5,149	4,891
Pension and deferred compensation	5,397	5,352
Net operating loss carryforward	--	1,272
Other	480	594
Valuation allowance	--	(1,995)
	-----	-----
Non-current	1,932	1,408
	-----	-----
Net deferred tax assets	\$ 13,072	\$ 13,041
	=====	=====

1 Payable at the time these earnings are distributed to the parent, however, tax planning strategies may mitigate this liability.

Net non-current deferred tax assets above are included in Other Assets. Total deferred tax assets were \$22,522,000 and \$22,247,000, and total deferred tax liabilities were \$9,450,000 and \$9,206,000 on December 26, 1997 and December 27, 1996, respectively. A valuation allowance of \$1,995,000 has been recorded as of December 27, 1996, primarily related to the uncertainty of obtaining tax benefits for subsidiary operating losses.

#### E. Debt

(In thousands)	1997	1996
-----	-----	-----
Term debt, 5.08% at October 1, 1997, final equal annual installment paid in 1997	\$ --	\$ 300
Industrial development refunding revenue bonds, 4.38% at December 26, 1997, payable through 2002 (property carried at \$2,852 pledged as collateral)	3,500	4,000
Obligations related to low-income housing investments	2,508	3,205
Other	1,951	2,415
	-----	-----
Total long-term debt	7,959	9,920
Less current portion	1,796	1,845
	-----	-----
Long-term portion	\$6,163	\$8,075
	=====	=====





Aggregate annual scheduled maturities of long-term debt for the next five years are as follows: 1998-\$1,796,000; 1999-\$3,088,000; 2000-\$1,215,000; 2001-\$1,310,000; 2002-\$550,000. Interest paid on debt during 1997, 1996, and 1995 amounted to \$856,000, \$841,000, and \$2,179,000, respectively. The fair value of the Company's long-term debt at December 26, 1997 and December 27, 1996, is not materially different than its recorded value.

The Company has an interest rate swap agreement in place whereby it fixed the interest rate of the remaining principal amounts of the Company's previously variable interest rate revenue bond debt at 4.38 percent through 2002. At December 26, 1997, the contractual variable interest rate under the revenue bonds was Bankers Trust reference rate plus 0.62 percent, or 4.78 percent. The cash flows related to the swap agreement are recorded as income when received and expense when paid. Market and credit risk are not significant.

On December 26, 1997, the Company had lines of credit with U.S. and foreign banks of \$70,082,000, including a \$25,000,000 revolving credit agreement. The unused portion of these credit lines was \$67,734,000 at December 26, 1997. Borrowing rates under these facilities vary with the prime rate, rates on domestic certificates of deposit, and the London interbank market. The weighted short-term borrowing rates were 5.8 percent, 3.6 percent, and 2.2 percent at December 26, 1997, December 27, 1996, and December 29, 1995, respectively. The Company pays commitment fees of up to 3/16 percent per annum on the daily average unused amounts on certain of these lines. No compensating balances are required.

The Company is in compliance with the financial covenants of its debt agreements. Under the most restrictive terms of the agreements, approximately \$28,137,000 of retained earnings were available for payment of cash dividends at December 26, 1997.

#### F. Shareholders' Equity

Changes in shareholders' equity accounts are as follows:

(In thousands)	1997	1996	1995
-----	-----	-----	-----
Preferred Stock			
Balance, beginning of year	\$ --	\$ --	\$ 1,474
Shares repurchased	--	--	(1,474)
	-----	-----	-----
Balance, end of year	--	--	--
	-----	-----	-----
Common Stock			
Balance, beginning of year	17,047	17,265	11,377
Stock split	8,516	--	5,754
Shares issued	250	188	143
Shares repurchased	(260)	(406)	(9)
	-----	-----	-----
Balance, end of year	25,553	17,047	17,265
	-----	-----	-----
Additional Paid-In Capital			
Balance, beginning of year	22,254	20,397	18,289
Shares issued	4,171	2,337	2,342
Shares repurchased	(340)	(480)	(234)
	-----	-----	-----
Balance, end of year	26,085	22,254	20,397
	-----	-----	-----
Retained Earnings			
Balance, beginning of year	85,232	64,949	50,702
Net income	44,716	36,169	27,706
Cash dividends declared	(10,033)	(8,657)	(7,705)
Stock split	(8,516)	--	(5,754)
Shares repurchased	(6,369)	(7,229)	--
	-----	-----	-----
Balance, end of year	105,030	85,232	64,949
	-----	-----	-----
Other, Net			
Balance, end of year	841	1,517	960
	-----	-----	-----
Total Shareholders' Equity	\$ 157,509	\$ 126,050	\$ 103,571
	=====	=====	=====

The Board of Directors declared three-for-two stock splits on December 12, 1997 and December 15, 1995, respectively; effected in the form of 50 percent stock dividends payable February 4, 1998 and February 7, 1996, respectively; to shareholders of record on January 7, 1998, and January 3, 1996, respectively. Accordingly, December 26, 1997 and December 29, 1995 balances reflect the splits with an increase in common stock and reduction in retained earnings of \$8,516,000 and \$5,754,000, respectively. All stock option, share, and per share data has been restated to reflect the splits.

At December 26, 1997, the Company had 22,549 authorized, but not issued, cumulative preferred shares. The Company also has authorized, but not issued, a separate class of 3,000,000 shares of preferred stock, \$1 par value.

During 1995, the Company redeemed all 14,740 outstanding shares of cumulative preferred stock at the call price of \$105 per share plus accrued and unpaid dividends. Prior to redemption, the holders of the cumulative preferred stock were entitled to fixed cumulative dividends of 5 percent per annum on the par value before cash dividends were paid or declared on common stock.

The Company maintains a Plan in which one preferred share purchase right ("Right") exists for each common share of the Company. Each Right will entitle its holder to purchase one one-hundredth of a share of a new series of junior participating preferred stock at an exercise price of \$80, subject to adjustment. The Rights are exercisable only if a person or group acquires beneficial ownership of 20 percent or more of the Company's outstanding common stock. The Rights expire in March 2000 and may be redeemed earlier by the Board of Directors for \$.01 per Right.

#### G. Employee Stock Ownership Plan

The Company has a leveraged Employee Stock Ownership Plan (ESOP) under which there was an outstanding debt of \$300,000 at December 27, 1996. The remaining balance of a concurrent loan to the ESOP Trust from the Company was paid in 1997. The Company's loan was included in long-term debt with the receivable from the ESOP in a like amount recorded as a reduction of shareholders' equity reflected in the Other, net category. The Company has made an annual contribution to the ESOP Trust through 1997 which was sufficient to repay the loan and interest thereon.

#### H. Stock Option and Purchase Plans

**Stock Option Plans.** The Company has a Long Term Stock Incentive Plan, under which a total of 5,212,500 common shares have been reserved for issuance, with 2,029,073 shares remaining reserved at December 26, 1997. Grants under this Plan are in the form of restrictive share awards and stock options. Restrictive share awards of 963,914 common shares have been made to certain key employees under the Plan, with 67,500 shares still restricted for disposition, such restrictions will lapse on 15,000, 22,500, and 30,000 common shares in 1998, 1999, and 2000, respectively. Compensation cost charged to operations for the restricted share awards was \$188,000, \$256,000, and \$319,000, in 1997, 1996, and 1995, respectively. In 1997, certain officers of the Company agreed to forfeit certain stock appreciation rights under an agreement which had been granted in prior years. The net impact on earnings before income taxes in 1997 was \$898,000. Unearned compensation expense relating to the remaining restricted shares is \$976,000 at December 26, 1997 and is included as a reduction of shareholders' equity in the Other, net category.

Stock options for 2,366,405 common shares have also been granted under the Plan. The option price is the market price at the date of grant. Options become exercisable at such time and in such installments as set by the Company, and expire ten years from the date of grant.

In 1996, the shareholders approved a Nonemployee Director Stock Option Plan, under which the Company makes initial and annual grants to the nonemployee directors of the Company. There are 300,000 common shares authorized for issuance under the Plan, all of which remained reserved at the end of 1997. Nonemployee directors receive an initial option grant of 3,000 shares upon first appointment or election and an annual option grant of 2,250 shares. The exercise price of each option is the fair market value at the date of grant. The options have a ten-year duration and may be exercised in equal installments over four years, beginning one year from the date of grant.

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

	Shares	Weighted Average Exercise Price
-----	-----	-----
Outstanding, December 30, 1994	1,026,815	\$ 8.00
Granted	220,716	12.60
Exercised	(58,478)	5.96
Canceled	(133,258)	7.66
-----	-----	-----
Outstanding, December 29, 1995	1,055,795	9.13
Granted	105,039	13.10
Exercised	(43,680)	8.02
Canceled	(54,362)	8.09
-----	-----	-----
Outstanding, December 27, 1996	1,062,792	9.56
Granted	237,000	19.51
Exercised	(80,961)	21.46
Canceled	(115,113)	10.92
-----	-----	-----
Outstanding, December 26, 1997	1,103,718	\$ 11.65
=====	=====	=====

The number of stock options exercisable was 460,146, 349,094, and 208,863, at December 26, 1997, December 27, 1996, and December 29, 1995, respectively. These stock options had a weighted average exercise price per share of \$8.73, \$7.97, and \$7.62, at December 26, 1997, December 27, 1996, and December 29, 1995, respectively.

The outstanding options at December 26, 1997 expire from 2002 to 2007, with a weighted average contractual life remaining of 7.2 years, at exercise prices ranging from \$6.89 to \$22.75.

Stock Purchase Plans. Under the Company's Employee Stock Purchase Plan, 3,900,000 common shares have been reserved for sale to employees, 914,174 of which remained unissued at the end of 1997. The purchase price of the shares under the Plan is the lesser of 85 percent of the fair market value on the first day or the last day of the Plan year.

In 1994, the shareholders approved a Nonemployee Director Stock Plan which enable individual nonemployee directors of the Company to elect to receive or defer all or part of a director's annual retainer in the form of shares of the Company's common stock instead of cash. The Company issued 2,725, 2,282, and 728 shares under this plan during 1997, 1996, and 1995, respectively. The expense related to this plan is not significant.

