

GRACO INC  
Form 10-Q  
July 26, 2012  
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**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 29, 2012**

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

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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
Non-accelerated Filer		Smaller reporting company

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

Yes  \_\_\_\_\_  No  X

60,517,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of July 18, 2012.

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

(Unaudited) (In thousands except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net Sales	\$ 268,184	\$ 234,663	\$ 502,306	\$ 452,342
Cost of products sold	128,654	102,217	230,597	195,499
Gross Profit	139,530	132,446	271,709	256,843
Product development	12,502	10,354	24,140	20,285
Selling, marketing and distribution	42,547	39,582	80,573	77,065
General and administrative	32,006	24,255	56,552	44,169
Operating Earnings	52,475	58,255	110,444	115,324
Interest expense	5,359	1,732	9,048	2,348
Other expense (income), net	(3,236)	324	(2,937)	324
Earnings Before Income Taxes	50,352	56,199	104,333	112,652
Income taxes	16,000	18,100	34,600	37,300
Net Earnings	\$ 34,352	\$ 38,099	\$ 69,733	\$ 75,352
<b>Per Common Share</b>				
Basic net earnings	\$ 0.57	\$ 0.63	\$ 1.16	\$ 1.25
Diluted net earnings	\$ 0.56	\$ 0.61	\$ 1.13	\$ 1.22
Cash dividends declared	\$ 0.23	\$ 0.21	\$ 0.45	\$ 0.42

See notes to consolidated financial statements.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited) (In thousands)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011

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Net Earnings	\$	34,352	\$	38,099	\$	69,733	\$	75,352
Other comprehensive income (loss)								
Cumulative translation adjustment		(9,458)		-		(9,458)		-
Pension and postretirement medical liability adjustment		2,470		1,429		4,809		2,792
Gain (loss) on interest rate hedge contracts		-		-		-		454
Income taxes		(888)		(537)		(1,731)		(1,203)
Other comprehensive income (loss)		(7,876)		892		(6,380)		2,043
Comprehensive Income	\$	26,476	\$	38,991	\$	63,353	\$	77,395

See notes to consolidated financial statements.

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

(Unaudited)

(In thousands)

	June 29, 2012	Dec 30, 2011
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 23,088	\$ 303,150
Accounts receivable, less allowances of \$5,900 and \$5,500	192,614	150,912
Inventories	124,428	105,347
Deferred income taxes	20,290	17,674
Investment in businesses held separate	426,813	-
Other current assets	6,694	5,887
<b>Total current assets</b>	<b>793,927</b>	<b>582,970</b>
Property, Plant and Equipment		
Cost	383,315	358,235
Accumulated depreciation	(229,046)	(219,987)
<b>Property, plant and equipment, net</b>	<b>154,269</b>	<b>138,248</b>
Goodwill	167,316	93,400
Other Intangible Assets, net	156,634	18,118
Deferred Income Taxes	33,293	29,752
Other Assets	14,282	11,821
<b>Total Assets</b>	<b>\$ 1,319,721</b>	<b>\$ 874,309</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Notes payable to banks	\$ 6,336	\$ 8,658
Trade accounts payable	31,730	27,402
Salaries and incentives	25,905	32,181
Dividends payable	13,634	13,445
Other current liabilities	76,314	49,596
<b>Total current liabilities</b>	<b>153,919</b>	<b>131,282</b>
<b>Long-term Debt</b>	<b>627,180</b>	<b>300,000</b>
Retirement Benefits and Deferred Compensation	130,059	120,287

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Deferred Income Taxes	17,175	-
Shareholders' Equity		
Common stock	60,514	59,747
Additional paid-in-capital	274,011	242,007
Retained earnings	139,724	97,467
Accumulated other comprehensive income (loss)	(82,861)	(76,481)
Total shareholders' equity	391,388	322,740
Total Liabilities and Shareholders' Equity	\$ 1,319,721	\$ 874,309

See notes to consolidated financial statements.

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

(Unaudited) (In thousands)

	Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011
<b>Cash Flows From Operating Activities</b>		
Net Earnings	\$ 69,733	\$ 75,352
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	18,381	17,542
Deferred income taxes	(8,074)	(4,223)
Share-based compensation	6,936	6,287
Excess tax benefit related to share-based payment arrangements	(2,000)	(1,700)
Change in		
Accounts receivable	(25,312)	(32,590)
Inventories	1,794	(21,446)
Trade accounts payable	2,146	7,642
Salaries and incentives	(11,832)	(11,633)
Retirement benefits and deferred compensation	7,296	4,040
Other accrued liabilities	4,527	62
Other	1,072	4,558
<b>Net cash provided by operating activities</b>	<b>64,667</b>	<b>43,891</b>
<b>Cash Flows From Investing Activities</b>		
Property, plant and equipment additions	(10,177)	(9,999)
Proceeds from sale of property, plant and equipment	96	188
Acquisition of businesses, net of cash acquired	(227,323)	(2,139)
Investment in businesses held separate	(426,813)	-
Capitalized software and other intangible asset additions	(1,879)	(485)
<b>Net cash used in investing activities</b>	<b>(666,096)</b>	<b>(12,435)</b>
<b>Cash Flows From Financing Activities</b>		
Borrowings on short-term lines of credit	8,292	13,550
Payments on short-term lines of credit	(10,539)	(8,328)
Borrowings on long-term notes and line of credit	452,695	252,175
Payments on long-term line of credit	(125,515)	(172,430)
Payments of debt issuance costs	(1,921)	(1,131)
Excess tax benefit related to share-based payment arrangements	2,000	1,700
Common stock issued	23,386	18,705
Common stock repurchased	(272)	-



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Cash dividends paid	(27,043)	(25,342)
<b>Net cash provided by (used in) financing activities</b>	321,083	78,899
Effect of exchange rate changes on cash	284	(679)
Net increase (decrease) in cash and cash equivalents	(280,062)	109,676
Cash and cash equivalents		
Beginning of year	303,150	9,591
End of period	\$ 23,088	\$ 119,267

See notes to consolidated financial statements.

