

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 30, 2001

Commission File Number: 001-9249

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GRACO INC.

-----  
(Exact name of Registrant as specified in its charter)

Minnesota

41-0285640

-----  
(State of incorporation)

-----  
(I.R.S. Employer Identification Number)

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

55413

-----  
(Address of principal executive offices)

-----  
(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  
-----              -----

30,794,894 common shares were outstanding as of May 3, 2001.

GRACO INC. AND SUBSIDIARIES

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## PART I

## GRACO INC. AND SUBSIDIARIES

## Item I. CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Thirteen Weeks Ended	
	March 30, 2001	March 31, 2000
	-----	
	(In thousands except per share amounts)	
Net Sales	\$109,814	\$122,227
Cost of products sold	54,676	60,098
	-----	
Gross Profit	55,138	62,129
Product development	6,287	5,024
Selling, marketing and distribution	20,672	23,814
General and administrative	7,696	8,644
	-----	
Operating Profit	20,483	24,647
Interest expense	450	1,235
Other (income) expense, net	213	437
	-----	
Earnings Before Income Taxes	19,820	22,975
Income taxes	6,700	8,000
	-----	
Net Earnings	\$ 13,120	\$ 14,975
	=====	
Basic Net Earnings Per Common Share	\$ .43	\$ .49
	=====	
Diluted Net Earnings Per Common Share	\$ .42	\$ .48
	=====	

See notes to consolidated financial statements.

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

	March 30, 2001 -----	Dec. 29, 2000 -----
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 4,682	\$ 11,071
Accounts receivable, less allowances of \$4,800 and \$4,700	83,301	85,836
Inventories	41,177	33,079
Deferred income taxes	11,627	11,574
Other current assets	2,565	2,182
	-----	-----
Total current assets	143,352	143,742
Property, Plant and Equipment:		
Cost	193,942	186,872
Accumulated depreciation	(106,615)	(102,883)
	-----	-----
	87,327	83,989
Other Assets		
	20,840	10,245
	-----	-----
	\$251,519	\$ 237,976
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Notes payable to banks	\$ 14,241	\$ 15,713
Current portion of long-term debt	1,050	1,310
Trade accounts payable	12,742	12,899
Salaries, wages & commissions	7,962	14,532
Accrued insurance liabilities	10,925	10,622
Income taxes payable	10,678	4,642
Other current liabilities	20,026	22,123
	-----	-----
Total current liabilities	77,624	81,841
Long-term Debt, less current portion	20,500	18,050
Retirement Benefits and Deferred Compensation	27,106	27,230
Shareholders' Equity:		
Common stock	30,778	20,274
Additional paid-in capital	45,902	39,954
Retained earnings	49,992	50,233
Other, net	(383)	394
	-----	-----
Total shareholders' equity	126,289	110,855
	-----	-----
	\$251,519	\$ 237,976
	=====	=====

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Thirteen Weeks	
	March 30, 2001	March 31, 2000
	-----	
CASH FLOWS FROM OPERATING ACTIVITIES:	(In thousands)	
Net Earnings	\$13,120	\$14,975
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	4,240	4,005
Deferred income taxes	(182)	127
Change in:		
Accounts receivable	4,065	(9,733)
Inventories	(5,510)	(4,255)
Trade accounts payable	(358)	1,941
Salaries, wages and commissions	(6,569)	(3,283)
Retirement benefits and deferred compensation	272	124
Other accrued liabilities	2,832	5,267
Other	(789)	(356)
	-----	-----
	11,121	8,812
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, plant and equipment additions	(6,203)	(2,968)
Proceeds from sale of property, plant and equipment	45	58
Acquisition of business, net of cash acquired	(15,949)	-
	-----	-----
	(22,107)	(2,910)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on notes payable and lines of credit	36,274	47,979
Payments on notes payable and lines of credit	(37,307)	(49,939)
Borrowings on long-term debt	23,000	20,000
Payments on long-term debt	(20,810)	(17,265)
Common stock issued	6,320	6,632
Retirement of common stock	(177)	(15,300)
Cash dividends paid	(3,044)	(2,862)
	-----	-----
	4,256	(10,755)
	-----	-----
Effect of exchange rate changes on cash	341	1,099
	-----	-----
Net increase (decrease) in cash and cash equivalents	(6,389)	(3,754)
Cash and cash equivalents:		
Beginning of year	11,071	6,588
	-----	-----
End of Period	\$ 4,682	\$ 2,834
	=====	=====

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of March 30, 2001, and the related statements of earnings and cash flows for the thirteen weeks then ended, have been prepared by the Company without being audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of March 30, 2001, 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 2000 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. Major components of inventories were as follows (in thousands):

