

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended **June 27, 2008**

Commission File Number: 001-09249

**GRACO INC.**

(Exact name of registrant as specified in its charter)

Minnesota

(State of incorporation)

41-0285640

(I.R.S. Employer Identification Number)

88 - 11<sup>th</sup> Avenue N.E.  
Minneapolis, Minnesota

(Address of principal executive offices)

55413

(Zip Code)

(612) 623-6000

(Registrant's telephone number, including area code)

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

Yes        X        No                

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	<u>      X      </u>	Accelerated Filer	<u>                  </u>
Non-accelerated Filer	<u>                  </u>	Smaller reporting company	<u>                  </u>

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

Yes                              No            X      

60,056,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of July 17, 2008.

**GRACO INC. AND SUBSIDIARIES**

**INDEX**

Page Number

**PART I      FINANCIAL INFORMATION**

Item 1.	Financial Statements	
	Consolidated Statements of Earnings	3
	Consolidated Balance Sheets	4
	Consolidated Statements of Cash Flows	5
	Notes to Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	20

## PART II OTHER INFORMATION

Item 1A.	Risk Factors	21
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	21
Item 4.	Submission of Matters to a Vote of Security Holders	22
Item 6.	Exhibits	22

## SIGNATURES

## EXHIBITS

## PART I

### Item 1.

### GRACO INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)  
(In thousands except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net Sales	\$ 239,230	\$ 231,384	\$ 443,350	\$ 428,879
Cost of products sold	110,467	109,152	202,734	201,785
Gross Profit	128,763	122,232	240,616	227,094
Product development	9,039	7,544	16,979	15,816
Selling, marketing and distribution	35,842	31,917	69,663	61,180
General and administrative	16,819	15,057	34,557	30,297
Operating Earnings	67,063	67,714	119,417	119,801
Interest expense	1,906	642	3,509	900
Other expense (income), net	98	92	(17)	(14)
Earnings Before Income Taxes	65,059	66,980	115,925	118,915
Income taxes	22,600	22,800	37,900	41,000
Net Earnings	\$ 42,459	\$ 44,180	\$ 78,025	\$ 77,915
Basic Net Earnings per Common Share	\$ 0.70	\$ 0.67	\$ 1.28	\$ 1.17
Diluted Net Earnings per Common Share	\$ 0.69	\$ 0.66	\$ 1.27	\$ 1.16
Cash Dividends Declared per Common Share	\$ 0.19	\$ 0.17	\$ 0.37	\$ 0.33

See notes to consolidated financial statements.

**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

(Unaudited)  
(In thousands)

	<u>June 27, 2008</u>	<u>Dec 28, 2007</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 4,889	\$ 4,922
Accounts receivable, less allowances of \$7,000 and \$6,500	167,182	140,489
Inventories	91,709	74,737
Deferred income taxes	25,498	21,650
Other current assets	4,215	7,034
Total current assets	293,493	248,832
Property, Plant and Equipment		
Cost	316,950	306,073
Accumulated depreciation	(173,458)	(165,479)
Property, plant and equipment, net	143,492	140,594
Prepaid Pension	33,273	31,823
Goodwill	84,880	67,204
Other Intangible Assets, net	55,394	41,889
Other Assets	6,940	6,382
Total Assets	<u>\$ 617,472</u>	<u>\$ 536,724</u>

**LIABILITIES AND SHAREHOLDERS' EQUITY**

Current Liabilities		
Notes payable to banks	\$ 19,415	\$ 18,991
Trade accounts payable	30,572	27,379
Salaries, wages and commissions	17,314	20,470
Dividends payable	11,137	11,476
Other current liabilities	45,093	47,561
Total current liabilities	123,531	125,877
Long-term Debt	188,900	107,060
Retirement Benefits and Deferred Compensation	41,386	40,639
Uncertain Tax Positions	1,650	5,400
Deferred Income Taxes	18,702	13,074
Shareholders' Equity		
Common stock	60,373	61,964
Additional paid-in-capital	171,886	156,420
Retained earnings	17,921	32,986
Accumulated other comprehensive income (loss)	(6,877)	(6,696)
Total shareholders' equity	243,303	244,674
Total Liabilities and Shareholders' Equity	<u>\$ 617,472</u>	<u>\$ 536,724</u>

See notes to consolidated financial statements.

4

**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited) (In thousands)

	<u>Twenty-six Weeks Ended</u>	
	<u>June 27, 2008</u>	<u>June 29, 2007</u>
<b>Cash Flows From Operating Activities</b>		
Net Earnings	\$ 78,025	\$ 77,915

Adjustments to reconcile net earnings to		
net cash provided by operating activities		
Depreciation and amortization	15,737	13,994
Deferred income taxes	(4,243)	(4,312)
Share-based compensation	5,081	4,351
Excess tax benefit related to share-based		
payment arrangements	(2,923)	(3,848)
Change in		
Accounts receivable	(22,217)	(24,733)
Inventories	(13,060)	(5,358)
Trade accounts payable	3,580	1,465
Salaries, wages and commissions	(3,647)	(10,313)
Retirement benefits and deferred compensation	(1,018)	(713)
Other accrued liabilities	(607)	4,830
Other	315	(114)
<b>Net cash provided by operating activities</b>	<u>55,023</u>	<u>53,164</u>
<b>Cash Flows From Investing Activities</b>		
Property, plant and equipment additions	(12,944)	(21,646)
Proceeds from sale of property, plant and equipment	1,517	207
Investment in life insurance	(1,499)	(1,499)
Capitalized software and other intangible asset additions	(726)	(5)
Acquisition of business, net of cash acquired	(35,266)	-
<b>Net cash used in investing activities</b>	<u>(48,918)</u>	<u>(22,943)</u>
<b>Cash Flows From Financing Activities</b>		
Net borrowings (payments) on short-term lines of credit	(660)	46,745
Borrowings on long-term line of credit	162,235	-
Payments on long-term line of credit	(80,395)	-
Excess tax benefit related to share-based		
payment arrangements	2,923	3,848
Common stock issued	13,176	19,194
Common stock retired	(80,130)	(78,470)
Cash dividends paid	(22,582)	(21,984)
<b>Net cash provided by (used in) financing activities</b>	<u>(5,433)</u>	<u>(30,667)</u>
Effect of exchange rate changes on cash	<u>(705)</u>	<u>(736)</u>
Net increase (decrease) in cash and cash equivalents	(33)	(1,182)
Cash and cash equivalents		
Beginning of year	4,922	5,871
End of year	<u>\$ 4,889</u>	<u>\$ 4,689</u>