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**GRACO INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of June 29, 2012 and the related statements of earnings for the thirteen and twenty-six weeks ended June 29, 2012 and July 1, 2011, and cash flows for the twenty-six weeks ended June 29, 2012 and July 1, 2011 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 29, 2012, 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 2011 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.

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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 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net earnings available to common shareholders	\$ 34,352	\$ 38,099	\$ 69,733	\$ 75,352
Weighted average shares outstanding for basic earnings per share	60,484	60,721	60,268	60,496
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,319	1,349	1,303	1,219
Weighted average shares outstanding for diluted earnings per share	61,803	62,070	61,571	61,715
Basic earnings per share	\$ 0.57	\$ 0.63	\$ 1.16	\$ 1.25
Diluted earnings per share	\$ 0.56	\$ 0.61	\$ 1.13	\$ 1.22

Stock options to purchase 572,000 and 438,000 shares were not included in the 2012 and 2011 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 29, 2012 is shown below (in thousands, except per share amounts):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 30, 2011	5,478	\$ 32.12	3,211	\$ 32.27
Granted	543	50.34		
Exercised	(530)	28.43		
Canceled	(36)	34.47		
Outstanding, June 29, 2012	5,455	\$ 34.28	3,464	\$ 32.32

The Company recognized year-to-date share-based compensation of \$6.9 million in 2012 and \$6.3 million in 2011. As of June 29, 2012, there was \$11.8 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.0 years.

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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 29, 2012	July 1, 2011
Expected life in years	6.5	6.5
Interest rate	1.3 %	2.8 %
Volatility	36.6 %	33.7 %
Dividend yield	1.8 %	2.0 %
Weighted average fair value per share	\$ 15.62	\$ 13.35

Under the Company's Employee Stock Purchase Plan, the Company issued 239,000 shares in 2012 and 313,000 shares in 2011. 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 29, 2012	July 1, 2011
Expected life in years	1.0	1.0
Interest rate	0.2 %	0.3 %
Volatility	40.6 %	27.8 %
Dividend yield	1.7 %	2.1 %
Weighted average fair value per share	\$ 15.58	\$ 10.05

In May 2012, the Company granted 6,000 Restricted Share Units to a key employee that will vest on the third anniversary of the date of grant. The market value of the units at the date of grant will be charged to operations over the vesting period. The expense related to this arrangement is not significant.

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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 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
<b>Pension Benefits</b>				
Service cost	\$ 1,724	\$ 1,232	\$ 3,014	\$ 2,465
Interest cost	3,567	3,370	6,798	6,740
Expected return on assets	(3,859)	(4,000)	(7,684)	(8,000)
Amortization and other	3,049	1,465	5,495	2,946
Net periodic benefit cost	\$ 4,481	\$ 2,067	\$ 7,623	\$ 4,151
<b>Postretirement Medical</b>				
Service cost	\$ 125	\$ 125	\$ 275	\$ 250
Interest cost	237	325	500	650
Amortization	(38)	-	(75)	-
Net periodic benefit cost	\$ 324	\$ 450	\$ 700	\$ 900

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

	June 29, 2012	Dec 30, 2011
Pension and postretirement medical liability adjustment	\$ (72,580)	\$ (75,658)
Cumulative translation adjustment	(10,281)	(823)
Total	\$ (82,861)	\$ (76,481)

The functional currency of certain subsidiaries related to the Powder Finishing business, acquired in April 2012, is the local currency. Accordingly, adjustments resulting from the translation of those subsidiaries' financial statements into U.S. dollars are charged or credited to accumulated other comprehensive income.

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6. The Company has three reportable segments: Industrial, Contractor and Lubrication. Sales and operating earnings by segment for the twenty-six weeks ended June 29, 2012 and July 1, 2011 were as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
<b>Net Sales</b>				
Industrial	\$ 158,220	\$ 129,304	\$ 292,323	\$ 252,134
Contractor	82,106	80,702	154,092	150,907
Lubrication	27,858	24,657	55,891	49,301
<b>Total</b>	<b>\$ 268,184</b>	<b>\$ 234,663</b>	<b>\$ 502,306</b>	<b>\$ 452,342</b>
<b>Operating Earnings</b>				
Industrial	\$ 43,171	\$ 45,339	\$ 91,484	\$ 90,364
Contractor	17,965	16,424	30,504	27,539
Lubrication	5,543	4,045	11,632	9,272
Unallocated corporate (expense)	(14,204)	(7,553)	(23,176)	(11,851)
<b>Total</b>	<b>\$ 52,475</b>	<b>\$ 58,255</b>	<b>\$ 110,444</b>	<b>\$ 115,324</b>

Unallocated corporate includes acquisition-related expenses of \$7 million for the quarter and \$11 million year-to-date in 2012 and \$3 million for both the quarter and year-to-date in 2011.

Assets by segment were as follows (in thousands):

	June 29, 2012	Dec 30, 2011
Industrial	\$ 566,755	\$ 302,805
Contractor	158,070	146,556
Lubrication	87,463	91,137
Unallocated corporate	507,433	333,811
<b>Total</b>	<b>\$ 1,319,721</b>	<b>\$ 874,309</b>

Unallocated corporate in 2012 includes \$427 million of investment in businesses held separate (see note 12).