Stock-Based Compensation. The Company applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock option and purchase plans. Accordingly, no compensation cost has been recognized for the Employee Stock Purchase Plan and stock options granted under the Long Term Incentive Plan and the Nonemployee Director Stock Option Plan. Had compensation cost for the stock option plans been determined based upon fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS No. 123 - "Accounting for Stock-Based Compensation," the Company's net earnings and earnings per share would have been reduced as follows:

	1997	1996	1995
-----	-----	-----	-----
Net earnings			
As reported	\$44,716	\$36,169	\$27,706
Pro forma	43,358	35,276	27,075
Net earnings per common share			
Basic as reported	\$1.75	\$1.40	\$1.07
Diluted as reported	1.71	1.38	1.06
Pro forma Basic	\$1.70	\$1.36	\$1.05
Pro forma Diluted	1.66	1.34	1.04

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1997, 1996, and 1995, respectively: dividend yields of 2.0%, 2.9%, and 2.6%, expected volatility of 32.0%, 25.1%, and 21.8%, risk-free interest rates of 6.6%, 6.3%, and 6.5% and expected lives of an average of 8 years. Based upon these assumptions, the weighted average fair value at grant date of options granted during 1997, 1996, and 1995 was \$10.47, \$5.25, and \$5.02, respectively.

The FAS No. 123 weighted average fair value of the employees' purchase rights under the Employee Stock Purchase Plan was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions for 1997, 1996, and 1995, respectively: dividend yields of 1.7%, 2.4%, and 2.7%, expected volatility of 31.7%, 25.1%, and 20.5%, risk-free interest rate of 6.5%, 6.1%, and 7.7% and expected lives of 1 year. The benefit of the 15% discount from the lesser of the fair market value per common share on the first day and the last day of the Plan year was added to the fair value of the employees' purchase rights determined using Black-Scholes. The weighted average fair value per common share was \$8.05, \$4.67, and \$3.51 in 1997, 1996, and 1995, respectively.

#### I. Retirement Benefits

The Company has a defined contribution plan, under Section 401(k) of the Internal Revenue Code, which provides additional retirement benefits to all U.S. employees who elect to participate. The Company matched employee contributions at a 50 percent rate, up to 3 percent of the employee's compensation prior to 1998. Currently, the Company matches employee contributions at a 100 percent rate, up to 3 percent of the employee's compensation. Employer contributions were \$941,000, \$841,000, and \$852,000 in 1997, 1996, and 1995, respectively.

The Company has noncontributory defined benefit pension plans covering substantially all U.S. employees and directors and certain of the employees of the Company's non-U.S. subsidiaries. For the U.S. plans, the benefits are based on years of service and the highest five consecutive years' earnings in the ten years preceding retirement. The Company funds these plans annually in amounts consistent with minimum funding requirements and maximum tax deduction limits and invests primarily in common stocks and bonds, including the Company's common stock. The market value of the plans' investment in the common stock of the Company was \$16,860,000 and \$11,070,000 at December 26, 1997 and December 27, 1996, respectively. The expenses for these plans consist of the following components:

(In thousands)	1997	1996	1995
Service cost - benefits earned during the period	\$ 2,366	\$ 2,366	\$ 2,385
Interest cost on projected benefit obligation	5,031	4,699	4,561
Actual return on assets	(14,557)	(12,228)	(12,774)
Net amortization and deferral	5,339	6,254	7,879
Cost of pension plans which are not significant and have not adopted SFAS No. 87	233	171	65
Net periodic pension cost	(\$ 1,588)	\$ 1,262	\$ 2,116

The plans' funded status and the amounts recognized in the Company's financial statements are summarized below:

(In thousands)	1997		1996	
	Plans Whose Assets Exceed Accumulated Benefits	Plans Whose Accumulated Benefits Exceed Assets	Plans Whose Assets Exceed Accumulated Benefits	Plans Whose Accumulated Benefits Exceed Assets
Actuarial present value:				
Vested benefit obligation	\$ 60,181	\$ 4,348	\$ 55,688	\$ 4,340
Accumulated benefit obligation	\$ 65,262	\$ 4,783	\$ 60,609	\$ 4,772
Projected benefit obligation	\$ 72,963	\$ 6,086	\$ 67,921	\$ 6,258
Plan assets at fair value	89,460	--	76,797	--
Projected benefit obligation (in excess of) less than plan assets	16,497	(6,086)	8,876	(6,258)
Unrecognized net (gain) loss	(23,824)	(404)	(18,553)	43
Unrecognized net (asset) liability being amortized	(113)	53	(128)	144
Adjustment required to recognize minimum liability	--	(210)	--	(327)
Accrued pension cost	(\$ 7,440)	(\$ 6,647)	(\$ 9,805)	(\$ 6,398)

Major assumptions at year-end:

	1997	1996	1995
Discount rate	4 - 7%	4 - 7%	4 - 7%
Rate of increase in future compensation levels	2 1/2 - 7%	2 1/2 - 7%	2 1/2 - 7%
Expected long-term rate of return on plan assets	11%	9%	9%

1 The estimated impact in 1997, of the change in the expected long-term rate of return on plan assets, was a reduction of employee benefit cost of approximately \$1,700.

In addition to providing pension benefits, the Company pays part of the health insurance costs for its retired U.S. employees and their dependents.

The Company's retiree health benefit expense for 1997, 1996, and 1995 was as follows:

(In thousands)	1997	1996	1995
Service cost	\$ 484	\$ 457	\$ 496
Interest cost	979	924	890
Net benefit expense	\$ 1,463	\$ 1,381	\$ 1,386

The Company's policy is to fund these benefits on a pay-as-you-go basis. The actuarial present value of these health benefit obligations and the amount recognized in the consolidated balance sheets were as follows:

(In thousands)	1997	1996
Accumulated postretirement benefit obligation:		
Retirees and beneficiaries	(\$ 6,444)	(\$ 6,000)
Fully eligible active plan participants	(2,456)	(2,531)
Other active plan participants	(6,165)	(5,738)
Accumulated benefit obligations	(15,065)	(14,269)
Unrecognized net loss	353	415
Accrued postretirement benefit cost	(\$ 14,712)	(\$ 13,854)

The Company's retirement medical benefit plan limits the annual cost increase that will be paid by the Company. In measuring the Accumulated Postretirement Benefit Obligation (APBO), a 6 percent maximum annual trend rate for healthcare costs was assumed for the year ending December 26, 1997. This rate is assumed to remain constant through the year 2001, decline by 1/2 percent for each of the following three years to 4.5 percent and remain at that level thereafter. The discount rate assumption at year-end for 1997, 1996, and 1995 was 7.0 percent. If the assumed healthcare cost trend rate changed by 1 percent, the APBO as of December 26, 1997 would change by 14.1 percent. The effect of a 1 percent change in the cost trend rate on the service and interest cost components of the net periodic postretirement benefits expense would be a change of 16.3 percent.

#### J. Commitments and Contingencies

Lease Commitments. Aggregate annual rental commitments at December 26, 1997, under operating leases with noncancelable terms of more than one year, were \$6,101,000, payable as follows:

(In thousands)	Buildings	Vehicles & Equipment	Total
-----	-----	-----	-----
1998	\$ 1,716	\$ 779	\$ 2,495
1999	1,032	459	1,491
2000	582	154	736
2001	389	11	400
2002	264	2	266
Thereafter	713	-	713
	-----	-----	-----
	\$ 4,696	\$ 1,405	\$ 6,101
	=====	=====	=====

Total rental expense was \$3,339,000 for 1997, \$3,815,000 for 1996, and \$4,722,000 for 1995.

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

#### K. Earnings per Share

In 1997, the Financial Accounting Standards Board issued Statement No. 128, "Earnings per Share." Statement 128 replaced the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share. Unlike primary earnings per share, basic earnings per share excludes any dilutive effects of options, warrants and convertible securities. Diluted earnings per share is very similar to the previously reported fully diluted earnings per share. All earnings per share amounts for all periods have been presented, where appropriate, restated to conform to the Statement 128 requirements.

Earnings per share for all years presented, has been calculated to reflect the 3 for 2 stock splits declared on December 12, 1997 and December 15, 1995, respectively. The following table set forth the computation of basic and diluted earnings per share:

(In thousands, except per share amounts)	1997	1996	1995
-----	-----	-----	-----
Numerator:			
Net earnings	\$44,716	\$36,169	\$27,706
Less dividends on preferred stock	--	--	61
	-----	-----	-----
Numerator for basic and diluted earnings per share			
-earnings available to common shareholders	\$44,716	\$36,169	\$27,645
	=====	=====	=====
Denominator			
Denominator for basic earnings per share - weighted average shares	25,575	25,908	25,774
Dilutive effect of stock options computed based on the treasury stock method using the average market price	591	394	239
	-----	-----	-----
Denominator for diluted earnings per share	26,166	26,302	26,013
	=====	=====	=====
Basic earnings per share	\$ 1.75	\$ 1.40	\$ 1.07
	=====	=====	=====
Diluted earnings per share	\$ 1.71	\$ 1.38	\$ 1.06
	=====	=====	=====

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

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information under the heading "Executive Officers of the Company" in Part I of this 1997 Annual Report on Form 10-K and the information under the headings "Election of Directors, Nominees and Other Directors" on pages 2 through 4 and under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" on page 13, of the Company's Proxy Statement for its 1998 Annual Meeting of Shareholders, to be held on May 5, 1998 (the "Proxy Statement"), is incorporated herein by reference.

Item 11. Executive Compensation

The information contained under the heading "Executive Compensation" on pages 5 through 12 of the Proxy Statement is incorporated herein by reference, other than the subsection thereunder entitled "Report of the Management Organization and Compensation Committee."

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information contained under the heading "Beneficial Ownership of Shares" on pages 12 through 13 of the Proxy Statement is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions

The Company knows of no relationships or transactions which meet the requirements of this Item 13.

PART IV

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

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

- (1) Financial Statements  
See Part II
- (2) Financial Statement Schedule  
Page  
o Schedule II - Valuation and Qualifying Accounts.....30  
  
All other schedules are omitted because they are not applicable, or not required, or because the required information is included in the Consolidated Financial Statements or Notes thereto.
- (3) Management Contract, Compensatory Plan or Arrangement. (See Exhibit Index).....32  
  
Those entries marked by an asterisk are Management Contracts, Compensatory Plans or Arrangements.

(b) Reports on Form 8-K

There were no reports on Form 8-K for the thirteen weeks ended December 26, 1997.