See notes to consolidated financial statements.

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

- The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of June 27, 2008 and the related statements of earnings for the thirteen and twenty-six weeks ended June 27, 2008 and June 29, 2007, and cash flows for the twenty-six weeks ended June 27, 2008 and June 29, 2007 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of June 27, 2008, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2007 Annual Report on Form 10-K.

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

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net earnings available to common shareholders	\$ 42,459	\$ 44,180	\$ 78,025	\$ 77,915
Weighted average shares outstanding for basic earnings per share	60,540	66,045	60,897	66,356
Dilutive effect of stock options computed using the treasury stock method and the average market price	682	1,025	672	1,036
Weighted average shares outstanding for diluted earnings per share	61,222	67,070	61,569	67,392
Basic earnings per share	\$ 0.70	\$ 0.67	\$ 1.28	\$ 1.17
Diluted earnings per share	\$ 0.69	\$ 0.66	\$ 1.27	\$ 1.16

6

Stock options to purchase 1,889,000 and 1,228,000 shares were not included in the 2008 and 2007 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the twenty-six weeks ended June 27, 2008 is shown below (in thousands, except per share amounts):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 28, 2007	3,779	\$ 28.63	2,228	\$ 21.41
Granted	749	36.13		
Exercised	(398)	16.61		
Canceled	(189)	38.95		
Outstanding, June 27, 2008	<u>3,941</u>	\$ 30.79	2,211	\$ 24.92

The aggregate intrinsic value of exercisable option shares was \$30.9 million as of June 27, 2008, with a weighted average contractual term of 4.7 years. There were approximately 3.9 million vested share options and share options expected to vest as of June 27, 2008, with an aggregate intrinsic value of \$32.7 million, a weighted average exercise price of \$30.65 and a weighted average contractual term of 6.6 years.

Information related to options exercised in the first six months of 2008 and 2007 follows (in thousands):

	Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007
Cash received	\$ 6,605	\$ 12,046
Aggregate intrinsic value	8,359	14,535
Tax benefit realized	3,000	5,300

The Company recognized year-to-date share-based compensation of \$5.1 million in 2008 and \$4.4 million in 2007. As of June 27, 2008, there was \$11 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.5 years.

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

	Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007
Expected life in years	6.0	6.0
Interest rate	3.2%	4.7%
Volatility	25.0%	26.1%
Dividend yield	2.1%	1.6%
Weighted average fair value per share	\$ 8.43	\$ 12.01

Under the Company's Employee Stock Purchase Plan, the Company issued 216,000 shares in 2008 and 202,000 shares in 2007. The fair value of the employees' purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

	Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007
Expected life in years	1.0	1.0
Interest rate	1.5%	4.9%
Volatility	27.1%	24.4%
Dividend yield	2.1%	1.6%
Weighted average fair value per share	\$ 8.14	\$ 9.79

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
<b>Pension Benefits</b>				
Service cost	\$ 1,412	\$ 1,501	\$ 2,803	\$ 2,980
Interest cost	3,144	2,885	6,290	5,767
Expected return on assets	(4,850)	(4,800)	(9,700)	(9,600)
Amortization and other	144	291	296	546
Net periodic benefit cost (credit)	<u>\$ (150)</u>	<u>\$ (123)</u>	<u>\$ \$(311)</u>	<u>\$ (307)</u>
<b>Postretirement Medical</b>				
Service cost	\$ 125	\$ 150	\$ 250	\$ 300
Interest cost	375	315	750	615
Amortization	-	623	-	573
Net periodic benefit cost	<u>\$ 500</u>	<u>\$ 1,088</u>	<u>\$ 1,000</u>	<u>\$ 1,488</u>

The Company paid \$1.5 million in June 2008 and \$1.5 million in June 2007 for contracts insuring the lives of certain employees who are eligible to participate in certain non-qualified pension and deferred compensation plans. These insurance contracts will be used to fund the non-qualified pension and deferred compensation arrangements. The insurance contracts are held in a trust and are available to general creditors in the event of the Company's insolvency. Cash surrender value of \$2.8 million and \$1.4 million is included in other assets in the consolidated balance sheet as of June 27, 2008 and June 29, 2007, respectively.