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Geographic information follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net Sales (based on customer location)				
United States	\$ 116,454	\$ 104,056	\$ 220,622	\$ 200,815
Other countries	151,730	130,607	281,684	251,527
Total	\$ 268,184	\$ 234,663	\$ 502,306	\$ 452,342
	June 29, 2012	Dec 30, 2011		
Long-lived assets				
United States	\$ 122,059	\$ 120,119		
Other countries	32,210	18,129		
Total	\$ 154,269	\$ 138,248		

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

	June 29, 2012	Dec 30, 2011
Finished products and components	\$ 57,781	\$ 51,943
Products and components in various stages of completion	41,333	39,268
Raw materials and purchased components	65,754	54,561
	164,868	145,772
Reduction to LIFO cost	(40,440)	(40,425)
Total	\$ 124,428	\$ 105,347

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

	Estimated Life (years)	Original Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
<b>June 29, 2012</b>					
Customer relationships	2 - 14	\$ 144,425	\$ (35,609)	\$ (5,331)	\$ 103,485
Patents, proprietary technology and product documentation	3 - 11	24,268	(11,751)	(85)	12,432
Trademarks, trade names and other	2 - 3	3,860	(3,723)	-	137
		172,553	(51,083)	(5,416)	116,054
<b>Not Subject to Amortization:</b>					
Brand names		40,580	-	-	40,580
<b>Total</b>		<b>\$ 213,133</b>	<b>\$ (51,083)</b>	<b>\$ (5,416)</b>	<b>\$ 156,634</b>
<b>December 30, 2011</b>					
Customer relationships	2 - 8	\$ 40,925	\$ (30,788)	\$ (181)	\$ 9,956
Patents, proprietary technology and product documentation	3 - 10	14,668	(10,570)	(87)	4,011
Trademarks, trade names and other	2 - 3	6,140	(5,169)	-	971
		61,733	(46,527)	(268)	14,938
<b>Not Subject to Amortization:</b>					
Brand names		3,180	-	-	3,180
<b>Total</b>		<b>\$ 64,913</b>	<b>\$ (46,527)</b>	<b>\$ (268)</b>	<b>\$ 18,118</b>

Amortization of intangibles was \$4.3 million in the second quarter of 2012 and \$6.8 million year-to-date. Estimated annual amortization expense is as follows: \$14.9 million in 2012, \$12.2 million in 2013, \$8.8 million in 2014, \$8.4 million in 2015 and \$8.1 million in 2016 and \$70.5 million thereafter.

Changes in the carrying amount of goodwill in 2012 were as follows (in thousands):

Beginning balance	\$ 93,400
Additions from business acquisitions	78,080
Foreign currency translation	(4,164)
Ending balance	\$ 167,316



See Note 12 for information on the business acquisition that added goodwill and other identifiable intangible assets to the Industrial segment in 2012. The estimated fair values of the assets acquired and liabilities assumed in the acquisition are based on the preliminary results of an independent appraisal, and could be subject to change upon finalization.

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

	June 29, 2012	Dec 30, 2011
Accrued self-insurance retentions	\$ 7,103	\$ 6,563
Accrued warranty and service liabilities	7,850	6,709
Accrued trade promotions	3,640	5,852
Payable for employee stock purchases	3,417	6,607
Customer advances and deferred revenue	12,374	280
Income taxes payable	5,786	2,689
Other	36,144	20,896
 Total other current liabilities	 \$ 76,314	 \$ 49,596

Increases in customer advances and deferred revenue and in other are related to business acquisitions (see note 12).

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):

	Twenty-six Weeks Ended June 29, 2012	Year Ended Dec 30, 2011
Balance, beginning of year	\$ 6,709	\$ 6,862
Assumed in business acquisition	1,121	-
Charged to expense	2,927	5,110
Margin on parts sales reversed	1,413	2,676
Reductions for claims settled	(4,320)	(7,939)
 Balance, end of period	 \$ 7,850	 \$ 6,709

10. The Company accounts for all derivatives, including those embedded in other contracts, as either assets or liabilities and measures those financial instruments at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation.

As part of its risk management program, the Company may periodically use forward exchange contracts and interest rate swaps to manage known market exposures. Terms of derivative instruments are structured to match the terms of the risk being managed and are generally held to maturity. The Company does not hold or issue derivative financial instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales. The Company's policy is to not

enter into contracts with terms that cannot be designated as normal purchases or sales.

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The Company periodically evaluates its monetary asset and liability positions denominated in foreign currencies. The Company enters into forward contracts or options, or borrows in various currencies, in order to hedge its net monetary positions. These instruments are recorded at current market values and the gains and losses are included in other expense (income), net. The notional amount of contracts outstanding as of June 29, 2012 totaled \$26 million. The Company believes it uses strong financial counterparts in these transactions and that the resulting credit risk under these hedging strategies is not significant.

The Company uses significant other observable inputs to value the derivative instruments used to hedge interest rate volatility and net monetary positions, including reference to market prices and financial models that incorporate relevant market assumptions. The fair market value and balance sheet classification of such instruments follows (in thousands):

	Balance Sheet	June 29,	Dec 30,
	Classification	2012	2011
Gain (loss) on foreign currency forward contracts			
Gains		\$ 201	\$ 218
Losses		(234)	(120)
Net	Other current liabilities	\$ (33)	
	Accounts receivable		\$ 98

11. On March 27, 2012, the Company's \$250 million credit agreement was terminated in connection with the execution of an amendment to a new unsecured revolving credit agreement. The new credit agreement is with a syndicate of lenders and expires in March 2017. It provides up to \$450 million of committed credit, available for general corporate purposes, working capital needs, share repurchases and acquisitions. The Company may borrow up to \$50 million under the swingline portion of the facility for daily working capital needs.