(c) Exhibit Index.....32

## Schedule II - Valuation and Qualifying Accounts

GRACO INC. &amp; Subsidiaries

(In thousands)

Description	Balance at beginning -----	Additions charged to costs and expenses -----	Deductions from reserves -----	Balance at end of year -----
Year ended December 26, 1997:				
Allowance for doubtful accounts	\$ 2,400	\$ 500	\$ 700	\$ 2,200
Allowance for obsolete and overstock inventory	5,100	1,500	1,900	4,700
Allowance for returns and credits	2,300	3,700	4,100	1,900
Valuation allowance for tax benefits	1,995	--	1,995	--
	-----	-----	-----	-----
	\$11,795	\$ 5,700	\$ 8,695	\$ 8,800
	=====	=====	=====	=====
Year ended December 27, 1996:				
Allowance for doubtful accounts	\$ 2,800	\$ 900	\$ 1,300	\$ 2,400
Allowance for obsolete and overstock inventory	5,900	2,500	3,300	5,100
Allowance for returns and credits	2,000	4,100	3,800	2,300
Valuation allowance for tax benefits	5,020	--	3,025	1,995
	-----	-----	-----	-----
	\$15,720	\$ 7,500	\$11,425	\$11,795
	=====	=====	=====	=====
Year ended December 29, 1995:				
Allowance for doubtful accounts	\$ 2,700	\$ 700	\$ 600	\$ 2,800
Allowance for obsolete and overstock inventory	6,400	1,400	1,900	5,900
Allowance for returns and credits	2,000	3,400	3,400	2,000
Valuation allowance for tax benefits	6,900	--	1,880	5,020
	-----	-----	-----	-----
	\$18,000	\$ 5,500	\$ 7,780	\$15,720
	=====	=====	=====	=====

1 Accounts determined to be uncollectible and charged against reserve, net of collections on accounts previously charged against reserves.

2 Items scrapped or otherwise disposed of during the year.

3 Credits issued and returns processed, related to prior years.



Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Graco Inc.

/s/George Aristides ----- George Aristides Chief Executive Officer	March 17, 1998 -----
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Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/George Aristides ----- George Aristides Chief Executive Officer (Principal Executive Officer)	March 17, 1998 -----
--	-------------------------

/s/Mark W. Sheahan ----- Mark W. Sheahan Treasurer (Principal Financial Officer)	March 17, 1998 -----
--	-------------------------

/s/James A. Graner ----- James A. Graner Vice President and Controller (Principal Accounting Officer)	March 17, 1998 -----
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D. A. Koch	Director, Chairman of the Board
G. Aristides	Director, and Chief Executive Officer
C. M. Osborne	Director, President and Chief Operating Officer
R. O. Baukol	Director
R. D. McFarland	Director
L. R. Mitau	Director
M. A.M. Morfitt	Director
D. R. Olseth	Director
J. L. Scott	Director
W. G. Van Dyke	Director

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

/s/George Aristides ----- George Aristides (For himself and as attorney-in-fact)	March 17, 1998 -----
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## Exhibit Index

Exhibit Number	Description
3.1	Restated Articles of Incorporation as amended December 12, 1997. See also Exhibit 4.3.
3.2	Restated Bylaws. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
4.1	Credit Agreement dated October 1, 1990, between the Company and First Bank National Association. (Incorporated by reference to Exhibit 5 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 28, 1990.)
4.2	Amendment 1 dated June 12, 1992, to Credit Agreement dated October 1, 1990, between the Company and First Bank National Association; and Amendment 2 dated December 31, 1992, to the same Agreement. (Incorporated by reference to Exhibit 1 to the Company's Report on Form 8-K dated March 11, 1993.) Amendment 3 dated November 8, 1993, and Amendment 4, dated February 8, 1994. (Incorporated by reference to Exhibit 4.2 to the Company's 1993 Annual Report on Form 10-K.) Amendment 5, dated April 10, 1995. (Incorporated by reference to Exhibit 4.2 to the Company's 1995 Annual Report on Form 10-K.) Amendment 6, dated September 27, 1996. (Incorporated by reference to Exhibit 4 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 27, 1996.) Amendment 7 dated May 27, 1997. (Incorporated by reference to Exhibit 4 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
4.3	Rights Agreement dated as of March 9, 1990, between the Company and Norwest Bank Minnesota, National Association, as Rights Agent, including as Exhibit A the form of the Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Shares. (Incorporated by reference to Exhibit 1 to the Company's Report on Form 8-K dated March 19, 1990.)
*10.1	1997 Corporate and Business Unit Annual Bonus Plan. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended March 28, 1997.)
*10.2	Deferred Compensation Plan Restated, effective December 1, 1992. (Incorporated by reference to Exhibit 2 to the Company's Report on Form 8-K dated March 11, 1993.) Amendment 1 dated September 1, 1996. (Incorporated by reference to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
*10.3	Executive Deferred Compensation Agreement. Form of supplementary agreement entered into by the Company which provides a retirement benefit to selected executive officers, as amended by Amendment 1, effective September 1, 1990. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 11, 1993.)
*10.4	Chairman's Award Plan. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 7, 1988.)
*10.5	Long Term Stock Incentive Plan, as amended December 12, 1997.
*10.6	Retirement Plan for Non-Employee Directors. (Incorporated by reference to Attachment C to Item 5 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 1991.)

- \*10.7 Deferred Compensation Plan for Non-Employee Directors. (Incorporated by reference to Exhibit 2 to the Company's Report on Form 8-K dated March 7, 1988.)
- \*10.8 Restoration Plan (1998 Restatement).
- \*10.9 Stock Option Agreement. Form of agreement used for incentive stock option/alternative stock appreciation right award to selected officers, dated February 25, 1993. (Incorporated by reference to Exhibit 10.14 to the Company's 1993 Annual Report on Form 10-K.)
- \*10.10 Stock Option Agreement. Form of agreement used for non-incentive stock option/alternative stock appreciation right award to selected officers, dated May 4, 1993. (Incorporated by reference to Exhibit 10.15 to the Company's 1993 Annual Report on Form 10-K.)
- \*10.11 Nonemployee Director Stock Plan, as amended November 6, 1997.
- \*10.12 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers, dated May 2, 1994. (Incorporated by reference to Exhibit 10.3 to the Company's Report on Form 10-Q for the twenty-six weeks ended July 1, 1994.)
- \*10.13 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to selected officers, dated December 15, 1994, December 27, 1994 and February 23, 1995. (Incorporated by reference to Exhibit 10.16 to the Company's 1994 Annual Report on Form 10-K.)
- \*10.14 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers, dated March 1, 1995. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended March 31, 1995.)
- \*10.15 Stock Option Agreement. Form of agreement used for award of non-incentive stock option to one executive officer, dated December 15, 1995. (Incorporated by reference to Exhibit 10.18 to the Company's 1995 Annual Report on Form 10-K.)
- \*10.16 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers, dated March 1, 1996. (Incorporated by reference to Exhibit 10.19 to the Company's 1995 Annual Report on Form 10-K.)
- \*10.17 Form of salary protection arrangement between the Company and executive officers. (Incorporated by reference to Exhibit 10.21 to the Company's 1995 Annual Report on Form 10-K.)
- \*10.18 Nonemployee Director Stock Option Plan, as amended November 6, 1997.
- \*10.19 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors, dated May 7, 1996. (Incorporated by reference to Exhibit 10.4 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 28, 1996.)
- \*10.20 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers, dated February 28, 1997. (Incorporated by reference to Exhibit 10.24 to the Company's 1996 Annual Report on Form 10-K.)
- \*10.21 Stock Option Agreement Amendment. Form of amendment, dated March 8, 1997, used to remove alternative stock appreciation right from incentive stock option agreement dated February 25, 1993, for selected officers. (Incorporated by reference to Exhibit 10.25 to the Company's 1996 Annual Report on Form 10-K.)

- \*10.22 Stock Option Agreement Amendment. Form of amendment, dated March 8, 1997, used to remove alternative stock appreciation right from non-incentive stock option agreement dated May 4, 1993, for selected officers. (Incorporated by reference to Exhibit 10.26 to the Company's 1996 Annual Report on Form 10-K.)
- \*10.23 Key Employee Agreement. Form of agreement with officers and other key employees relating to change of control, dated April 2, 1997. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.24 Stock Option Agreement Amendment. Form of amendment, dated April 14, 1997, used to add change of control provision to non-incentive stock options to executive officer dated May 2, 1994, March 1, 1995 and March 1, 1996. (Incorporated by reference to Exhibit 10.6 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.25 Stock Option Agreement Amendment. Form of amendment, dated April 14, 1997, used to add change of control provision to non-incentive stock options to selected officers dated December 15, 1994. (Incorporated by reference to Exhibit 10.7 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.26 Stock Option Agreement Amendment. Form of amendment, dated April 14, 1997, used to add change of control provision to non-incentive stock options to one executive officer dated December 15, 1995. (Incorporated by reference to Exhibit 10.8 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.27 Stock Option Agreement. Form of agreement used for award of non-incentive stock option to one executive officer, dated April 23, 1997. (Incorporated by reference to Exhibit 10.9 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.28 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors, dated May 6, 1997. (Incorporated by reference to Exhibit 10.10 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.29 Executive Long Term Incentive Agreement. Form of restricted stock award agreement used for award to one executive officer, dated May 6, 1997. (Incorporated by reference to Exhibit 10.11 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.30 Stock Option Agreement. Form of agreement used for award of non-incentive stock option to two executive officers, dated May 6, 1997. (Incorporated by reference to Exhibit 10.12 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
- \*10.31 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee director, dated September 5, 1997. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 26, 1997.)
- \*10.32 Trust Agreement dated September 30, 1997, between the Company and Norwest Bank Minnesota, N.A. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 26, 1997.)
- \*10.33 Key Employee Agreement Amendment. Form of amendment dated January 9, 1998, revising payment reduction provisions.

- 11 Statement of Computation of Earnings per share included in footnote K on page 28.
- 21 Subsidiaries of the Registrant included herein on page 36.
- 23 Independent Auditor's Consent included herein on page 36.
- 24 Power of Attorney included herein on page 37.
- 27 Financial Data Schedule (EDGAR filing only).
- 99 Cautionary Statement Regarding Forward-Looking Statements.

\*Management Contracts, Compensatory Plans or Arrangements.

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

Exhibit 21

Subsidiaries of Graco Inc.