	Mar. 30, 2001	Dec. 29, 2000
	-----	-----
Finished products and components	\$29,675	\$26,812
Products and components in various stages of completion	21,961	20,153
Raw materials	22,601	19,259
	-----	-----
Reduction to LIFO cost	74,237 (33,060)	66,224 (33,145)
	-----	-----
	\$41,177	\$33,079
	=====	=====

GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. The Company has three reportable segments; Industrial/Automotive, Contractor and Lubrication. The Company does not identify assets by segment. Sales and operating profit by segment for the thirteen weeks ended March 30, 2001 and March 31, 2000 are as follows (in thousands):

	Mar. 30, 2001	Mar. 31, 2000
	-----	-----
Net Sales		
Industrial/Automotive	\$ 47,649	\$ 56,831
Contractor	49,901	54,481
Lubrication	12,264	10,915
	-----	-----
Total	\$109,814	\$122,227
	=====	=====
Operating Profit		
Industrial/Automotive	\$ 9,394	\$ 12,507
Contractor	8,620	10,486
Lubrication	2,956	2,316
Unallocated Corporate Expenses	(487)	(662)
	-----	-----
Consolidated Operating Profit	\$ 20,483	\$ 24,647
	=====	=====

4. There have been no changes to the components of comprehensive income from those noted in the 2000 Form 10-K. Total comprehensive income for the quarter was \$12.4 million in 2001 and \$14.2 million in 2000.
5. The adoption of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" on December 30, 2000, resulted in no transition adjustment. See Note A to financial statements included in the Company's 2000 Form 10-K for a description of the Company's use of derivative instruments and hedging activities.
6. On March 19, 2001, the Company purchased ASM Company, Inc. for \$16 million cash. Based on management's estimates of value, the purchase price has been allocated to net tangible assets of approximately \$5 million and intangible assets totaling approximately \$11 million. Intangible assets are included in the other assets caption on the consolidated balance sheets. The purchase price allocation is subject to adjustment upon completion of an independent appraisal. ASM manufactures and markets spray tips, guns, poles and other accessories for the professional painter. ASM had sales of approximately \$11 million in 2000.

Item 2.

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

Results of Operations  
-----

Net sales and earnings in the first quarter decreased from last year. The impact of reduced sales on net earnings was mitigated by a reduction of expenses. The increase in product development expense was more than offset by reductions in other operating expenses.

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

	Thirteen Weeks Ended	
	March 30, 2001	March 31, 2000
	-----	-----
Net Sales	100.0%	100.0%
Cost of products sold	49.8	49.2
Product development	5.7	4.1
Selling, marketing and distribution	18.8	19.5
General and administrative	7.0	7.0
	-----	-----
Operating Profit	18.7	20.2
Interest expense	0.4	1.0
Other (income) expense, net	0.2	0.4
	-----	-----
Earnings Before Income Taxes	18.1	18.8
Income taxes	6.1	6.5
	-----	-----
Net Earnings	12.0%	12.3%
	=====	=====



## Net Sales

Net sales in the first quarter of 2001 were down 10 percent from first quarter 2000. Economic conditions in North America led to reduced demand and lower sales in the Industrial / Automotive segment (down 16 percent) and the Contractor Equipment segment (down 8 percent). Lubrication Equipment segment sales (up 12 percent) were helped by new products launched last September and large sales to several key customers. Within the Contractor Equipment segment, sales in the home center channel were \$9.3 million, up 3 percent from the first quarter of 2000. The Company began selling through the home center channel in January 2000, and most of the sales in the first quarter of 2000 were initial stocking orders.

Geographically, sales in the Americas decreased 13 percent. In Europe, sales measured in local currencies increased 2 percent, but decreased 4 percent after unfavorable currency translation. Asia Pacific sales were 3 percent lower than last year, but would have increased 4 percent if translated at consistent exchange rates. Fluctuations in exchange rates adversely impacted consolidated net sales for the quarter by approximately \$2 million.

## Gross Profit

Gross profit as a percentage of net sales was 50.2 percent compared to 50.8 percent last year. Gross profit as a percentage of net sales would have decreased only .2 percentage points if sales and cost of products sold were translated at consistent exchange rates.

## Operating Expenses

Product development expense increased 25 percent from the first quarter of 2000, as several new products approached launch dates. Other operating expenses decreased commensurate with reduced sales levels. Selling, marketing and distribution expense decreased 13 percent and decreased as a percentage of sales to 18.8 percent from 19.5 percent. First quarter 2000 included significant spending related to the introduction of new products and entry into the home center channel. General and administrative expenses were down 11 percent due to controls placed on spending, including restrictions on discretionary items, and the impact of reduced sales on incentive bonus provisions.