Loans denominated in U.S. Dollars bear interest, at the Company's option, at either a base rate or a LIBOR-based rate. Loans denominated in currencies other than U.S. Dollars bear interest at a LIBOR-based rate. The base rate is an annual rate equal to a margin ranging from 0% to 1%, depending on the Company's cash flow leverage ratio (debt to earnings before interest, taxes, depreciation, amortization and extraordinary, non-operating or non-cash charges and expenses), plus the highest of (i) the bank's prime rate, (ii) the federal funds rate plus 0.5% or (iii) one-month LIBOR plus 1.5%. In general, LIBOR-based loans bear interest at LIBOR plus 1% to 2%, depending on the Company's cash flow leverage ratio. The Company is also required to pay a fee on the undrawn amount of the loan commitment at an annual rate ranging from 0.15 percent to 0.40 percent, depending on the Company's cash flow leverage ratio.

In 2011, the Company entered into a note agreement and sold \$300 million of unsecured notes with maturities ranging from 2018 to 2026. The notes have a carrying amount of \$300 million and an estimated fair value of \$330 million as of June 29, 2012. The Company uses significant other observable inputs to estimate fair value based on the present value of future cash flows and rates that would be available for issuance of debt with similar terms and remaining maturities.



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The Company's debt agreements require the Company to maintain certain financial ratios as to cash flow leverage and interest coverage. The Company is in compliance with all financial covenants of its debt agreements.

12. On April 2, 2012, the Company completed the purchase of the finishing businesses of Illinois Tool Works Inc. (the ITW Finishing Group), first announced in April 2011. The acquisition includes powder and liquid finishing equipment operations, technologies and brands. In powder finishing, Graco acquired the Gema® businesses (the Powder Finishing business). Gema is a global leader in powder coating technology, a market in which Graco had no previous product offerings, with global manufacturing and distribution capabilities. Results of the Powder Finishing business, including sales of \$31 million and net operating loss of \$0.2 million, have been included in the Industrial segment since the date of acquisition. In liquid finishing, Graco acquired the Binks® spray finishing equipment businesses, DeVilbiss® spray guns and accessories businesses, Ransburg® electrostatic equipment and accessories businesses, and BGK curing technology businesses (collectively known as the Liquid Finishing business or the Hold Separate business).

Sales of the ITW Finishing Group were \$375 million in 2011, of which Powder Finishing contributed approximately one-third and Liquid Finishing contributed two-thirds. Acquisition-related expenses of \$8 million in 2011 and \$11 million in 2012 year-to-date are included in general and administrative expense in the Company's consolidated statements of earnings.

In December 2011, the United States Federal Trade Commission (FTC) filed a formal complaint to challenge the proposed acquisition on the grounds that the addition of the Liquid Finishing business to Graco would be anti-competitive, a position which Graco denied. In March 2012, the FTC issued an order (the Hold Separate Order) that allowed the acquisition to proceed to closing on April 2, 2012, subject to certain conditions, while it evaluated a settlement proposal from Graco. Pursuant to the Hold Separate Order, the Liquid Finishing business was to be held separate from the rest of Graco's businesses until the FTC determined which portions, if any, of the Liquid Finishing business Graco must divest.

In May 2012, the FTC issued a proposed decision and order (the Decision and Order), subject to a 30-day comment period, which requires Graco to sell the Liquid Finishing business assets, including business activities related to the development, manufacture, and sale of products under the Binks, DeVilbiss, Ransburg and BGK brand names, no later than 180 days from the date the order becomes final. The FTC has not yet issued its final Decision and Order.

The Company has retained the services of an investment bank to help it market the Liquid Finishing business and identify potential buyers. While it seeks a buyer, Graco must continue to hold the Liquid Finishing business assets separate from its other businesses and maintain them as viable and competitive. In accordance with the Hold Separate Order, the Liquid Finishing business is managed independently by experienced Liquid Finishing business managers, under the supervision of a trustee appointed by the FTC, who reports directly to the FTC.

The Hold Separate Order requires the Company to provide sufficient resources to maintain the viability, competitiveness and marketability of the Liquid Finishing

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business, including general funds, capital, working capital and reimbursement of losses. To the extent that the Liquid Finishing business generates funds in excess of financial resources needed, the Company has access to such funds consistent with practices in place prior to the acquisition.

As a result of the Hold Separate Order, we do not have the power to direct the activities of the Liquid Finishing businesses that most significantly impact the economic performance of those businesses. Therefore, we have determined that the Liquid Finishing businesses are variable interest entities for which the Company is not the primary beneficiary, and that they should not be consolidated. Under terms of the Hold Separate Order, the Company does not have a controlling interest in the Liquid Finishing business, nor is it able to exert significant influence over the Liquid Finishing business. Consequently, the Company's investment in the shares of the Liquid Finishing business, totaling \$427 million, has been reflected as a cost-method investment on our Consolidated Balance Sheet as of June 29, 2012, and its results of operations have not been consolidated with those of the Company. The Company's maximum exposure to loss as a result of its involvement with the Liquid Finishing business would include the entirety of its investment of \$427 million and reimbursement of losses of the operations of the Liquid Finishing business in accordance with the Hold Separate Order, which cannot be quantified. For the quarter ended June 29, 2012, the operating earnings of the Liquid Finishing business were \$13 million and no additional financial resources were required to be funded by the Company. As a cost-method investment, income is recognized based on dividends received from current earnings of Liquid Finishing. Dividends of \$4 million received in the second quarter ended June 29, 2012 are included in other expense (income) on the Consolidated Statements of Earnings for the quarter ended June 29, 2012. The Company will evaluate its cost-method investment for other-than-temporary impairment at each reporting period. As of June 29, 2012, the Company evaluated its investment in Liquid Finishing and determined that there is no impairment.