The following are subsidiaries of the Company:

Subsidiary -----	Jurisdiction of Organization -----	Percentage of Voting Securities Owned by the Company -----
Equipos Graco Argentina S.A.	Argentina	100%*
Graco Barbados FSC Limited	Barbados	100%
Graco Canada Incorporated	Canada	100%
Graco Chile Limitada	Chile	100%*
Graco do Brasil Limitada	Brazil	100%*
Graco Europe N.V.	Belgium	100%*
Graco GmbH	Germany	100%
Graco Hong Kong Limited	Hong Kong	100%*
Graco K.K.	Japan	100%
Graco Korea Inc.	Korea	100%
Graco Limited	England	100%*
Graco N.V.	Belgium	100%*
Graco S.A.	France	100%*
Graco S.r.l.	Italy	100%*

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

Exhibit 23

Independent Auditors' Consent

We consent to the incorporation by reference in Registration Statement No. 333-17691 on Form S-8 (the Company's Long Term Stock Incentive Plan), in Registration Statement No. 333-17787 on Form S-8 (the Company's Employee Stock Purchase Plan), in Registration Statement No. 33-54205 on Form S-8 (the Company's Nonemployee Director Stock Plan) and in Registration Statement No. 333-03459 on Form S-8 (the Company's Nonemployee Director Stock Option Plan) of our report dated January 19, 1998, appearing in this Annual Report on Form 10-K of Graco Inc. for the year ended December 26, 1997.

Deloitte & Touche LLP  
Minneapolis, Minnesota  
March 13, 1998

## Power of Attorney

Know all by these presents, that each person whose signature appears below hereby constitutes and appoints George Aristides or Mark W. Sheahan, that person's true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution for that person and in that person's name, place and stead, in any and all capacities, to sign the Report on Form 10-K for the year ended December 26, 1997, of Graco Inc. (and any and all amendments thereto) and to file the same with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as that person might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitutes, may lawfully do or cause to be done by virtue hereof.

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

	Date
	-----
/s/G. Aristides	February 20, 1998
-----	-----
G. Aristides	
/s/R. O. Baukol	February 20, 1998
-----	-----
R. O. Baukol	
/s/D. A. Koch	February 20, 1998
-----	-----
D. A. Koch	
/s/R. D. McFarland	February 20, 1998
-----	-----
R. D. McFarland	
/s/L. R. Mitau	February 20, 1998
-----	-----
L. R. Mitau	
/s/M. A.M. Morfitt	February 20, 1998
-----	-----
M. A.M. Morfitt	
/s/D. R. Olseth	February 20, 1998
-----	-----
D. R. Olseth	
/s/C. M. Osborne	February 20, 1998
-----	-----
C. M. Osborne	
/s/J. L. Scott	February 20, 1998
-----	-----
J. L. Scott	
/s/W. G. Van Dyke	February 20, 1998
-----	-----
W. G. Van Dyke	



ARTICLES OF AMENDMENT  
RESTATING  
ARTICLES OF INCORPORATION OF  
GRACO INC.

1. The name of the corporation is Graco Inc., a Minnesota corporation.
2. On December 12, 1997, the Board of Directors of Graco Inc. amended article 5.1(a) of its Articles of Incorporation, pursuant to the Minnesota Business Corporation Act, Minnesota Statutes, Section 302A.402, subd. 3, to read as follows:

5.1(a) The total number of shares which this corporation shall be authorized to issue is Thirty-six Million Seven Hundred Seventy-two, Five Hundred Forty-nine (36,772,549), of which Thirty-three Million Seven Hundred Fifty Thousand (33,750,000) 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.
3. The document entitled "Restated Articles of Incorporation of Graco Inc." marked as Exhibit A and attached hereto, contains the full text of the Articles of Incorporation of Graco Inc., incorporating in its entirety the amendment of Article 5.1(a) adopted by the Board of Directors on December 12, 1997.
4. The document entitled "Restated Articles of Incorporation of Graco Inc." attached hereto as Exhibit A correctly sets forth, without change, the corresponding provisions of the existing articles as previously amended and merely restates the existing Articles, including the amendment to Article 5.1(a), in their entirety.
5. The "Restated Articles of Incorporation of Graco Inc." attached hereto as Exhibit A, supersede the prior restated Articles and all amendments thereto.

IN WITNESS WHEREOF, the undersigned, the Secretary of Graco Inc., being duly authorized on behalf of Graco Inc., has executed this document this twelfth day of December, 1997.

/s/Robert M. Mattison  
Robert M. Mattison  
Secretary

Exhibit A  
RESTATED ARTICLES OF INCORPORATION  
OF  
GRACO INC.

(Approved by the Board of Directors on December 12, 1997)

ARTICLE I

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

ARTICLE 2

2. CT Corporation System Inc., is this corporation's registered agent in the State of Minnesota, and 405 Second Avenue South, Minneapolis, Minnesota 55401, the business office address of CT Corporation System Inc., is the registered office of this corporation.

ARTICLE 3

3. Except as provided in Article 6, (i) the holders of a majority of the Common Shares outstanding shall have power to authorize the sale, lease, exchange, or other disposal of all, or substantially all, of the property and assets of the corporation, including its goodwill, to adopt or reject a plan of merger or exchange and (ii) the holders of a majority of the Common Shares present and entitled to vote at a meeting shall have the power to amend the Articles of Incorporation.

ARTICLE 4

4. 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 5

5.1 (a) The total number of shares which this corporation shall be authorized to issue is Thirty-six Million Seven Hundred Seventy-two, Five Hundred Forty-nine (36,772,549), of which Thirty-three Million Seven Hundred Fifty Thousand (33,750,000) 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.

5.2 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 6

6.1 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.

6.2 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.

6.3 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.

6.4 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 7

7.1 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.

7.2 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.

7.3 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.

7.4 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 8

8. 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 9

9. 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.

December 12, 1997

## LONG TERM STOCK INCENTIVE PLAN

1. Purpose. The purpose of the Graco Inc. Long Term Stock Incentive Plan (the "Plan") is to further the growth in earnings and market appreciation of Graco Inc. (the "Company"). The Plan provides substantial contributions to the Company through ability, performance, industry and invention. The Company intends that the Plan will thereby facilitate securing, retaining and motivating officers and key employees of high caliber and good potential.

2. Administration. The Plan shall be administered by a committee (the "Committee") selected by the Board of Directors of the Company (the "Board"). The Committee shall consist of two or more members who are members of the Board and who are "Non-Employee Directors" within the meaning of Rule 16b-3 promulgated by the Securities and Exchange Commission under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), which term "Non-Employee Director" is defined in this paragraph for purposes of describing the members of the Committee only and is not intended to define such term as it may be used elsewhere in the Plan. The Committee may delegate to one or more officers of the Company or a committee of such officers the authority, subject to such terms and limitations as the Committee shall determine to grant awards to employees of the Company who are not officers or directors of the Company for purposes of Section 16 of the Exchange Act.

The Committee shall have full and final authority, in its discretion, to interpret the provisions of the Plan and to decide all questions of fact arising in its application; to determine the employees to whom awards shall be made under the Plan; to determine the type of award to be made and the amount, size, terms and conditions of each such award; to determine and establish additional terms and conditions not inconsistent with the Plan and for any agreements entered into with participants in connection with the Plan; to determine the time when awards will be granted and when rights may be exercised, which may be after termination of employment; and to make all other determinations necessary or advisable for the administration of the Plan.

The Committee shall select one of its members as its Chairman and shall hold its meetings at such times and places as it may determine. A majority of its members shall constitute a quorum. All determinations of the Committee shall be made by not less than a majority of its members. Any decision or determination reduced to writing and signed by all of the members of the Committee shall be fully effective as if it had been made by a majority vote at a meeting duly called and held. The granting of a stock option or restricted stock award pursuant to the Plan shall be effective only if a written agreement shall have been duly executed and delivered by and on behalf of the Company and, in the case of a restricted stock award, by the employee to whom such right is granted. The Committee may appoint a Secretary and may make such rules and regulations for the conduct of its business as it shall deem advisable.

3. Participants. Persons eligible to participate in the Plan shall be those officers and key employees of the Company or its subsidiaries who are in positions in which their decisions, actions and counsel significantly impact the performance of the Company or its subsidiaries. Directors of the Company who are not otherwise salaried employees of the Company shall not be eligible to receive awards under the Plan. For the purpose of awards of incentive stock options (as hereinafter defined) made under the Plan, the term "subsidiary" shall have the meaning given to it by Section 424 of the Internal Revenue Code of 1986, as amended (the "Code"). For the purpose of all other awards made under the Plan, the term "subsidiary" shall have the meaning given to it by Rule 405 promulgated under the Securities Act of 1933, as amended. References to "the Company" in this Plan or in any option or other award granted pursuant to the Plan shall be deemed references to a subsidiary if appropriate.

4. Awards under the Plan. Awards by the Committee under the Plan may be in the form of stock options intended to qualify as "incentive stock options" under the provision of Section 422 of the Code, stock options which do not qualify for special tax treatment under Section 422, restricted stock and other stock awards pursuant to such bonus and incentive plans as the Committee may deem appropriate.

4.1 Award Limitation. In any calendar year beginning with January 31, 1997, the Committee may not award stock options or stock appreciation rights on more than 300,000 Shares in the aggregate to any Participant who is an employee of the Company at the time of such award. This award limit may be adjusted in accordance with the provisions of Section 15. This limitation is intended to qualify the award of options and stock appreciation rights as performance-based compensation within the meaning of Section 162(m) of the Code.

5. Shares Subject to Plan. The shares that may be issued under the Plan shall not exceed in the aggregate 5,212,500 common shares, \$1.00 par value, of the Company. Except as otherwise provided herein, any shares subject to an option or right or other awards which for any reason expires or terminates



without issuance or final vesting of such shares shall again be available under the Plan. No fractional shares shall be issued under the Plan.

6. Stock Options. Stock options shall be evidenced by stock option agreements in such form not inconsistent with the Plan as the Committee shall approve from time to time, which agreements shall contain in substance the following terms and conditions.

6.1. Option Price. The purchase price per common share deliverable upon the exercise of an option shall not be less than 100% of the fair market value of the stock on the day the option is granted, as determined by the Committee.

6.2. Exercise of Option. Each stock option agreement shall state the period or periods of time within which the option may be exercised by the participant, in whole or in part, which shall be such period or periods of time as may be determined by the Committee, provided that the option period shall not end later than ten years after the date of the grant of the option.

6.3. Payment of Shares. An optionee electing to exercise an option shall give written notice to the Company of such election and of the number of shares subject to such exercise. The full purchase price of such shares shall be tendered with such notice of exercise or, at the discretion of the Committee, pursuant to any arrangements satisfactory to the Committee which provide that the Company will be paid at the time the shares are delivered to the optionee or his designee. Payment shall be made either in cash (including check, bank draft or money order) or, at the discretion of the Committee, (i) by delivering the Company's common shares already owned by the optionee having a fair market value equal to the full purchase price of the shares, or (ii) a combination of cash and such shares.