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net earnings	\$ 42,459	\$ 44,180	\$ 78,025	\$ 77,915

Cumulative translation adjustment	(26)	121	(31)	114
Pension and postretirement medical liability adjustment	65	144	189	130
Gain (loss) on interest rate hedge contracts	2,352	-	(423)	-
Income taxes	(893)	(54)	84	(49)
Comprehensive income	<u>\$ 43,957</u>	<u>\$ 44,391</u>	<u>\$ 77,844</u>	<u>\$ 78,110</u>

9

Components of accumulated other comprehensive income (loss) were (in thousands):

	<u>June 27, 2008</u>	<u>Dec 28, 2007</u>
Pension and postretirement medical liability adjustment	\$ (5,556)	\$ (5,672)
Gain (loss) on interest rate hedge contracts	(1,338)	(1,072)
Cumulative translation adjustment	17	48
Total	<u>\$ (6,877)</u>	<u>\$ (6,696)</u>

6. The Company has three reportable segments: Industrial, Contractor and Lubrication. The Company does not track assets by segment. Sales and operating earnings by segment for the thirteen and twenty-six weeks ended June 27, 2008 and June 29, 2007 were as follows (in thousands):

	<u>Thirteen Weeks Ended</u>		<u>Twenty-six Weeks Ended</u>	
	<u>June 27, 2008</u>	<u>June 29, 2007</u>	<u>June 27, 2008</u>	<u>June 29, 2007</u>
<b>Net Sales</b>				
Industrial	\$ 133,092	\$ 114,281	\$ 247,343	\$ 219,346
Contractor	82,061	94,231	148,241	163,982
Lubrication	24,077	22,872	47,766	45,551
Consolidated	<u>\$ 239,230</u>	<u>\$ 231,384</u>	<u>\$ 443,350</u>	<u>\$ 428,879</u>
<b>Operating Earnings</b>				
Industrial	\$ 44,075	\$ 39,555	\$ 81,973	\$ 73,973
Contractor	20,741	28,619	34,437	45,646
Lubrication	4,607	2,196	8,924	5,260
Unallocated corporate (expense)	(2,360)	(2,656)	(5,917)	(5,078)
Consolidated	<u>\$ 67,063</u>	<u>\$ 67,714</u>	<u>\$ 119,417</u>	<u>\$ 119,801</u>

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

	<u>June 27, 2008</u>	<u>Dec 28, 2007</u>
Finished products and components	\$ 57,353	\$ 46,677
Products and components in various stages of completion	28,755	24,805
Raw materials and purchased components	<u>39,007</u>	<u>37,311</u>
	125,115	108,793
Reduction to LIFO cost	<u>(33,406)</u>	<u>(34,056)</u>
Total	<u>\$ 91,709</u>	<u>\$ 74,737</u>

10

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

Estimated

Foreign

	Life (years)	Original Cost	Accumulated Amortization	Currency Translation	Book Value
<u>June 27, 2008</u>					
Customer relationships	3 - 8	\$ 37,230	\$ (10,414)	\$ 23	\$ 26,839
Patents, proprietary technology and product documentation	3 - 15	23,598	(9,468)	12	14,142
Trademarks and trade names	3 - 10	4,684	(3,201)	20	1,503
		65,512	(23,083)	55	42,484
Not Subject to Amortization:					
Brand names		12,910	-	-	12,910
Total		<u>\$ 78,422</u>	<u>\$ (23,083)</u>	<u>\$ 55</u>	<u>\$ 55,394</u>

<u>December 28, 2007</u>					
Customer relationships and distribution network	4 - 8	\$ 26,102	\$ (11,092)	\$ 29	\$ 15,039
Patents, proprietary technology and product documentation	5 - 15	22,243	(7,720)	16	14,539
Trademarks, trade names and other	3 - 10	4,684	(2,555)	22	2,151
		53,029	(21,367)	67	31,729
Not Subject to Amortization:					
Brand names		10,160	-	-	10,160
Total		<u>\$ 63,189</u>	<u>\$ (21,367)</u>	<u>\$ 67</u>	<u>\$ 41,889</u>

Amortization of intangibles was \$2.6 million in the second quarter of 2008 and \$4.9 million year-to-date. Estimated annual amortization expense is as follows: \$10.2 million in 2008, \$9.5 million in 2009, \$8.6 million in 2010, \$7.5 million in 2011, \$6.7 million in 2012 and \$4.9 million thereafter.

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

	<u>June 27, 2008</u>	<u>Dec 28, 2007</u>
Accrued self-insurance retentions	\$ 7,962	\$ 7,842
Accrued warranty and service liabilities	7,471	7,084
Accrued trade promotions	4,556	6,480
Payable for employee stock purchases	2,557	5,829
Income taxes payable	3,014	678
Other	19,533	19,648
Total	<u>\$ 45,093</u>	<u>\$ 47,561</u>

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

	<u>Twenty-six Weeks Ended June 27, 2008</u>	<u>Year Ended Dec 28, 2007</u>
Balance, beginning of year	\$ 7,084	\$ 6,675
Charged to expense	3,122	6,053
Margin on parts sales reversed	1,948	3,186
Reductions for claims settled	(4,683)	(8,830)
Balance, end of period	<u>\$ 7,471</u>	<u>\$ 7,084</u>



10. The examination of the Company's U.S. income tax returns for 2004 and 2005 was completed in the first quarter of 2008. Completion of the examination resulted in a payment of approximately \$1 million and reductions of uncertain tax positions totaling approximately \$4 million. The settlement of the examination decreased the Company's effective tax rate for the year-to-date to 33 percent.

With few exceptions, the Company is no longer subject to U.S. federal, state and local, or foreign income tax examinations by tax authorities for years prior to 2002.

12

11. In February 2008, the Company acquired GlasCraft Inc. for approximately \$35 million cash. GlasCraft has an office and manufacturing facility in Indianapolis, Indiana and had sales of approximately \$18 million in 2007. It designs, manufactures and sells spray systems for the composites manufacturing industry and high performance dispense systems for the polyurethane foam and polyurea coatings industries. The products, brands, distribution channels and engineering capabilities of GlasCraft will expand and complement the Company's Industrial Equipment business.