Sales and operating earnings of the Liquid Finishing business were as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net Sales	\$ 66,608	\$ 63,556	\$ 133,758	\$ 122,850
Operating Earnings	12,801	12,909	24,384	22,887

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The Company transferred cash purchase consideration of \$660 million to the seller on April 2, 2012. In July 2012, the Company transferred additional cash purchase consideration of \$8 million, representing the difference between cash balances acquired and the amount estimated at the time of closing. Total purchase consideration was allocated to assets acquired and liabilities assumed based on preliminary estimated fair values as follows (in thousands):

Cash and cash equivalents	\$	6,007
Accounts receivable		17,835
Inventories		21,733
Other current assets		2,534
Property, plant and equipment		18,359
Other non-current assets		50
Identifiable intangible assets		150,500
Goodwill		78,080
<b>Total assets acquired</b>		<b>295,098</b>
Current liabilities assumed		(27,434)
Non-current liabilities assumed		(7,942)
Deferred income taxes		(18,171)
<b>Net assets acquired, Powder Finishing</b>		<b>241,551</b>
Investment in businesses held separate		426,813
<b>Total purchase consideration</b>	<b>\$</b>	<b>668,364</b>

The estimated fair values of the assets acquired and liabilities assumed are based on the preliminary results of an independent appraisal, and could be subject to change upon finalization.

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

		Estimated Life (years)
Customer relationships	\$ 103,500	14
Developed technology	9,600	11
Trade names	37,400	Indefinite
<b>Total identifiable intangible assets</b>	<b>\$ 150,500</b>	



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The following pro forma information reflects the combined results of Graco and Powder Finishing operations as if the acquisition had occurred at the beginning of 2011 (in thousands, except per share amounts):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net Sales	\$ 268,184	\$ 266,949	\$ 535,300	\$ 516,124
Operating Earnings	66,896	65,296	133,203	118,901
Net Earnings	39,726	40,793	80,074	73,002
Basic earnings per share	0.66	0.67	1.33	1.21
Diluted earnings per share	0.64	0.66	1.30	1.18

Additional depreciation and amortization of \$2 million per quarter are reflected in the pro forma results as if the acquisition of Powder Finishing had occurred at the beginning of 2011. Non-recurring acquisition expenses of \$7 million for the second quarter and \$11 million year-to-date were eliminated from the 2012 pro forma results, and \$3 million were eliminated from pro forma results for the quarter and year-to-date 2011. Purchase accounting effects of \$7 million related to inventory were removed from the second quarter and year-to-date 2012 and reflected in 2011.

To the extent that the Liquid Finishing business generates funds in excess of financial resources needed, the Company has access to such funds consistent with practices in place prior to the acquisition. Net earnings of the Liquid Finishing business, from which dividends could have been paid, subject to funds availability, were \$7 million and \$15 million for the quarter and year-to-date, respectively, in 2012, and \$8 million and \$15 million for the quarter and year-to-date, respectively, in 2011. For pro forma purposes, dividend income from Liquid Finishing of \$4 million was eliminated from other income in the second quarter of 2012.

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**Item 2.**

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

**Overview**

The Company designs, manufactures and markets systems and equipment to move, measure, control, dispense and spray fluid materials. Management classifies the Company's business into three reportable segments: Industrial, Contractor and Lubrication. Key strategies include developing and marketing new products, expanding distribution globally, opening new markets with technology and channel expansion and completing strategic acquisitions.

The following Management's Discussion and Analysis reviews significant factors affecting the Company's results of operations and financial condition. This discussion should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

**Acquisition**

On April 2, 2012, the Company completed the purchase of the finishing businesses of Illinois Tool Works Inc. (the Finishing Brands acquisition), first announced in April 2011. The acquisition includes powder ( Powder Finishing ) and liquid ( Liquid Finishing ) equipment operations, technologies and brands. In Powder Finishing, Graco acquired the Gema® businesses. Gema is a global leader in powder coating technology, a market in which Graco had no previous product offerings. Results of the Powder Finishing business have been included in the Industrial segment since the date of acquisition. In Liquid Finishing, Graco acquired the Binks® spray finishing equipment businesses, DeVilbiss® spray guns and accessories businesses, Ransburg® electrostatic equipment and accessories businesses, and BGK curing technology.

In December 2011, the United States Federal Trade Commission ( FTC ) filed a formal complaint to challenge the proposed acquisition on the grounds that the addition of the Liquid Finishing business to Graco would be anti-competitive, a position which Graco denied. In March 2012, the FTC issued an order (the Hold Separate Order ) that allowed the acquisition to proceed to closing on April 2, 2012, subject to certain conditions while it evaluated a settlement proposal from Graco. Pursuant to the Hold Separate Order, the Liquid Finishing business was to be held separate from the rest of Graco's businesses until the FTC determined which portions, if any, of the Liquid Finishing business Graco must divest.

In May 2012, the FTC issued a proposed decision and order (the Decision and Order ), subject to a 30-day comment period, which requires Graco to sell the Liquid Finishing business assets, including business activities related to the development, manufacture, and sale of products under the Binks, DeVilbiss, Ransburg and BGK brand names, no later than 180 days from the date the order becomes final. The FTC has not yet issued its final Decision and Order.

The Company has retained the services of an investment bank to help it market the Liquid Finishing business and identify potential buyers. While it seeks a buyer, Graco must continue to hold the Liquid Finishing business assets separate from its other businesses and maintain them as viable and competitive. In accordance with the Hold Separate Order, the Liquid Finishing business is managed independently by experienced Liquid Finishing business

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managers, under the supervision of a trustee appointed by the FTC, who reports directly to the FTC.