6.4. Special Rule for Incentive Stock Options. The aggregate fair market value (determined as of the time the option is granted) of the common shares with respect to which all incentive stock options granted after January 1, 1987 are exercisable for the first time by any individual during any calendar year (under all option plans of the Company and its parent and subsidiary corporations) shall not exceed \$100,000.

7. Restricted Stock Awards. Restricted stock awards shall be evidenced by restricted stock agreements in such form not inconsistent with the Plan as the Committee shall approve from time to time, which agreements shall contain in substance the following terms and conditions.

7.1. Restriction Period. Shares awarded pursuant to restricted stock awards shall be subject to such conditions, terms and restrictions (including continued employment, achievement of performance targets, forfeiture and transfer) and for such period or periods as shall be determined by the Committee. The Committee shall have the power, in its discretion, to permit an acceleration of the expiration of the applicable restriction period with respect to any part of all of the shares awarded to a participant.

7.2 Restrictions Upon Transfer. The common shares subject to an award, may not be sold, assigned, transferred, exchanged, pledged, hypothecated, or otherwise encumbered, except as herein provided, during the restriction period applicable to such shares, but a participant shall have all the other rights of a stockholder, including the right to receive cash dividends and the right to vote such shares, until such time as the restrictions have lapsed or the shares have been forfeited.

7.3 Certificates. Each certificate issued in respect of common shares awarded to a participant shall be deposited with the Company, or its designee, and shall bear an appropriate legend noting the existence of restrictions upon the transfer of such Common Stock.

7.4 Lapse of Restrictions. The agreement governing the awards shall specify the conditions and terms upon which any restrictions upon shares awarded under the Plan shall lapse, as determined by the Committee. Upon lapse of such restrictions, common shares free of any restrictive legend, other than as may be required under Section 9 hereof, shall be issued and delivered to the participant or his legal representative.

8. Fair Market Value. The fair market value of the Company's common shares for purposes of the Plan shall be the last sale price of the common shares as reported on the New York Stock Exchange on the business day as of which the fair market value is being determined or if no sale occurred on that date, the last sale on the most recent date for which a sale is reported. If the Company's common shares are not then traded on the New York Stock Exchange, the Committee may determine fair market value in some other reasonable way.

9. General Restrictions. Each award under the Plan shall be subject to the requirement that, if at anytime the Committee shall determine that (a) the listing, registration or qualification of the common shares subject or related thereto upon any securities exchange or under any state or federal law, or (b) the consent or approval of any government regulatory body, or (c) an agreement

by the recipient of an award with respect to the disposition of common shares, is necessary or desirable in connection with, the granting of such award or the issue or purchase of common shares thereunder, such award may not be consummated in whole or in part unless such listing, registration, qualification, consent, approval or agreement shall have been effected or obtained free of any conditions not acceptable to the Committee. A participant shall agree, as a condition of receiving any award under the Plan, to execute any documents, make any representations, agree to restrictions on stock transferability and take any actions which in the opinion of legal counsel to the Company is required by any applicable law, ruling or regulation.

10. Rights of a Shareholder. The recipient of any award under the Plan, unless otherwise provided by the Plan, shall have no rights as a shareholder with respect thereto unless and until certificates for common shares are issued to the recipient.

11. Right to Terminate Employment. Nothing in the Plan or in any agreement entered into pursuant to the Plan shall confer upon any participant the right to continue in the employment of the Company or its subsidiaries, or affect any right which the Company or such subsidiaries may have to terminate the employment of the participant.

12. Withholding.

12.1. Payment of Withholding Taxes. Whenever the Company proposes or is required to issue or transfer common shares under the Plan, the Company shall have the right to require the recipient to remit to the Company, or provide indemnification satisfactory to the Company for, an amount sufficient to satisfy any federal, state or local withholding tax requirements prior to the issuance or delivery of any certificate or certificates for such shares.

12.2. Use of Common Shares to Satisfy Tax Obligation. In order to assist an optionee or grantee in paying all federal, state and local taxes to be withheld or collected upon exercise of an option or the grant of a stock award or the lapse of restrictions relating to a restricted stock award hereunder, the Committee in its sole discretion and subject to such rules as it may adopt, may permit the optionee or grantee to satisfy such tax obligation, in whole or in part, by (i) electing to have the Company withhold common shares otherwise to be delivered with a fair market value equal to the amount of such tax obligation, or (ii) electing to surrender to the Company previously owned common shares with a fair market value equal to the amount of such tax obligation. The election must be made on or before the date that the amount of tax to be withheld is determined.

13. Non-Assignability. No award under the Plan shall be assignable or transferable by the participant except by will or by laws of descent and distribution. During the life of a participant, such award shall be exercisable only by the participant or by the participant's guardian or legal representative.

14. Non-Uniform Determinations. The Committee's determinations under the Plan (including, without limitation, determinations of the persons to receive awards, the form, amount and timing of such awards, the terms and provisions of awards and the agreements evidencing the awards, and the establishment of values and performance targets) need not be uniform and may be made by it selectively among persons who receive, or are eligible to receive, awards under the Plan whether or not such persons are similarly situated.

15. Adjustments in Shares. In the event of any change in the outstanding common shares of the Company by reason of a stock dividend or distribution, recapitalization, merger, consolidation, split-up, combination, exchange of shares or otherwise, the Board shall adjust the number of shares which may be issued under the Plan and the Board shall provide for an equitable adjustment of any shares issuable pursuant to awards outstanding under the Plan.

16. Adoption, Amendment and Termination.

16.1. Adoption. This Plan was originally adopted in February 1982 as the Graco Inc. Incentive Stock Option Plan. The Plan was amended and restated as the Graco Inc. Long Term Stock Incentive Plan by the Board of Directors on March 4, 1988 and was further amended by the Board on December 13, 1991, February 21, 1992, February 23, 1996 and May 7, 1996, which amendments requiring shareholder approval were approved by the shareholders on May 5, 1992 and May 7, 1996, respectively.

16.2 Amendment. The Board may amend, suspend, or terminate the Plan at any time, but without shareholder approval, no amendment shall materially increase the maximum number of shares which may be issued under the Plan (other than increases pursuant to Section 15 hereof), materially increase the benefits accruing to participants under the Plan, materially modify the requirements as to eligibility for participation, or extend the term of the Plan.

16.3. Termination. Unless the Plan shall have been discontinued at an earlier date, the Plan shall terminate on December 13, 2001. No option,

restricted stock award or stock awards may be granted after such termination, but termination of the Plan shall not, without the consent of the optionee or grantee, alter or impair any rights or obligations under any award theretofore granted.

GRACO INC.  
NONEMPLOYEE DIRECTOR STOCK PLAN  
("PLAN")

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

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

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

4. Election to Receive Stock and Stock Issuance.

4.1. Election to Receive Stock/Credit in Lieu of Cash. On forms provided by the Company, each Eligible Director may irrevocably elect ("Stock Election") in lieu of cash, (i) to be issued shares of Common Stock or (ii) to have credited to an account ("Deferred Stock Account") the number of shares of Common Stock having a Fair Market Value, as defined in Section 4.3, equal to 25%, 50%, 75% or 100% of the annual cash retainer (the "Retainer") payable to that director for services rendered as a director ("Participating Director"). A Stock Election shall apply only to the Retainer and not to any fees payable for attendance at Board or Committee meetings. Eligible Directors are customarily paid the Retainer in quarterly installments in arrears at the end of each calendar quarter. Any Stock Election must be received by the Company before the commencement of the calendar quarter with respect to which such election is made. Any Stock Election may only be amended or revoked ("Amended Stock Election") in accordance with the procedure set forth in Section 4.4.

4.2. Issuance of Stock/Application of Credit in Lieu of Cash. If the Stock Election is for the issuance of shares of Common Stock, shares of Common Stock having a Fair Market Value equal to the amount of the Retainer so elected shall be issued to each Participating Director when each quarterly installment of the Retainer is customarily paid. The Company shall not issue fractional shares, but in lieu thereof shall pay cash of equivalent value using the same Fair Market Value used to determine the number of Shares to be issued on the relevant issue date. If the Stock Election is for a credit to a Deferred Stock Account, the number of shares of Common Stock (rounded to the nearest hundredth of a share) having a Fair Market Value equal to the amount of the Retainer so elected shall be credited to the Participating Director's Deferred Stock Account when each quarterly installment of the Retainer is customarily paid. In the event that a Participating Director elects to receive less than 100% of each quarterly installment of the Retainer in shares of Common Stock, either issued or credited, he shall receive the balance of the quarterly installment in cash.

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

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

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

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

## 5. Shares Available for Issuance.

5.1. Maximum Number of Shares Available. The maximum number of shares of the Company's Common Stock, par value \$1.00 per share, that will be available for issuance under the Plan will be 150,000 shares, subject to any adjustments made in accordance with the provisions of Section 5.2. At the election of the Administrator, the shares of Common Stock available for issuance under the Plan may be either authorized but unissued shares or treasury shares. If treasury shares are used, all references in the Plan to the issuance of shares will be deemed to mean the transfer of shares from treasury.

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

## 6. Deferral Payment

6.1 Deferral Payment Election. At the time of making the Stock Election in which the Participating Director elects to have a Deferred Stock Account credited in accordance with the provisions of Section 4.1, the Participating Director will also elect the manner and timing for payment of the amounts credited to his or her Deferred Stock Account ("Deferral Payment Election") from the alternatives described in Section 6.2. The Participating Director may change the manner and timing for payment of amounts to be credited to his or her Deferred Stock Account by executing another Deferral Payment Election; provided, however, that the previously made Deferral Payment Election will be irrevocable as to all amounts credited to the Participating Director's Deferred Stock Account prior to receipt by the Company of a new Deferral Payment Election.

6.2 Payment from Deferred Stock Accounts. A Participating Director may elect to receive payment from his or her Deferred Stock Account in a lump sum or installments. Payments, whether in a lump sum or by installments, shall be made in shares of Common Stock plus cash in lieu of any fractional share. Unless the Participating Director elects to receive payment in installments, credits to a Participating Director's Deferred Stock Account shall be payable in full on January 10 of the year following the Participating Director's termination of service on the Board, or the first business day thereafter, or such other date as elected by the Participating Director pursuant to Section 6.1. If the Participating Director elects to receive payment from his or her Deferred Stock Account in installments, each installment payment will be made annually on January 10 of each year, or the first business day thereafter, and the amount of each payment will be computed by multiplying the number of shares credited to the Deferred Stock Account as of January 10 of each year by a fraction, the numerator of which is one and the denominator of which is the total number of installments elected (not to exceed fifteen) minus the number of installments previously paid. Amounts paid prior to the final installment payment will be rounded to the nearest whole number of shares; the final installment payment shall be for the whole number of shares remaining credited to the Deferred Stock Account, plus cash in lieu of any fractional share.