The purchase price was allocated based on estimated fair values as follows (in thousands):

Accounts receivable and prepaid expenses	\$ 2,200
Inventories	3,700
Deferred income taxes	700
Property, plant and equipment	700
Identifiable intangible assets	18,200
Goodwill	17,700
Total purchase price	43,200
Current liabilities assumed	(1,000)
Deferred income taxes	(6,900)
Net assets acquired	<u>\$ 35,300</u>

Identifiable intangible assets and weighted average estimated useful life are as follows (dollars in thousands):

Product documentation (5 years)	\$ 900
Customer relationships (6 years)	14,100
Proprietary technology (3 years)	500
Total (6 years)	15,500
Brand name (indefinite useful life)	2,700
Total identifiable intangible assets	<u>\$ 18,200</u>

None of the goodwill or identifiable intangible assets is expected to be deductible for tax purposes.

13

12. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, "Fair Value Measurements." This statement establishes a consistent framework for measuring fair value and expands disclosures on fair value measurements. SFAS No. 157 was effective for the Company starting in fiscal 2008 with respect to financial assets and liabilities. The impact of the initial adoption of SFAS No. 157 in 2008 had no impact on the consolidated financial statements.

The Company uses significant other observable inputs to value the derivative instruments used to hedge interest rate volatility and net monetary positions. The fair market value of such instruments follows (in thousands):

	<u>June 27, 2008</u>	<u>Dec 28, 2007</u>
Gain (loss) on interest rate hedge contracts	\$ (2,123)	\$ (1,700)
Gain (loss) on foreign currency forward contracts	(33)	(282)
Total	<u>\$ (2,156)</u>	<u>\$ (1,982)</u>

With respect to non-financial assets and liabilities, SFAS No. 157 is effective for the Company starting in fiscal 2009. The Company has not determined the impact, if any, the adoption of this statement as it pertains to non-financial assets and liabilities will have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities.” This statement expands disclosures but does not change accounting for derivative instruments and hedging activities. The statement is effective for the Company starting in fiscal 2009.

**Item 2.**

**GRACO INC. AND SUBSIDIARIES**

**MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS**

**Results of Operations**

Net sales, net earnings and earnings per share were as follows (in millions except per share amounts and percentages):

	Thirteen Weeks Ended			Twenty-six Weeks Ended		
	June 27, 2008	June 29, 2007	% Change	June 27, 2008	June 29, 2007	% Change
Net Sales	\$ 239.2	\$ 231.4	3 %	\$ 443.4	\$ 428.9	3 %
Net Earnings	42.5	44.2	(4)%	78.0	77.9	0 %
Diluted Net Earnings per Common Share	\$ 0.69	\$ 0.66	5 %	\$ 1.27	\$ 1.17	9 %

Foreign currency translation rates had a favorable impact on sales and net earnings. Translated at consistent exchange rates, sales for both the quarter and year-to-date were flat compared to 2007 and net earnings decreased 12 percent for the quarter and 8 percent year-to-date.

Sales include \$5 million from GlasCraft operations since the date of acquisition, including \$3.5 million in the second quarter.

Investments in product and market development, along with rising costs of doing business, continued to apply pressure on earnings.

Earnings per share increased at a higher rate than net earnings due to purchases and retirement of approximately 2.2 million shares of Company common stock, including approximately 0.5 million shares in the second quarter.

**Consolidated Results**

Sales by geographic area were as follows (in millions):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Americas <sup>1</sup>	\$ 131.9	\$ 141.5	\$ 247.8	\$ 262.0
Europe <sup>2</sup>	72.0	58.7	131.6	108.1
Asia Pacific	35.3	31.2	64.0	58.8
Consolidated	<u>\$ 239.2</u>	<u>\$ 231.4</u>	<u>\$ 443.4</u>	<u>\$ 428.9</u>

<sup>1</sup> North and South America, including the U.S.

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

The decrease in the Americas was driven by weakness in the Contractor Business. Translated at consistent exchange rates, sales in Europe increased 10 percent for both the quarter and year-to-date, and sales in Asia Pacific increased by 11 percent for the quarter and 6 percent year-to-date.

Gross profit margin, expressed as a percentage of sales, was 53.8 percent for the quarter and 54.3 percent year-to-date, versus 52.8 percent and 53.0 percent for the same periods last year, respectively. The increase was due mainly to favorable currency translation rates. The effects of higher material and other manufacturing costs on gross margin rate have been offset by the impact of pricing and the benefits of integrating Lubriquip and consolidating Lubrication Equipment operations in the Company’s Anoka facility.

Operating expenses for both the quarter and year-to-date are 13 percent higher than last year. The effects of currency translation contributed approximately 3 percentage points of the increase. Operating expenses in 2008 increased \$3 million from acquired GlasCraft operations. Continued investments in product and market development also contributed to the increase in operating expenses, including expenses related to the introduction of new product lines in the home center channel, new product development teams and additional sales and marketing personnel in developing countries.

Higher operating expenses offset the favorable effects of higher sales and gross profit margins, resulting in flat operating earnings for both the quarter and year-to-date.

Interest expense is \$3 million higher than last year due to borrowings used for the purchase and retirement of Company shares and for the acquisition of GlasCraft. The Company repurchased approximately 2.2 million shares of its common stock for \$80 million in the first half of 2008.

The Company's effective tax rate for the first half was 33 percent, down from 35 percent for the first half last year. The decrease resulted from the completion of the examination of the Company's income tax returns in the first quarter of 2008.