As a result of the Hold Separate Order, we have determined that the Liquid Finishing businesses are variable interest entities for which the Company is not the primary beneficiary, and that they should not be consolidated. Under terms of the Hold Separate Order, the Company does not have a controlling interest in the Liquid Finishing business, nor is it able to exert significant influence over the Liquid Finishing business. Consequently, the Company's investment in the shares of the Liquid Finishing business has been reflected as a cost-method investment on our Consolidated Balance Sheet as of June 29, 2012, and its results of operations have not been consolidated with those of the Company. As a cost-method investment, income is recognized based on dividends received from current earnings of Liquid Finishing. Dividends of \$4 million received in the second quarter ended June 29, 2012 are included in other expense (income) on the Consolidated Statements of Earnings for the quarter ended June 29, 2012. The Company will evaluate its cost-method investment for other-than-temporary impairment at each reporting period. As of June 29, 2012, the Company evaluated its investment in Liquid Finishing and determined that there is no impairment.

**Consolidated Results**

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 29, 2012	July 1, 2011	% Change	June 29, 2012	July 1, 2011	% Change
Net Sales	\$ 268.2	\$ 234.7	14%	\$ 502.3	\$ 452.3	11%
Net Earnings	\$ 34.4	\$ 38.1	(10)%	\$ 69.7	\$ 75.4	(7)%
Diluted Net Earnings per Common Share	\$ 0.56	\$ 0.61	(8)%	\$ 1.13	\$ 1.22	(7)%

The completion of the Finishing Brands acquisition and changes in currency translation rates had significant impacts on the quarter and year-to-date financial results.

Powder Finishing contributed \$31 million of sales, accounting for most of the increase for the quarter. Year-to-date sales were up 11 percent from last year, with 7 percentage points of the growth from the addition of Powder Finishing. Costs and expenses related to the acquisition led to lower operating earnings compared to last year.

Changes in currency translation rates decreased sales by approximately \$7 million for the quarter and \$8 million year-to-date, and decreased net earnings by approximately \$3 million for both the quarter and year-to-date.

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The following table presents components of changes in sales:

	Quarter						
	Segment			Region			
	Industrial	Contractor	Lubrication	Americas	Europe	Asia Pacific	Total
Volume and Price	1 %	4 %	15 %	7 %	(1) %	(2) %	3 %
Acquisitions	24 %	- %	- %	5 %	30 %	18 %	14 %
Currency	(3) %	(2) %	(2) %	- %	(10) %	(2) %	(3) %
Total	22 %	2 %	13 %	12 %	19 %	14 %	14 %

	Year-to-Date						
	Segment			Region			
	Industrial	Contractor	Lubrication	Americas	Europe	Asia Pacific	Total
Volume and Price	5 %	4 %	14 %	8 %	3 %	3 %	6 %
Acquisitions	13 %	- %	- %	3 %	15 %	9 %	7 %
Currency	(2) %	(2) %	(1) %	(1) %	(7) %	- %	(2) %
Total	16 %	2 %	13 %	10 %	11 %	12 %	11 %

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Americas <sup>1</sup>	\$ 140.6	\$ 125.7	\$ 266.6	\$ 241.3
Europe <sup>2</sup>	69.4	58.0	124.1	111.3
Asia Pacific	58.2	51.0	111.6	99.7
Consolidated	\$ 268.2	\$ 234.7	\$ 502.3	\$ 452.3

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

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

Sales included \$31 million from the Powder Finishing operations acquired at the beginning of April, including \$6 million in the Americas, \$16 million in Europe and \$9 million in Asia Pacific. Sales growth at consistent translation rates and before acquisitions was 7 percent for the quarter in the Americas and down slightly in Europe and Asia Pacific. On the same basis, sales growth was 8 percent year-to-date in the Americas and 3 percent in both Europe and

Asia Pacific.

Gross profit margin, expressed as a percentage of sales, was 52 percent for the quarter and 54 percent year-to-date, down 4 percentage points from the second quarter last year and 3 percentage points lower than last year-to-date. Non-recurring purchase accounting effects totaling \$7 million related to inventory reduced the margin rate by approximately 3 percentage points for the quarter and 1 <sup>1</sup>/<sub>2</sub> points year-to-date. Unfavorable currency translation effects reduced the margin rate by approximately 1 percentage point for both the quarter and year-to-date.

Total operating expenses increased \$13 million for the quarter and \$20 million year-to-date. Powder Finishing operations accounted for \$8 million of the quarter and year-to-date increases.

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Acquisition expenses accounted for another \$5 million of the increase for the quarter and \$9 million of the year-to-date increase.

Interest expense increased \$4 million for the quarter and \$7 million year-to-date due to higher borrowing levels. Other expense (income) includes \$4 million of dividends received from the Liquid Finishing business that is required to be held separate from the Company's other businesses and accounted for as a cost-method investment.

The effective income tax rates of 32 percent for the quarter and 33 percent for the year-to-date are consistent with the comparable periods last year. This year's rate is reduced by the effect of the investment income from the Liquid Finishing business held separate. Last year's rate was reduced by the effect of the federal R&D credit that is not available in 2012.

**Segment Results**

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

**Industrial**

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
Net sales (in millions)				
Americas	\$ 65.6	\$ 55.9	\$ 125.0	\$ 108.8
Europe	49.9	36.1	86.7	70.5
Asia Pacific	42.7	37.3	80.6	72.8
<b>Total</b>	<b>\$ 158.2</b>	<b>\$ 129.3</b>	<b>\$ 292.3</b>	<b>\$ 252.1</b>
Operating earnings as a percentage of net sales	27 %	35 %	31 %	36 %

Industrial segment sales increased 22 percent for the quarter and 16 percent year-to-date, mostly from the addition of Powder Finishing operations. Without Powder Finishing, sales for the quarter increased 6 percent in the Americas, decreased 6 percent in Europe (1 percent increase at consistent translation rates) and decreased 9 percent in Asia Pacific. On the same basis, year-to-date sales increased 9 percent in the Americas, were flat in Europe (6 percent increase at consistent translation rates) and decreased 1 percent in Asia Pacific. Purchase accounting effects related to inventory reduced the operating margin for the quarter by approximately 4 percentage points. Intangibles amortization charges and changes in currency translation also adversely affected operating earnings in the Industrial segment.