6.3 Change of Control. Notwithstanding the foregoing, in the event of a Change of Control (as defined in Section 11), the number of shares credited to the Deferred Stock Account of a Participating Director as of the business day immediately prior to the effective date of the transaction constituting the Change of Control, shall be paid in full to the Participating Director or the Participating Director's beneficiary or estate, as the case may be, in whole shares of Common Stock plus cash in lieu of any fractional share on the tenth business day following the effective date of the transaction constituting the Change of Control.

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

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

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

8. Plan Amendment, Modification and Termination. The Board may suspend or terminate the Plan at any time. The Board may amend the Plan from time to time in such respects as the Board may deem advisable in order that the Plan will conform to any change in applicable laws or regulations or in any other respect that the Board may deem to be in the Company's best interests; provided, however, that no amendments to the Plan will be effective without approval of the Company's shareholders, if shareholder approval of the amendment is then required pursuant to Rule 16b-3 (or any successor rule) under the Securities Exchange Act of 1934, as amended, (the "Exchange Act") or the rules of the New York Stock Exchange.

9. Effective Date and Duration of the Plan. The Plan shall become effective as of the date the Company's shareholders approve it and will terminate on December 31, 2003, unless earlier terminated by the Company's Board.

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

## 11. Change of Control

11.1 A "Change of Control" means any one of the following events:

(1) acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the Exchange 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 any 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 Common Stock or other voting securities of the Company 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 11, a Trust Person shall not be deemed to have beneficial ownership of the Common Stock or other voting securities of the Company owned by The Graco Foundation or any employee benefit plan of the Company, including the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Participating Director or any group that includes the Participating Director, or
- (vi) an acquisition by any corporation pursuant to a

transaction that complies with clauses (a), (b) and (c) of subsection (4) below; and

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

11.2 A Change of Control shall not be deemed to have occurred with respect to a Participating Director if:

(1) the acquisition of the 25% or greater interest referred to in subparagraph 11.1(1) of this Section 11 is by a group, acting in concert, that includes the Participating 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 subparagraph 11.1(4) or (5) of this Section by a group, acting in concert, that includes that Participating Director.

## 12. Miscellaneous.

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

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

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

12.2 Governing Law. The validity, construction, interpretation, administration and effect of the Plan and any rules, regulations and actions relating to the Plan will be governed by and construed exclusively in accordance with the laws of the State of Minnesota.



GRACO INC. NONEMPLOYEE DIRECTOR STOCK OPTION PLAN

1. Purpose

The purpose of the Graco Inc. Nonemployee Director Stock Option Plan (the "Plan") is to secure for Graco Inc. (the "Company") and its shareholders the benefits of the long-term incentives inherent in increased common stock ownership by the members of the Board of Directors (the "Board") of the Company who are not employees of the Company or its Affiliates, by strengthening the identification of Nonemployee Directors with the interests of all Graco shareholders.

2. Definitions

The terms defined in this Section 2 shall have the following meanings, unless the context otherwise requires.

- a. Affiliate shall mean any corporation, partnership, joint venture or other entity in which the Company holds an equity, profit or voting interest of more than fifty percent (50%).
- b. Annual Meeting of Shareholders shall mean the annual meeting of shareholders of the Company held each calendar year.
- c. Code shall mean the Internal Revenue Code of 1986, as amended to date and as it may be amended from time to time.
- d. Company shall mean Graco Inc., a Minnesota corporation.
- e. ERISA shall mean the Employee Retirement Income Security Act of 1974, as amended to date and as it may be amended from time to time.
- f. Fair Market Value per Share shall mean as of any day
  - (1) The fair market value of a share of the Company's common stock is the last sale price reported on the composite tape by the New York Stock Exchange on the business day immediately preceding the date as of which fair market value is being determined or, if there were no sales of shares of the Company's common stock reported on the composite tape on such day, on the most recently preceding day on which there were sales, or
  - (2) if the shares of the Company's stock are not listed or admitted to trading on the New York Stock Exchange on the day as of which the determination is made, the amount determined by the Board or its delegate to be the fair market value of a share on such day.
- g. Nonemployee Director shall mean a member of the Board of Directors of the Company who is not also an officer or other employee of the Company or an Affiliate.
- h. Nonstatutory Stock Option ("NSO") shall mean a stock option, which does not qualify for special tax treatment under Sections 421 or 422 of the Internal Revenue Code.
- i. Option shall mean either a First Option or an Annual Option granted pursuant to the provisions of Section 4 of this Plan.
- j. Participant shall mean any person who holds an Option granted under this Plan.
- k. Plan shall mean this Graco Inc. Nonemployee Director Stock Option Plan.

3. Administration

- a. The Plan shall be administered by the Board. The Board may, by resolution, delegate part or all of its administrative powers with respect to the Plan.
- b. The Board shall have all of the powers vested in it by the terms of the Plan, such powers to include the authority, within the limits prescribed herein, to establish the form of the agreement embodying grants of Options made under the Plan.
- c. The Board shall, subject to the provisions of the Plan, have the power to construe the Plan, to determine all questions arising thereunder and to adopt and amend such rules and regulations for the administration of the Plan as it may deem desirable, such administrative decisions of the Board to be final and conclusive.

- d. The Board shall have no discretion to select the Nonemployee Directors to receive Option grants under the Plan, to determine the number of shares of the Company's common stock subject to the Plan or to each grant, nor the exercise price of the Options granted pursuant to the Plan.
- e. The Board may authorize any one or more of their number or the Secretary or any other officer of the Company to execute and deliver documents on behalf of the Board. The Board hereby authorizes the Secretary to execute and deliver all documents to be delivered by the Board pursuant to the Plan.
- f. The expenses of the Plan shall be borne by the Company.

#### 4. Automatic Grants to Nonemployee Directors

- a. As of the date of adoption of this Plan by the shareholders of the Company, each Nonemployee Director shall be granted an option to purchase two thousand (2,000) shares of the Company's common stock under the Plan (the "First Option"). Thereafter, as of the day upon which shareholders vote to elect directors at each annual meeting of the Company, each Nonemployee Director of the Board shall be granted an additional option to purchase fifteen hundred (1,500) shares of the Company's common stock under the Plan (the "Annual Option"); provided, however, that a Nonemployee Director who has not previously been elected as a member of the Board of Directors of the Company shall also be granted a First Option; i.e., an option to purchase two thousand (2,000) shares of the Company's common stock under the Plan, on the first business day of the Nonemployee Director's election to the Board, including election by the Board of Directors to fill a vacancy on the Board.
- b. The automatic grants to Nonemployee Directors shall not be subject to the discretion of any person.
- c. Each Option granted under the Plan shall be evidenced by a written Agreement. Each Agreement shall be subject to, and incorporate, by reference or otherwise, the applicable terms of this Plan.
- d. During the lifetime of a Participant, each Option shall be exercisable only by the Participant. No Option granted under the Plan shall be assignable or transferable by the Participant, except by will or by the laws of descent and distribution.

#### 5. Shares of Stock Subject to the Plan

- a. Subject to adjustment as provided in Section 11 of the Plan, an aggregate of two hundred thousand (200,000) shares of the Company's common stock, \$1.00 par value, shall be available for issuance to Nonemployee Directors under the Plan. No fractional shares shall be issued.
- b. First Option Grants and Annual Option Grants shall reduce the shares available for issuance under the Plan by the number of shares subject thereto. The shares deliverable upon exercise of any First Option Grant or Annual Option Grant may be made available from authorized but unissued shares or shares reacquired by the Company, including shares purchased in the open market or in private transactions. If any unexercised First Option Grant or Annual Option Grant shall terminate for any reason, the shares subject to, but not delivered under, such First Option Grant or Annual Option Grant shall be available for other First Option Grants or Annual Option Grants.

#### 6. Nonstatutory Options.

- a. All Options granted to Nonemployee Directors pursuant to the Plan shall be NSOs.

#### 7. Exercise Price.

- a. The price per share of the shares of the Company's common stock which may be purchased upon exercise of an Option ("Exercise Price") shall be one hundred percent (100%) of the Fair Market Value per Share on the date the Option is granted and shall be payable in full at the time the Option is exercised as follows:
  - (1) in cash or by certified check,
  - (2) by delivery of shares of common stock to the Company which shall have been owned for at least six (6) months and have a Fair Market Value per Share on the date of surrender equal to the exercise price, or

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

b. Such price shall be subject to adjustment as provided in Section 11 hereof.

#### 8. Duration and Vesting of Options.

- a. The term of each Option granted to a Nonemployee Director shall be for ten (10) years from the date of grant, unless terminated earlier pursuant to the provisions of Section 10 hereof.
- b. Each Option shall vest and become exercisable according to the following schedule:
  - (1) twenty-five percent (25%) of the total number of shares covered by the Option shall become exercisable beginning with the first anniversary date of the grant of the Option;
  - (2) thereafter twenty-five percent (25%) of the total number of shares covered by the Option shall become exercisable on each subsequent anniversary date of the grant of the Option until the fourth anniversary date of the grant of the Option upon which the total number of shares covered by Option shall become exercisable.

#### 9. Change of Control

a. Notwithstanding Section 8b(1) and (2) hereof, all outstanding Options not yet exercisable shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by their terms. A "Change of Control" means:

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

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

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 9, a Trust Person shall not be deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Nonemployee Director or any group that includes the Nonemployee Director, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of subsection (4) below; and

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

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

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

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

- (1) the acquisition of the 25% or greater interest referred to in subsection a(1) of this Section 9 is by a group, acting in concert, that includes the Nonemployee Director or
- (2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in subsections (4) or (5) of this section by a group, acting in concert, that includes that Nonemployee Director.

#### 10. Effect of Termination of Membership on the Board.

a. The right to exercise an Option granted to a Nonemployee Director shall be limited as follows, provided the actual date of exercise is in no event after the expiration of the term of the Option:

(1) If a Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in subparagraph (2) of this Section 10, the Nonemployee Director shall have the right to exercise the Options as follows, subject to the condition that no Option shall be exercisable after the expiration of the term of the Option:

(a) If the Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, all outstanding Options become immediately exercisable upon the date the Nonemployee Director ceases being a director. The Nonemployee Director may exercise the Options for a period of thirty-six months (36) from the date the Nonemployee Director ceased being a director, provided that if the Nonemployee Director dies before the thirty-six (36) month period has expired, the Options may be exercised by the Nonemployee Director's legal representative or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death for a period of twelve (12) months from the date of the Nonemployee Director's death.