## Segment Results

Certain measurements of segment operations compared to last year are summarized below:

### Industrial

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net sales (in millions)				
Americas	\$ 61.6	\$ 54.7	\$ 114.9	\$ 105.1
Europe	46.1	36.8	85.8	69.3
Asia Pacific	25.4	22.8	46.6	44.9
Total	<u>\$ 133.1</u>	<u>\$ 114.3</u>	<u>\$ 247.3</u>	<u>\$ 219.3</u>
Operating earnings as a percentage of net sales	<u>33 %</u>	<u>35 %</u>	<u>33 %</u>	<u>34 %</u>

16

The Industrial segment had second quarter sales growth in all regions and in all major product categories. Translated at consistent exchange rates, sales for the quarter were up 12 percent in both the Americas and in Europe and 9 percent in Asia Pacific. Year-to-date sales were up 8 percent in the Americas, 12 percent in Europe and 1 percent in Asia Pacific, all at consistent translation rates. Operating earnings in this segment were affected by an operating loss from GlasCraft, resulting from acquisition and integration related activities.

### Contractor

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net sales (in millions)				
Americas	\$ 51.4	\$ 67.2	\$ 93.7	\$ 117.8
Europe	24.0	20.4	42.0	35.5
Asia Pacific	6.7	6.6	12.5	10.7
Total	<u>\$ 82.1</u>	<u>\$ 94.2</u>	<u>\$ 148.2</u>	<u>\$ 164.0</u>
Operating earnings as a percentage of net sales	<u>25 %</u>	<u>30 %</u>	<u>23 %</u>	<u>28 %</u>

The Contractor segment continued to experience softness in both the North American paint store and home center channels. Year-to-date increases in Europe (18 percent increase, including 12 percentage points from currency translation) and in Asia Pacific (17 percent increase, including 2 percentage points from currency translation) were not enough to offset the 20 percent decrease in the Americas.

Operating earnings in this segment were affected by approximately \$6 million (half in the second quarter) related to the launch and production of new paint sprayer units in the home center channel.

### Lubrication

Thirteen Weeks Ended

Twenty-six Weeks Ended

	June 27, 2008	June 29, 2007	June 27, 2008	June 29, 2007
Net sales (in millions)				
Americas	\$ 19.0	\$ 19.6	\$ 39.1	\$ 39.1
Europe	1.9	1.5	3.8	3.3
Asia Pacific	3.2	1.8	4.9	3.2
Total	<u>\$ 24.1</u>	<u>\$ 22.9</u>	<u>\$ 47.8</u>	<u>\$ 45.6</u>
Operating earnings as a percentage of net sales	<u>19%</u>	<u>10%</u>	<u>19%</u>	<u>12%</u>

In the Lubrication segment, second quarter sales increases in Europe and Asia Pacific more than offset a decrease in the Americas. Year-to-date, sales were flat in the Americas and up in Europe and Asia Pacific.

17

The improvement in operating profitability is related to the integration and consolidation of Lubrication operations completed in 2007.

### **Liquidity and Capital Resources**

In the first half of 2008, the Company used cash and borrowings under its long-term line of credit to purchase and retire \$80 million of Company shares. Other significant uses of cash included \$35 million to acquire GlasCraft and \$23 million for payment of dividends. Significant uses of cash in the first half of 2007 included \$78 million for purchases and retirement of Company common stock, \$22 million for capital additions and \$22 million for payment of dividends.

Increases in accounts receivable and inventories since the end of 2007 reflect the acquisition of GlasCraft operations and the higher level of business activity in the second quarter of 2008 compared to the fourth quarter of 2007.

At June 27, 2008, the Company had various lines of credit totaling \$295 million, of which \$90 million was unused. Internally generated funds and unused financing sources provide the Company with the financial flexibility to meet liquidity needs.

### **Outlook**

Management remains cautious about the outlook for the Company's business in the U.S. and will continue to manage accordingly. At the same time, with the gains experienced in the Industrial and international business, management is encouraged that its strategies for achieving product and market diversification are paying off. The Company will continue to make long-term investments in key growth strategies including new product development, expanding distribution, entering new markets and pursuing strategic acquisitions.

18

### **SAFE HARBOR CAUTIONARY STATEMENT**

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

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2007 for a more comprehensive discussion of these and other risk factors.

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

19

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

There have been no material changes related to market risk from the disclosures made in the Company's 2007 Annual Report on Form 10-K.

**Item 4. Controls and Procedures****Evaluation of disclosure controls and procedures**

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

**Changes in internal controls**

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

20

**PART II OTHER INFORMATION****Item 1A. Risk Factors**

There have been no material changes to the Company's risk factors from those disclosed in the Company's 2007 Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds****Issuer Purchases of Equity Securities**

On September 28, 2007, the Board of Directors authorized the Company to purchase up to a total of 7,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization expires on September 30, 2009.

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

Information on issuer purchases of equity securities follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period)
Mar 29, 2008 – Apr 25, 2008	155,565	\$ 37.31	155,565	4,304,390
Apr 26, 2008 – May 23, 2008	89,000	\$ 40.16	89,000	4,215,390
May 24, 2008 – Jun 27, 2008	265,626	\$ 39.84	264,590	3,950,800

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

At the Annual Meeting of Shareholders held on April 25, 2008, three directors were elected to the Board of Directors with the following votes:

	<u>For</u>	<u>Withheld</u>
Patrick J. McHale	51,850,208	1,372,816
Lee R. Mitau	51,320,659	1,902,365
Marti Morfitt	51,772,973	1,450,052

At the same meeting, the appointment of Deloitte & Touche LLP as the Independent Registered Public Accounting Firm was ratified, with the following votes:

<u>For</u>	<u>Against</u>	<u>Abstentions</u>
52,183,467	958,747	80,809

**Item 6. Exhibits**

- |      |   |
|------|---|
| 10.1 | Restoration Plan (2005 Statement). Third Amendment adopted March 27, 2008.  |
| 10.2 | Stock Option Agreement. Form of agreement used for award in 2008 of nonstatutory stock options to non-employee directors under the Graco Inc. Amended and Restated Stock Incentive Plan (2006). |
| 31.1 | Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a).  |
| 31.2 | Certification of Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a).  |
| 32   | Certification of the President and Chief Executive Officer and the Chief Financial Officer and Treasurer pursuant to Section 1350 of Title 18, U.S.C.   |

22

**SIGNATURES**

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

**GRACO INC.**

Date:	<u>July 23, 2008</u>	By:	<u>/s/Patrick J. McHale</u> Patrick J. McHale President and Chief Executive Officer (Principal Executive Officer)
-------	----------------------	-----	--

Date:	<u>July 23, 2008</u>	By:	<u>/s/James A. Graner</u> James A. Graner Chief Financial Officer and Treasurer (Principal Financial Officer)
-------	----------------------	-----	--

Date:	<u>July 23, 2008</u>	By:	<u>/s/Caroline M. Chambers</u> Caroline M. Chambers Vice President and Controller
-------	----------------------	-----	---

*(Principal Accounting Officer)*

**THIRD AMENDMENT  
GRACO RESTORATION PLAN  
(2005 Statement)**

Graco Inc. (the "Principal Sponsor") has established and maintains a nonqualified deferred compensation plan (the "Plan") which, in its most recent amended and restated form, is embodied in a document entitled "GRACO RESTORATION PLAN (2005 Statement)" effective January 1, 2005 (as amended, the "Plan Statement") and is hereby amended as follows:

**1. DISTRIBUTION FORMS.** Effective for distributions made on and after July 1, 2007, Subsection 7.1.2 shall be amended (i) to re-number Subsection 7.1.2(b) as Subsection 7.1.2(d), and (ii) to add the following new Subsections 7.1.2(b) and 7.1.2(c) that read in full as follows:

(b) **Election to Change the Form or Delay the Time of Distribution.** A Participant may make an election to change the form or delay the time of distribution. If (i) a Participant's form of payment prior to electing one of the alternative forms of payment listed below is an annuity, (ii) the Participant elects an alternative form that is an annuity (options (i), (ii), (iii), (iv), (v), and (vi), but not (vii) – the lump sum form), and (iii) the annuity elected is actuarially equivalent applying reasonable actuarial methods and assumptions, then the Participant's benefit shall commence on the same date the benefit would have been paid but for the election of the alternative form. In all other cases, if a Participant elects one of these alternative forms of payment, the election (i) shall not take effect until the date that is twelve (12) months after the date on which the Participant makes the election, (ii) shall delay the distribution to a date that is at least five (5) years after the date the distribution would have been made to the Participant absent the election, and (iii) in the case of a distribution as of a specified time (but not upon a Participant's Separation from Service, Disability, or death), the election shall not take effect unless the Participant makes the election at least twelve (12) months prior to the date the distribution is to commence. An election form that does not satisfy the advance filing requirements of the preceding sentence shall be void and shall be disregarded. In all cases an election form shall not be considered filed until the completed form is actually received by the Committee or its designated agent.

(c) **Alternate Forms of Distribution.** Subject to satisfying the conditions in Section 7.1.4(b), the participant may elect to receive distribution the following forms

(i) A fifty percent (50%) survivor annuity.

---

(ii) A sixty-six and two-thirds percent (66-2/3%) survivor annuity (available only if the joint annuitant is not more than twenty-four (24) years younger than the Participant).

(iii) A seventy-five percent (75%) survivor annuity.

(iv) A one hundred percent (100%) survivor annuity (available only if the joint annuitant is not more than ten (10) years younger than the Participant).

(v) A term certain single life annuity based on the Participant's life with a term certain period of one hundred twenty (120) months (available only if the Participant has not attained age 92).

(vi) A term certain single life annuity based on the Participant's life with a term certain period of one hundred eighty (180) months (available only if the Participant has not attained age 84).

(vii) A single lump sum payment.

The actuarial determination of all forms in section 7.1.2 shall be based upon the terms of the Graco Employee Retirement Plan.

**2. SAVINGS CLAUSE.** Save and except as hereinabove expressly amended, the Restoration Plan shall continue in full force and effect.





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

**NON-EMPLOYEE DIRECTOR STOCK OPTION AGREEMENT  
(Non-Qualified)**

**THIS AGREEMENT**, made this \_\_\_\_ day of \_\_\_\_\_, 200\_\_ by and between Graco Inc., a Minnesota corporation (the “Company”) and «Name»(the “Nonemployee Director”).

**WITNESSETH THAT:**

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

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

1. Grant of Option

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

2. Duration and Exercisability

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

**Vesting Schedule**

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

If Nonemployee Director does not purchase in any one year the full number of shares of Common Stock of the Company to which he/she is entitled under this Option, he/she may, subject to the terms and conditions of Section 3 hereof, purchase such shares of Common

1 *Nonemployee Director Stk Opt Agmt 2/08*

Stock in any subsequent year during the term of this Option. The Option shall expire as of the close of trading at the national securities exchange on which the Common Stock is traded (“Exchange”) on the tenth anniversary of the Date of Grant, or if the Exchange is closed on the anniversary date, or the Common Stock of the Company is not trading on said anniversary date, such earlier business day on which the Common Stock is trading on the Exchange.