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	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
<b>Net sales (in millions)</b>				
Americas	\$ 54.6	\$ 52.5	\$ 100.8	\$ 97.4
Europe	17.2	19.6	33.2	36.3
Asia Pacific	10.3	8.6	20.1	17.2
<b>Total</b>	<b>\$ 82.1</b>	<b>\$ 80.7</b>	<b>\$ 154.1</b>	<b>\$ 150.9</b>
Operating earnings as a percentage of net sales	22 %	20 %	20 %	18 %

Contractor segment sales increased 2 percent for both the quarter and year-to-date, with gains for the quarter of 4 percent in the Americas and 21 percent in Asia Pacific. Contractor sales for the quarter were down 12 percent in Europe (5 percent at consistent translation rates) compared to the second quarter last year. Year-to-date sales increased 3 percent in the Americas, decreased 9 percent in Europe (3 percent at consistent translation rates) and increased 17 percent in Asia Pacific. Product display and store set costs incurred in 2011 were not repeated in 2012, leading to reduced selling, marketing and distribution expenses and improved operating earnings in this segment.

**Lubrication**

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 29, 2012	July 1, 2011	June 29, 2012	July 1, 2011
<b>Net sales (in millions)</b>				
Americas	\$ 20.5	\$ 17.2	\$ 40.8	\$ 35.0
Europe	2.3	2.3	4.2	4.5
Asia Pacific	5.1	5.2	10.9	9.8
<b>Total</b>	<b>\$ 27.9</b>	<b>\$ 24.7</b>	<b>\$ 55.9</b>	<b>\$ 49.3</b>
Operating earnings as a percentage of net sales	20 %	16 %	21 %	19 %

Lubrication segment sales increased 13 percent for both the quarter and year-to-date, with 19 percent growth for the quarter in the Americas. Sales for the quarter were flat in Europe (6 percent increase at consistent translation rates) and in Asia Pacific. Year-to-date, sales increased 16 percent in the Americas, decreased 7 percent in Europe (3 percent at consistent translation rates) and increased 12 percent in Asia Pacific. Higher volume and leveraging of expenses led to improved operating earnings in the Lubrication segment.

**Liquidity and Capital Resources**

Net cash provided by operating activities was \$65 million in 2012 and \$44 million in 2011. Inventory levels stabilized in the first half of 2012 after increasing in 2011. Increases in receivables moderated compared to the first half of last year.



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On March 27, 2012, the Company's \$250 million credit agreement was terminated in connection with the execution of a new unsecured revolving credit agreement. The new credit agreement is with a syndicate of lenders and expires in March 2017. It provides up to \$450 million of committed credit, available for general corporate purposes, working capital needs, share repurchases and acquisitions. The Company may borrow up to \$50 million under the swingline portion of the facility for daily working capital needs.

Loans denominated in U.S. Dollars bear interest, at the Company's option, at either a base rate or a LIBOR-based rate. Loans denominated in currencies other than U.S. Dollars bear interest at a LIBOR-based rate. The base rate is an annual rate equal to a margin ranging from 0% to 1%, depending on the Company's cash flow leverage ratio (debt to earnings before interest, taxes, depreciation, amortization and extraordinary, non-operating or non-cash charges and expenses), plus the highest of (i) the bank's prime rate, (ii) the federal funds rate plus 0.5% or (iii) one-month LIBOR plus 1.5%. In general, LIBOR-based loans bear interest at LIBOR plus 1% to 2%, depending on the Company's cash flow leverage ratio. The Company is also required to pay a fee on the undrawn amount of the loan commitment at an annual rate ranging from 0.15 percent to 0.40 percent, depending on the Company's cash flow leverage ratio.

The agreement requires the Company to maintain certain financial ratios as to cash flow leverage and interest coverage. The Company is in compliance with all financial covenants of its debt agreements.

On April 2, 2012, the Company paid \$660 million to complete the Finishing Brands acquisition, using available cash and \$350 million of borrowings on the new credit agreement. In July 2012, the Company made an additional payment of \$8 million, representing the difference between cash balances acquired and the amount estimated at the time of closing. Assets acquired in the acquisition included \$18 million of cash, of which \$6 million was available to Powder Finishing operations.

Under terms of the FTC's Hold Separate Order, the Company is required to provide sufficient resources to maintain the viability, competitiveness and marketability of the Liquid Finishing business, including general funds, capital, working capital and reimbursement of losses. To the extent that the Liquid Finishing business generates funds in excess of financial resources needed, the Company has access to such funds consistent with practices in place prior to the acquisition. In the second quarter, the Company received \$4 million of dividends from current earnings of the Liquid Finishing business.

While the FTC has not yet issued a final Decision and Order requiring the Company to divest the Liquid Finishing business, the Company has retained the services of an investment bank to help it market the business and identify potential buyers. The Company believes its investment in the Liquid Finishing business, carried at a cost of \$427 million, is not impaired.

At June 29, 2012, the Company had various lines of credit totaling \$469 million, of which \$137 million was unused. Internally generated funds and unused financing sources are expected to provide the Company with the flexibility to meet its liquidity needs in 2012, including the needs of the Powder Finishing and Liquid Finishing businesses acquired in April 2012.

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### **Outlook**

Management is optimistic that all business segments will show organic growth in the second half of 2012 on a constant currency basis, despite headwinds from Western Europe, China and India. The demand environment in the Americas is expected to remain favorable in all business segments in the second half. In Europe, continued unfavorable currency translation rates may drive year-over-year growth rates into negative territory. Growth in the developing economies of Asia Pacific, along with continued demand for Contractor and Lubrication products in the region, is expected to more than offset continued softness in industrial project activity in China. Management remains focused on executing core strategies to deliver long-term shareholder returns.