## Interest Expense and Other Income (Expense)

Interest expense decreased due to reduced debt levels.

## Liquidity and Capital Resources

- - - - -

The Company generated \$11.1 million of cash flow from operating activities in the first three months of 2000, compared to \$8.8 million for the same period last year. Significant uses of cash in 2001 included the acquisition of ASM Company, Inc. and the construction in progress of expanded manufacturing, warehouse and office facilities in Minneapolis. In 2000, the Company utilized cash flow to retire \$15.3 million of common stock. The Company plans to expand its Sioux Falls, South Dakota manufacturing facilities to accommodate the move of ASM operations from its current location in California. The Company had unused lines of credit available at March 30, 2001 totaling \$90 million. The available credit facilities and internally generated funds provide the Company with the financial flexibility to meet liquidity needs.

## Outlook

- - - - -

The Company remains cautious about its outlook for 2001, as the North American economy has slowed down considerably from the levels of a year ago. Nonetheless, management remains confident that the Company will continue to post good results in light of the circumstances. Management expects to generate incremental revenues and profits by aggressively implementing growth strategies of developing new products, expanding distribution, entering new markets and pursuing strategic acquisitions.

The information in this 10-Q 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. These 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 2000.

PART II

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

2001 Executive Corporate and SBU Bonus Plan	Exhibit 10
Non-employee Director Stock Option Plan, as amended and restated February 23, 2001	Exhibit 10.1
Computation of Net Earnings per Common Share	Exhibit 11

(b) No reports on Form 8-K have been filed during the quarter for which this report is filed.

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: May 1, 2001  
-----

By: /s/George Aristides  
-----  
George Aristides  
Chief Executive Officer

Date: May 1, 2001  
-----

By: /s/James A. Graner  
-----  
James A. Graner  
Vice President & Controller  
("duly authorized officer")

Objectives

- - - - -

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

Plan Design

- - - - -

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

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

Eligibility Requirements

- - - - -

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

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

Participation

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

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

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

Bonus Maximum

- - - - -

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

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

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

Bonus Payment

- - - - -

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

Base Salary for the Plan Year, to determine the total Bonus Payment.

Example:

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

Administration

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

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

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

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

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

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

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

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

8. Targets and actual performance for Corporate and Division measures will be

at actual exchange rates. Targets and actual performance for international measures where business is conducted in foreign currency will be at prior year's actual rates.

9. Acquisitions and divestitures not included in the annual business plan for the Plan Year will be excluded from the Corporate Sales and/or Net Earnings calculations.
10. Significant changes in historical FASB accounting practices or income tax rates will be included in corporate earnings calculations at the discretion of the Management Organization and Compensation Committee of the Board of Directors.
11. Payments will be made by March 15th of the year following each successive Corporate and Business Unit performance year.

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

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 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 option to purchase two thousand five hundred (2,500) shares of the Company's common stock under the Plan (the "Annual Option"); and a Nonemployee Director who has not previously been elected as a member of the Board of Directors of the Company shall be granted a First Option; i.e., an option to purchase three thousand (3,000) 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 four hundred fifty thousand (450,000) 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, and the number and the price of shares of common stock subject to outstanding Options, shall be appropriately adjusted automatically.
- b. No right to purchase fractional shares shall result from any adjustment in 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.

## GRACO INC. AND SUBSIDIARIES

## COMPUTATION OF NET EARNINGS PER COMMON SHARE

(Unaudited)

Thirteen Weeks Ended

	Mar. 30, 2001	Mar. 31, 2000
Net earnings applicable to common shareholders for basic and diluted earnings per share	\$13,120	\$14,975
Weighted average shares outstanding for basic earnings per share	30,561	30,590
Dilutive effect of stock options computed using the treasury stock method and the average market price	568	479
Weighted average shares outstanding for diluted earnings per share	31,129	31,068
Basic earnings per share	\$ 0.43	\$ 0.49
Diluted earnings per share	\$ 0.42	\$ 0.48

(in thousands except per share amounts)

	Mar. 30, 2001	Mar. 31, 2000
Net earnings applicable to common shareholders for basic and diluted earnings per share	\$13,120	\$14,975
Weighted average shares outstanding for basic earnings per share	30,561	30,590
Dilutive effect of stock options computed using the treasury stock method and the average market price	568	479
Weighted average shares outstanding for diluted earnings per share	31,129	31,068
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