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

3. Effect of Termination of Membership on the Board

- A. In the event Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in Section 3B below, Nonemployee Director shall have the right to exercise the Option as follows:

- (1) If Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, the portion of the Option not yet exercisable shall become immediately exercisable upon the date Nonemployee Director ceases being a director. Nonemployee Director may exercise all or any portion of the Option not yet exercised for a period beginning on the day after the date of Nonemployee Director's ceasing to be a director and ending at the close of trading on the Exchange on the tenth anniversary of the Date of Grant, provided that if Nonemployee Director dies during the period between the date of Nonemployee Director ceasing to be a director and the expiration of the Option, the executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent may exercise the unexercised portion of the Option at any time during a period beginning the day after the date of Nonemployee Director's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later. In no event shall the Option be exercisable following the tenth anniversary of the Date of Grant.
- (2) If Nonemployee Director was a member of the Board of Directors of the Company for less than five (5) years, Nonemployee Director may exercise that portion of the Option exercisable upon the date Nonemployee Director ceases being a director at any time within the period beginning on the day after Nonemployee Director ceases being a director and ending at the close of trading on the Exchange thirty (30) days later. If Nonemployee Director dies within the thirty (30) day period and shall not have fully exercised the Option, all shares remaining under the Option shall become immediately exercisable. The executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, may exercise the remaining portion of the Option at any time during a period beginning on the day after the date of

2 *Nonemployee Director Stk Opt Agmt 2/08*

---

Nonemployee Director's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.

- (3) If Nonemployee Director dies while a member of the Board of Directors of the Company, the Option, to the extent exercisable by Nonemployee Director at the date of death, may be exercised by the executor(s) or administrator(s) of Nonemployee Director's estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent, at any time during a period beginning on the day after the date of Nonemployee Director's death and ending at the close of trading on the Exchange on the anniversary of death one (1) year later.
- (4) In the event the Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased Nonemployee Director, the Company shall be under no obligation to issue stock thereunder unless and until the Company is satisfied that the person(s) exercising the Option is the duly appointed legal representative of Nonemployee Director's estate or the proper legatee or distributee thereof.

- B. If Nonemployee Director ceases being a director of the Company by reason of Nonemployee Director's gross and willful misconduct, including but not limited to, (i) fraud or intentional misrepresentation; (ii) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any affiliate of the Company; (iii) breach of fiduciary duty, or (iv) any other gross or willful misconduct, as determined by the Board, in its sole and conclusive discretion, the unexercised portion of the Option granted to such Nonemployee Director shall immediately be forfeited as of the time of the misconduct. If the Board determines subsequent to the time Nonemployee Director ceases being a director of the Company for whatever reason, that Nonemployee Director engaged in conduct while a member of the Board of Directors of the Company that would constitute gross and willful misconduct, the Option shall terminate as of the time of such misconduct. Furthermore, if the Option is exercised in whole or in part and the Board thereafter determines that Nonemployee Director engaged in gross and willful misconduct while a member of the Board of Directors of the Company at any time prior to the date of such exercise, the Option shall be deemed to have terminated as of the time of the misconduct and the Company may elect to rescind the Option exercise.
- C. For purposes of this Section 3, if the last day of the relevant period is a day upon which the Exchange is not open for trading or the Common Stock is not trading on that day, the relevant period will expire at the close of trading on such earlier business day on which the Exchange is open and the Common Stock is trading.

- A. Nonemployee Director or other proper party may exercise the Option only by delivering within the term of the Option written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the Option is being exercised and, except

as provided in Sections 4B(2) and 4C, accompanied by payment in full of one hundred percent (100%) of the Option price.

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

- (1) by cash or check (bank check, certified check, or personal check),
- (2) by delivery of shares of Common Stock to the Company, which shall have been owned for at least six (6) months and have a fair market value per share on the date of surrender equal to the exercise price.

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

- C. The Nonemployee Director may, with the consent of the Company, pay the Option price by delivery to 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.

5. Change of Control

- A. Notwithstanding Section 2A hereof, the entire Option shall become immediately and fully exercisable upon a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:

- (1) an acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Securities Exchange Act of 1934, as amended (the "1934 Act")), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) which, together with other acquisitions by such Person, results in the aggregate beneficial ownership by such Person of 30% 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 by any employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
  - (ii) an acquisition by the Employee or any group that includes the Employee, or
  - (iii) an acquisition by any entity pursuant to a transaction that complies with clauses (a), (b) and (c) of Section 5A(3) below; 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 by or on behalf of a Person other than the Board; or

- (3) Consummation of a reorganization, merger or consolidation of the Company with or into another entity or a 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"); 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 and Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, a majority 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 (or comparable equity interests), as the case may be, of the surviving or acquiring entity resulting from such Business Combination (including, without limitation, an entity that as a result of such transaction beneficially owns 100% of the outstanding shares of common stock and the combined voting power of the then outstanding voting securities (or comparable equity securities) or all or substantially all of the Company's assets either directly or indirectly) in substantially the same proportions (as compared to the other holders of the Company's common stock and voting securities prior to the Business Combination) as their respective ownership,

---

immediately prior to such Business Combination, of the Outstanding Company Common Stock and Outstanding Company Voting Securities,

- (b) no Person (excluding (i) any employee benefit plan (or related trust) sponsored or maintained by the Company or such entity resulting from such Business Combination or any entity controlled by the Company or the entity resulting from such Business Combination, (ii) any entity beneficially owning 100% of the outstanding shares of common stock and the combined voting power of the then outstanding voting securities (or comparable equity securities) or all or substantially all of the Company's assets either directly or indirectly and (iii) the Employee and any group that includes the Employee) beneficially owns, directly or indirectly, 30% or more of the then outstanding shares of common stock (or comparable equity interests) of the entity resulting from such Business Combination or the combined voting power of the then outstanding voting securities (or comparable equity interests) of such entity, and
- (c) immediately after the Business Combination, a majority of the members of the board of directors (or comparable governors) of the entity 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
- (4) approval by the shareholders of the Company of a complete liquidation or dissolution of the Company.