### **SAFE HARBOR CAUTIONARY STATEMENT**

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, as well as in press or earnings releases, analyst briefings, conference calls and the Company's Overview report to shareholders, 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 undertakes no obligation to update these statements in light of new information or future events.

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. In addition, risk factors related to the Company's acquisition of the ITW finishing businesses include: to what extent or when the required regulatory approvals will be obtained, whether and when the Company will be able to realize the expected financial results and accretive effect of the transaction, how customers, competitors, suppliers and employees will react to the transaction, economic changes in global markets, the extent of the acquired businesses required to be divested, whether the Company will be able to find a suitable purchaser(s) and structure the divestiture on acceptable terms, and whether the Company will be able to complete a divestiture in a time frame that is satisfactory to the Federal Trade Commission. Please refer to Item 1A of, and Exhibit 99 to, the Company's Annual Report on Form 10-K for fiscal year 2011 and Item 1A of this Quarterly Report on Form 10-Q 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.

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**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 2011 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, 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.

**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.

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## **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 2011 Annual Report on Form 10-K, except for changes in the status of the previously proposed (now completed) acquisition, as described below:

#### **Acquisition - Our acquisition of the finishing business operations of Illinois Tool Works Inc. is subject to regulatory approvals and the expected benefits from the acquisition may not be fully realized.**

On April 2, 2012, the Company closed on its \$650 million acquisition of the Illinois Tool Works Inc. finishing businesses. The acquisition added Gema®, a global leader in powder coating technology, which represented approximately one-third of the purchase. The remaining two-thirds of the acquisition is a collection of industrial liquid finishing businesses, which the United States Federal Trade Commission (FTC) has ordered to be held separate from Gema and other Graco businesses while the FTC investigates and considers a settlement proposal from Graco. In compliance with the FTC's order, the industrial liquid finishing businesses are being run independently by existing management under the supervision of a trustee who reports directly to the FTC.

In May 2012, the FTC issued a proposed decision and order (the Decision and Order), subject to a 30-day comment period, which requires Graco to sell the Liquid Finishing business assets, including business activities related to the development, manufacture, and sale of products under the Binks, DeVilbiss, Ransburg and BGK brand names, no later than 180 days from the date the order becomes final. The FTC has not yet issued its final Decision and Order.

The Company has retained the services of an investment bank to help it market the Liquid Finishing business and identify potential buyers. While it seeks a buyer, Graco must continue to hold the Liquid Finishing business assets separate from its other businesses and maintain them as viable and competitive.

The Hold Separate Order requires the Company to provide sufficient resources to maintain the viability, competitiveness and marketability of the Liquid Finishing business, including general funds, capital, working capital and reimbursement of losses.

We cannot predict to what extent or when the required regulatory approvals will be obtained. Additional risk factors include: the extent of the acquired businesses required to be divested, whether the Company will be able to find a suitable purchaser(s) and structure the divestiture on acceptable terms, and whether the Company will be able to complete a divestiture in a time frame that is satisfactory to the FTC.

Significant changes to our financial condition as a result of global economic changes or difficulties in the integration or addition of the newly acquired businesses, including how customers, competitors, suppliers and employees react to the transaction, may affect our ability to obtain the expected benefits from the transaction or to satisfy the financial covenants included in the terms of the financing arrangements.

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

On September 18, 2009, the Board of Directors authorized the Company to purchase up to 6,000,000 shares of its outstanding common stock, primarily through open-market transactions. The authorization expires on September 30, 2012.

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.

No shares were purchased in the second quarter of 2012. As of June 29, 2012, there were 3,990,978 shares that may yet be purchased under the Board authorization.

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**Item 6. Exhibits**

- 3.1 Restated Articles of Incorporation as amended June 14, 2007. (Incorporated by reference to Exhibit 3.1 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2007.)
- 3.2 Restated Bylaws as amended June 13, 2002. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)
- 3.3 Articles of Amendment of Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Shares. (Incorporated by reference to Exhibit 2 to the Company's Registration Statement on Form 8-A filed February 16, 2010.)
- 4.1 Rights Agreement, dated as of February 12, 2010, between the Company and Wells Fargo Bank, N.A., as Rights Agent. (Incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A filed February 16, 2010.)
- 10.1 Amendment No. 2 dated as of April 2, 2012 to Pledge Agreement dated as of May 23, 2011.
- 10.2 Amendment No. 3 dated as of April 13, 2012 to Pledge Agreement dated as of May 23, 2011.
- 10.3 Graco Inc. Incentive Bonus Plan. (Incorporated by reference to Appendix A to the Company's Definitive Proxy Statement on Schedule 14A filed March 7, 2012.)
- 10.4 Agreement Containing Consent Orders. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 8-K filed June 6, 2012.)
- 31.1 Certification of President and Chief Executive Officer pursuant to Rule 13a-14(a).
- 31.2 Certification of Chief Financial Officer pursuant to rule 13a-14(a).
- 32 Certification of President and Chief Executive Officer and Chief Financial Officer pursuant to Section 1350 of Title 18, U.S.C.
- 101 Interactive Data File.

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## 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: July 26, 2012

By: /s/ Patrick J. McHale  
Patrick J. McHale  
President and Chief Executive Officer  
*(Principal Executive Officer)*

Date: July 26, 2012

By: /s/ James A. Graner  
James A. Graner  
Chief Financial Officer  
*(Principal Financial Officer)*

Date: July 26, 2012

By: /s/ Caroline M. Chambers  
Caroline M. Chambers  
Vice President and Controller  
*(Principal Accounting Officer)*