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

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

(d) In the event any Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased optionee, the Company shall be under no obligation to issue stock thereunder unless and until the Company is satisfied that the person or persons exercising the Option are the duly appointed legal representatives of the deceased optionee's estate or the proper legatees or distributees thereof.

(2) If a Nonemployee Director ceases being a director of the Company due to an act of

(a) fraud or intentional misrepresentation or

(b) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any Affiliate of the Company or

(c) any other gross or willful misconduct

as determined by the Board, in its sole and conclusive discretion, all Options granted to such Nonemployee Director shall immediately be forfeited as of the date of the misconduct.

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

- a. If there is any change in the common stock of the Company by reason of any stock dividend, stock split, spin-off, split-up, merger, consolidation, recapitalization, reclassification, combination or exchange of shares, or any other similar corporate event, the aggregate number of shares available under the Plan, the number and the price of shares of common stock subject to outstanding Options and the number of shares referenced by the terms, "First Option" and "Annual Option", respectively, in Section 4a hereof, shall be appropriately adjusted automatically.
- b. No right to purchase fractional shares shall result from any adjustment in Options pursuant to this Section 11. In case of any such adjustment, the shares subject to the Option shall be rounded down to the nearest whole share.
- c. Notice of any adjustment shall be given by the Company to each holder of any Option which shall have been so adjusted and such adjustment (whether or not such notice is given) shall be effective and binding for all purposes of the Plan.

#### 12. Effective Date of the Plan

- a. The Plan shall become effective on the date it is approved by the shareholders of the Company.
- b. Any amendment to the Plan shall become effective when adopted by the Board, unless specified otherwise, but no Option granted under any increase in shares authorized to be issued under this Plan shall be exercisable until the increase is approved in the manner prescribed in Section 13 of this Plan.

#### 13. Amendment of the Plan

- a. The Board of Directors may amend, suspend or terminate the Plan at any time, but without shareholder approval, no amendment shall materially increase the maximum number of shares which may be issued under the Plan (other than adjustments pursuant to Section 11 hereof), materially increase the benefits accruing to Participants under the Plan, materially modify the requirements as to eligibility for participation or extend the term of the Plan. Approval of the shareholders may be obtained, at a meeting of shareholders duly called and held, by the affirmative vote of a majority of the holders of the Company's voting stock who are present or represented by proxy and are entitled to vote on the Plan.
- b. It is intended that the Plan meet the requirements of Rule 16b-3 or any successor thereto promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, including any applicable requirements regarding shareholder approval. Amendments to the Plan shall be subject to approval by the shareholders of the Company to the extent determined by the Board of Directors to be necessary to satisfy such requirements as in effect from time to time.
- c. Rights and obligations under any Option granted before any amendment of this Plan shall not be materially and adversely affected by amendment of the Plan, except with the consent of the person who holds the Option, which consent may be obtained in any manner that the Board or its delegate deems appropriate.

#### 14. Termination of the Plan

- a. The Plan, unless sooner terminated, shall terminate at the end of ten (10) years from the date the Plan is approved by the shareholders of the Company. No Option may be granted under the Plan while the Plan is suspended or after it is terminated.
- b. Rights or obligations under any Option granted while the Plan is in effect, including the maximum duration and vesting provisions, shall

not be altered or impaired by suspension or termination of the Plan, except with the consent of the person who holds the Option, which consent may be obtained in any manner that the Board or its delegate deems appropriate.

15. Registration, Listing, Qualification, Approval of Stock and Options

- a. If the Board shall determine, in its discretion, that it is necessary or desirable that the shares of common stock subject to any Option

(1) be registered, listed or qualified on any securities exchange or under any applicable law, or

(2) be approved by any governmental regulatory body, or

(3) approved by the shareholders of the Company,

as a condition of, or in connection with, the granting of such Option, or the issuance or purchase of shares upon exercise of the Option, the Option may not be exercised in whole or in part unless such registration, listing, qualification or approval has been obtained free of any condition not acceptable to the Board of Directors.

16. No Right to Option or as Shareholder

- a. No Nonemployee Director or other person shall have any claim or right to be granted an Option under the Plan, except as expressly provided herein. Neither the Plan nor any action taken hereunder shall be construed as giving any Nonemployee Director any right to be retained in the service of the Company.

- b. Neither a Nonemployee Director, the Nonemployee Director's legal representative, nor any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of common stock receivable upon the exercise of any Option granted under this Plan, in whole or in part, unless and until certificates for such shares shall have been issued.

17. Governing Law

The validity, construction, interpretation, administration and effect of this Plan and any rules, regulations and actions relating to this Plan will be governed by and construed exclusively in accordance with the laws of the State of Minnesota.

AMENDMENT TO  
GRACO INC. KEY EMPLOYEE AGREEMENT

AMENDMENT AGREEMENT, by and between Graco Inc., a Minnesota corporation (the "Company") and \_\_\_\_\_ (the "Executive"), dated as of the 9th day of January, 1998.

WHEREAS, the Executive and the Company have entered into an agreement entitled Graco Inc. Key Employee Agreement, dated March, 1997 (the "Key Employee Agreement"); and

WHEREAS, the parties wish to amend the Key Employee Agreement as set forth below in order to assure that the purposes of said Key Employee Agreement, as set forth in the premises thereto, are fulfilled;

Now, therefore, the parties agree as follows:

1. Section 6(e) of the Key Employee Agreement is hereby amended to read as set forth below, and a new Section 6(f), as set forth below, is hereby added to the Key Employee Agreement:

6(e) Possible Payment Reduction.

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

6(f) Certain Additional Payments by the Company.

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

(ii) Subject to the provisions of Section 6(f)(iii), all determinations required to be made under this Section 6(f), including whether and when a Gross-Up Payment is required and the amount of such Gross-Up Payment and the assumptions to be utilized in arriving at such determination, shall be made by Deloitte and Touche LLP or such other certified public accounting firm as may be designated by the



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

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

(A) give the Company any information reasonably requested by the Company relating to such claim,

(B) take such action in connection with contesting such claim as the Company shall reasonably request in writing from time to time, including, without limitation, accepting legal representation with respect to such claim by an attorney reasonably selected by the Company,

(C) cooperate with the Company in good faith in order to effectively contest such claim, and

(D) permit the Company to participate in any proceedings relating to such claim; provided, however, that the Company shall bear and pay directly all costs and expenses (including additional interest and penalties) incurred in connection with such contest and shall indemnify and hold the Executive harmless, on an after-tax basis, for any Excise Tax or income tax (including interest and penalties with respect thereto) imposed as a result of such representation and payment of costs and expenses. Without limitation on the foregoing provisions of this Section 6(f)(iii), the Company shall control all proceedings taken in connection with such contest and, at its sole option, may pursue or forgo any and all administrative appeals, proceedings, hearings and conferences with the taxing authority in respect of such claim and may, at its sole option, either direct the Executive to pay the tax claimed and sue for a refund or contest the claim in any permissible manner, and the Executive agrees to prosecute such contest to a determination before any administrative tribunal, in a court of initial jurisdiction and in one or more appellate courts, as the Company shall determine; provided, however, that if the Company directs the Executive to pay such claim and sue for a refund, the Company shall advance the amount of such payment to the Executive, on an interest-free basis, and shall indemnify and hold the Executive harmless, on an after-tax basis, from any Excise Tax or income tax (including interest or penalties with respect thereto) imposed with respect to such advance or with respect to any imputed income with respect to such advance; and further provided that any extension of

the statute of limitations relating to payment of taxes for the taxable year of the Executive with respect to which such contested amount is claimed to be due is limited solely to such contested amount. Furthermore, the Company's control of the contest shall be limited to issues with respect to which a Gross-Up Payment would be payable hereunder and the Executive shall be entitled to settle or contest, as the case may be, any other issue raised by the Internal Revenue Service or any other taxing authority.

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

3. The Key Employee Agreement shall in all other respects stay in full force and effect in accordance with its terms.

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

Executive  
- - - - -

Graco Inc.  
- - - - -

\_\_\_\_\_  
George Aristides  
Chief Executive Officer

## CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

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

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

- o With respect to the Company's business as a whole, the Company's prospects and operating results may be affected by:
  - changing economic conditions in the United States and other major world economies, including economic downturns or recessions and foreign currency exchange rate fluctuations;
  - international trade factors, including changes in international trade policy, such as trade sanctions, increased tariff barriers and other restrictions, weaker protection of the Company's proprietary technology in certain foreign countries, the burden of complying with foreign laws and standards, and potentially adverse taxes;
  - the ability of the Company to develop new products and technologies, maintain and enhance its market position relative to its competitors, maintain and enhance its distribution channels, realize productivity and product quality improvements, and continue to control expenses.
  - the ability of the Company and its suppliers, customers, creditors and financial service organizations to implement information processing software and hardware that will accommodate the Year 2000;
  - disruption in operations, transportation, communication, sources of supply, customer operations or payment, caused by acts of God, labor disputes, war, embargo, fire or other cause beyond its reasonable control.
- o The prospects and operating results of the Company's Contractor Equipment Division may be affected by: variations in the level of housing starts; the level of repairs, remodeling and additions to existing homes; the level of commercial and institutional building and remodeling activity; the availability and cost of financing; changes in the environmental regulation of coatings; the consolidation in the paint manufacturing industry; changes in construction materials and techniques; the cost of labor in foreign markets; the regional market strength of certain competitors; and the level of government spending on road construction and infrastructure development.
- o The prospects and operating results of the Company's Industrial Equipment Division may be affected by the capital equipment spending levels of industrial customers, the availability and cost of financing, changes in the environmental regulation of coatings, changes in the technical characteristics of materials, changes in application technology, and the ability of the Company to meet changing customer requirements.
- o The prospects and operating results of the Company's Lubrication Equipment Division may be affected by variations in the equipment spending levels of the major oil companies, and the relative market strength and pricing strategies of competitors, especially in major foreign markets.

- o The prospects and operating results of the Company's Automotive Equipment Division may be affected by the equipment purchase plans of major automobile manufacturers worldwide (which are in turn impacted by the level of automotive sales worldwide), changes in automotive manufacturing processes, and the pricing strategies of competitors.