## 6. Adjustments; Fundamental Change

- A. If there shall be any change in the number or character of the Common Stock of the Company through merger, consolidation, reorganization, recapitalization, dividend in the form of stock (of whatever amount), stock split or other change in the corporate structure of the Company, and all or any portion of the Option shall then be unexercised and not yet expired, appropriate adjustments in the outstanding Option shall be made by the Company, in order to prevent dilution or enlargement of Employee's Option rights. Such adjustments shall include, where appropriate, changes in the number of shares of Common Stock and the price per share subject to the outstanding Option.
- B. In the event of a proposed (i) dissolution or liquidation of the Company, (ii) a sale of substantially all of the assets of the Company, (iii) a merger or consolidation of the Company with or into any other corporation, regardless of whether the Company is the surviving

corporation, or (iv) a statutory share exchange involving the capital stock of the Company (each, a “Fundamental Change”), the Management Organization and Compensation Committee of the Board (the “Committee”) may, but shall not be obligated to:

- (1) with respect to a Fundamental Change that involves a merger, consolidation or statutory share exchange, make appropriate provision for the protection of the Option

---

by the substitution of options and appropriate voting common stock of the corporation surviving any such merger or consolidation or, if appropriate, the “parent corporation” (as defined in Section 424(e) of the Internal Revenue Code of 1986, as amended from time to time, and any regulations promulgated thereunder, or any successor provision) of the Company or such surviving corporation, in lieu of the Option and shares of Common Stock of the Company, or

- (2) with respect to any Fundamental Change, including, without limitation, a merger, consolidation or statutory share exchange, declare, prior to the occurrence of the Fundamental Change, and provide written notice to the holder of the Option of the declaration, that the Option, whether or not then exercisable, shall be canceled at the time of, or immediately prior to the occurrence of, the Fundamental Change in exchange for payment to the holder of the Option, within 20 days after the Fundamental Change, of cash (or, if the Committee so elects in lieu of solely cash, of such form(s) of consideration, including cash and/or property, singly or in such combination as the Committee shall determine, that the holder of the Option would have received as a result of the Fundamental Change if the holder of the Option had exercised the Option immediately prior to the Fundamental Change) equal to, for each share of Common Stock covered by the canceled Option, the amount, if any, by which the Fair Market Value (as defined in this Section 6B) per share of Common Stock exceeds the exercise price per share of Common Stock covered by the Option. At the time of the declaration provided for in the immediately preceding sentence, the Option shall immediately become exercisable in full and the holder of the Option shall have the right, during the period preceding the time of cancellation of the Option, to exercise the Option as to all or any part of the shares of Common Stock covered thereby in whole or in part, as the case may be. In the event of a declaration pursuant to this Section 6B, the Option, to the extent that it shall not have been exercised prior to the Fundamental Change, shall be canceled at the time of, or immediately prior to, the Fundamental Change, as provided in the declaration. Notwithstanding the foregoing, the holder of the Option shall not be entitled to the payment provided for in this Section 6B if such Option shall have expired or been forfeited. For purposes of this Section 6B only, “Fair Market Value” per share of Common Stock means the fair market value, as determined in good faith by the Committee, of the consideration to be received per share of Common Stock by the shareholders of the Company upon the occurrence of the Fundamental Change, notwithstanding anything to the contrary provided in this Agreement.

## 7. Miscellaneous

- A. This Option is granted pursuant to the Plan and is subject to its terms. The terms of the Plan are available for inspection during business hours at the principal offices of the Company.
- B. Neither the Plan nor any action taken hereunder shall be construed as giving Nonemployee Director any right to be retained in the service of the Company.

- 
- C. Neither Nonemployee Director, Nonemployee Director’s legal representative, nor the executor(s) or administrator(s) of Nonemployee Director’s estate, or any person(s) to whom the Option was transferred by will or the applicable laws of distribution and descent shall be, or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of Common Stock receivable upon the exercise of this Option, in whole or in part, unless and until such shares shall have been issued upon exercise of this Option.
  - D. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
  - E. The internal law, and not the law of conflicts, of the State of Minnesota, U.S.A., shall govern all questions concerning the validity, construction and effect of this Agreement, the Plan and any rules and regulations relating to the Plan or this Option.

- F. Nonemployee Director hereby consents to the transfer to his employer or the Company of information relating to his/her participation in the Plan, including the personal data set forth in this Agreement, between them or to other related parties in the United States or elsewhere, or to any financial institution or other third party engaged by the Company, but solely for the purpose of administering the Plan and this Option. Nonemployee Director also consents to the storage and processing of such data by such persons for this purpose.

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

GRACO INC.

By  
Its Vice President, General Counsel  
and Secretary

NONEMPLOYEE DIRECTOR

«Name»

## CERTIFICATION

I, Patrick J. McHale, certify that:

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

Date: July 23, 2008

/s/Patrick J. McHale  
 Patrick J. McHale  
 President and Chief Executive Officer



**CERTIFICATION**

I, James A. Graner, certify that:

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

Date: July 23, 2008

/s/James A. Graner

James A. Graner  
Chief Financial Officer and Treasurer

## CERTIFICATION UNDER SECTION 1350

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

Date: July 23, 2008/s/Patrick J. McHale

Patrick J. McHale  
President and Chief Executive Officer

Date: July 23, 2008/s/James A. Graner

James A. Graner  
Chief Financial Officer and Treasurer