GRACO INC.  
RESTORATION PLAN  
(1998 Restatement)

Article 1  
Purpose

1.1 Purpose. Effective as of July 1, 1988, the Board of Directors of Graco Inc. ("Graco"), a Minnesota corporation, established an unfunded restoration benefit plan (the "Restoration Plan") consisting of:

- a. an excess benefit plan designed to provide retirement benefits to eligible employees as a replacement for the retirement benefits limited under the Graco Employee Retirement Plan by operation of Section 415 of the Code ("Plan A"), which plan is not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), and
- b. an excess compensation plan designed to provide benefits to eligible employees as a replacement for the retirement benefits limited under the Graco Employee Retirement Plan by operation of Section 401(a)(17) of the Code ("Plan B"), which plan is subject to ERISA as a so-called "top hat" plan for a select group of management or highly compensated employees.

Plan A and Plan B under the Restoration Plan shall constitute separate plans. It now is desired to amend and restate the Restoration Plan in its entirety in a new document. This is the amended and restated plan document so contemplated and is effective January 1, 1998.

Article 2  
Definitions

2.1 Incorporation by Reference. The Definitions contained in Subsection 1.1 and the Rules of Interpretation contained in Subsection 1.2 of the Graco Employee Retirement Plan, as the same may be amended from time to time, are hereby incorporated herein by reference as if set forth herein in full, subject to the following qualifications:

- a. "Plan" when used herein shall mean the Restoration Plan.
- b. "Effective Date" when used herein shall mean January 1, 1998. This Plan Restatement shall not affect the rights of or the benefits payable to, or with respect to, any employee who died, retired or otherwise had a Termination of Employment prior to the Effective Date.
- c. "Graco Employee Retirement Plan" when used herein shall mean the tax-qualified defined benefit pension plan established by the Employer for the benefit of employees eligible to participate therein, as amended in the written document entitled "Graco Employee Retirement Plan (1991 Restatement)" as the same may be further amended from time to time.
- d. "Restoration Plan" when used herein shall mean the Plan established by the Employers consisting of the unfunded excess benefit plan ("Plan A") and the unfunded excess compensation plan ("Plan B") as set forth in the Plan Statement.
- e. "Plan Statement" when used herein shall mean this written document entitled "Restoration Plan (1998 Restatement)" as the same may be amended from time to time.

Article 3  
Eligibility

3.1 General Eligibility Rule. The individuals eligible to participate in and receive benefits under the Plan are those employees of the Employer:

- a. who, on or after July 1, 1988, are Participants in the Graco Employee Retirement Plan,
- b. who, at some time on or after July 1, 1988, are in Covered Employment, and
- c. who have experienced a legislated reduction in benefits under the Graco Employee Retirement Plan due to limitations imposed by Code Section 415 [Plan A] or Code Section 401(a)(17) [Plan B].

3.2 Continuation. Any Participant in the Plan shall continue as a Participant until all benefits which are due under the Plan have been received without regard to whether he or she continues as a participant in the Graco Employee Retirement Plan or in Covered Employment. Notwithstanding anything apparently to the contrary contained in this Plan, the Plan shall be construed and administered to prevent the duplication of benefits provided under this Plan and any other qualified or nonqualified plan maintained in whole or in part by

the Employer.

3.3 Select Group. Notwithstanding anything apparently to the contrary in this Plan or in any written communication, summary, resolution or document or oral communication, no individual shall be a Participant in this Plan, develop benefits under this Plan or be entitled to receive benefits under this Plan (either for himself or his or her survivors) unless such individual is a member of a select group of management or highly compensated employees (as that expression is used in ERISA). If a court of competent jurisdiction, any representative of the U.S. Department of Labor or any other governmental, regulatory or similar body makes any direct or indirect, formal or informal, determination that an individual is not a member of a select group of management or highly compensated employees (as that expression is used in ERISA), such individual shall not be (and shall not have ever been) a Participant in this Plan at any time. If any person not so defined has been erroneously treated as a Participant in this Plan, upon discovery of such error such person's erroneous participation shall immediately terminate ab initio and upon demand such person shall be obligated to reimburse the Employer for all amounts erroneously paid to him or her.

#### Article 4 Benefits

4.1 Retirement Benefits. Upon Termination of Employment, this Plan shall pay as a benefit to a Participant the excess, if any, of:

- a. the amount that would have been payable to the Participant under the Graco Employee Retirement Plan if such benefit had been determined:
  - (i) without regard to the benefit limitations under Section 415 of the Code,
  - (ii) without regard to the compensation limitation of Section 401(a)(17) of the Code,
  - (iii) disregarding, however, any Accrued Benefit over One Hundred Seventy Thousand Dollars (\$170,000) per year;minus
- b. the amount actually paid from the Graco Employee Retirement Plan.

Except as may be otherwise specifically provided in this Plan, this benefit (minus the withholding, payroll and other taxes which must be deducted therefrom) shall be paid to the Participant in the same manner, at the same time, for the same duration and in the same form as if such benefit had been paid directly from the Graco Employee Retirement Plan. All elections and optional forms of settlement in effect and all other rules governing the payment of benefits under the Graco Employee Retirement Plan shall, to the extent practicable, be given effect under this Plan so that the Participant will receive from a combination of the Graco Employee Retirement Plan and this Plan the same benefit (minus the withholding, payroll and other taxes which must be deducted therefrom) which would have been received under the Graco Employee Retirement Plan if this Plan benefit had been paid from the Graco Employee Retirement Plan.

4.2 Death Benefits. Upon the death of a Participant, this Plan shall pay as a benefit to the surviving spouse or other joint or contingent annuitant or beneficiary of a Participant, the excess, if any, of:

- a. the amount that would have been payable to such person under the Graco Employee Retirement Plan if such benefit had been determined:
  - (i) without regard to the benefit limitations under Section 415 of the Code,
  - (ii) without regard to the compensation limitation of Section 401(a)(17) of the Code,
  - (iii) disregarding, however, any Accrued Benefit over One Hundred Seventy Thousand Dollars (\$170,000) per year;minus
- b. the amount actually paid from the Graco Employee Retirement Plan.

The death benefit (minus the withholding, payroll and other taxes which must be deducted therefrom) shall be paid to such person in the same manner, at the same time, for the same duration and in the same form as if such benefit had been paid directly from the Graco Employee Retirement Plan. All elections and optional forms of settlement in effect and all other rules governing the payment of benefits under the Graco Employee Retirement Plan shall, to the extent practicable, be given effect under this Plan so that such person will receive from a combination of the Graco Employee Retirement Plan and this Plan the same benefit (minus the withholding, payroll and other taxes which must be deducted therefrom)

which would have been received under the Graco Employee Retirement Plan if the Plan benefit had been paid from the Graco Employee Retirement Plan.

4.3 Incorporation by Reference. The following provisions of the Graco Employee Retirement Plan, as they may from time to time be amended, are hereby incorporated herein by reference as if set forth herein in full with the qualifications set forth in Subsection 2.1 hereof:

- a. Subsection 5.1 Suspension of Benefits;
- b. Subsection 5.4 Effect of Misstatements by Participants
- c. Subsection 5.6 Facility of Payment
- d. Section 6 Spendthrift Provisions

4.4 Nonduplication of Benefits. There shall be no duplication of benefits under this Plan. If by reason of his employment, a Participant is eligible for more than one benefit, he shall elect only one such benefit.

4.5 Lump Sum Payment. If the value of the Participant's benefit under this Plan is less than \$15,000 when calculated using rates provided by the Graco Employee Retirement Plan, the benefit shall be paid in a lump sum.

#### Article 5 Funding

5.1 Benefits Unfunded. The benefits payable under Plan A and Plan B shall be paid by the Employer each year out of its general assets and shall not be funded in any manner. No fund, trust or account will be established or maintained by the Employer for the purpose of paying these benefits, nor shall any action pursuant to the Restoration Plan be construed to create a trust of any kind. Participants' (or a beneficiary's) rights to receive payments from the Employer under the Restoration Plan shall be no greater than the right of any unsecured creditor of the Employer. Title to and beneficial ownership of any assets, whether cash or investments set aside or earmarked by the Employers to meet their contingent deferred obligation hereunder shall at all times remain in the name of the Employers, and neither the Participants nor any beneficiary shall under any circumstances acquire any property interest or rights in any specific assets of the Employers.

#### Article 6 Amendment and Termination

6.1 Amendment. Graco, by action of its Board of Directors, shall have the power to amend this Restoration Plan from time to time in any respect. The entire power of amendment herein reserved shall be vested in Graco and, when exercised, shall be effective not only to Graco, its Participants and employees, but also to each other Employer and its Participants and employees, and to the spouses, children, joint annuitants and beneficiaries of such Participants and employees.

6.2 Termination. Each Employer contemplates that this Plan will be continued indefinitely into the future, but Graco, by action of its Board of Directors, shall have the right at any time to terminate this entire Plan. Any Employer who has adopted this Plan, by action of its Board of Directors and with the consent of Graco, may at any time terminate this Plan with respect to the Participants in its employ.

#### Article 7 Administration

7.1 Administrator. Graco shall be the administrator for purposes of Section 3(16)(A) or ERISA.

7.2 Benefit Plans Committee. The provisions of Subsection 8.2 Benefit Plans Committee of the Graco Employee Retirement Plan are hereby incorporated by reference as if set forth herein in full. The Benefit Plans Committee shall be responsible for administering this Plan and shall have the authority set forth in Subsection 8.2 and other sections of the Graco Employee Retirement Plan Statement.

#### Article 8 Miscellaneous

8.1 No Right to Employment. Participation in this Plan or eligibility for participation in it shall not give any employee the right to be retained in an Employer's employment nor, upon dismissal or severance of employment, to have any right or interest in this Plan, other than as herein provided.

8.2 Source of Benefits. The general assets of the Employer shall be the sole source of all benefits provided for under this Plan.

8.3 Headings. The headings used in this Plan Statement are for information purposes only.

8.4 Governing Law. The laws of the State of Minnesota shall govern the interpretation and application of this Plan.

IN WITNESS WHEREOF, Graco has caused this Restoration Plan to be executed by its duly authorized officers the 20th day of March, 1998.

GRACO INC.

By: /s/Robert M. Mattison

By: /s/Clyde W. Hansen



THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS AND CONSOLIDATED BALANCE SHEETS FOR THE 52 WEEKS ENDED DECEMBER 26, 1997 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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GRACO INC.

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U.S. Dollars

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DEC-28-1996  
DEC-26-1997

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