

GRACO INC  
Form 10-Q  
October 24, 2007

**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 **September 28, 2007**

Commission File Number: 001-9249

**GRACO INC.**

\_\_\_\_\_  
(Exact name of registrant as specified in its charter)

\_\_\_\_\_  
Minnesota

\_\_\_\_\_  
(State of incorporation)

\_\_\_\_\_  
41-0285640

\_\_\_\_\_  
(I.R.S. Employer Identification Number)

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

\_\_\_\_\_  
(Address of principal executive offices)

\_\_\_\_\_  
55413

\_\_\_\_\_  
(Zip Code)

\_\_\_\_\_  
(612) 623-6000

\_\_\_\_\_  
(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

Large Accelerated Filer ☒ Accelerated Filer ☐ Non-accelerated Filer ☐

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

Yes ☐ No ☒

62,893,000 shares of the Registrant's Common Stock, \$1.00 par value were outstanding as of October 18, 2007.

**GRACO INC. AND SUBSIDIARIES****INDEX**

	<u>Page Number</u>
<b>PART I FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	
Consolidated Statements of Earnings	3
Consolidated Balance Sheets	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6-13
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	14-17
Item 3. Quantitative and Qualitative Disclosures About Market Risk	18
Item 4. Controls and Procedures	18
<b>PART II OTHER INFORMATION</b>	
Item 1A. Risk Factors	19
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	19
Item 4. Submission of Matters to a Vote of Security Holders	20
Item 6. Exhibits	20

**SIGNATURES****EXHIBITS****PART I****Item 1.**

**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS**  
(Unaudited)  
(In thousands, except per share amounts)

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	Sep 28, 2007	Sep 29, 2006	Sep 28, 2007	Sep 29, 2006
Net Sales	\$ 207,270	\$ 202,199	\$ 636,149	\$ 613,047
Cost of products sold	96,624	95,588	298,409	286,263
Gross Profit	110,646	106,611	337,740	326,784

**INDEX**

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Product development	7,087	7,487	22,903	22,237
Selling, marketing and distribution	30,382	29,081	91,562	87,547
General and administrative	14,641	15,039	44,938	43,516
	-	-	-	-
Operating Earnings	58,536	55,004	178,337	173,484
Interest expense	1,034	342	1,934	656
Other expense, net	39	170	25	179
	-	-	-	-
Earnings Before Income Taxes	57,463	54,492	176,378	172,649
Income Taxes	18,200	17,100	59,200	58,500
	-	-	-	-
Net Earnings	\$ 39,263	\$ 37,392	\$ 117,178	\$ 114,149
	-	-	-	-
Basic Net Earnings per Common Share	\$ 0.61	\$ 0.55	\$ 1.78	\$ 1.68
Diluted Net Earnings per Common Share	\$ 0.60	\$ 0.54	\$ 1.75	\$ 1.65
Cash Dividends Declared per Common Share	\$ 0.17	\$ 0.15	\$ 0.50	\$ 0.44

See notes to consolidated financial statements.

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

	<u>Sep 28, 2007</u>	<u>Dec. 29, 2006</u>
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 9,771	\$ 5,871
Accounts receivable, less allowances of \$6,800 and \$5,800	145,021	134,105
Inventories	77,592	76,311
Deferred income taxes	20,708	20,682
Other current assets	3,267	2,014
	-	-
Total current assets	256,359	238,983
Property, Plant and Equipment		
Cost	300,362	278,318
Accumulated depreciation	(162,937)	(153,794)
	-	-
Total property, plant and equipment, net	137,425	124,524

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Prepaid Pension	29,261	26,903
Goodwill	67,230	67,174
Other Intangible Assets, net	44,103	50,325
Other Assets	6,382	3,694
	<hr/>	<hr/>
Total Assets	\$ 540,760	\$ 511,603
	<hr/>	<hr/>

## LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities		
Notes payable to banks	\$ 17,324	\$ 18,363
Trade accounts payable	31,706	27,442
Salaries, wages and commissions	19,071	26,303
Dividends payable	10,503	11,055
Other current liabilities	41,794	45,766
	<hr/>	<hr/>
Total current liabilities	120,398	128,929
Long-term Debt	85,680	
Retirement Benefits and Deferred Compensation	38,009	36,946
Uncertain Tax Positions	5,200	
Deferred Income Taxes	11,626	14,724
Shareholders' Equity		
Common stock	63,485	66,805
Additional paid-in-capital	155,406	130,621
Retained earnings	65,813	138,702
Accumulated other comprehensive income (loss)	(4,857)	(5,124)
	<hr/>	<hr/>
Total shareholders' equity	279,847	331,004
	<hr/>	<hr/>
Total Liabilities and Shareholders' Equity	\$ 540,760	\$ 511,603
	<hr/>	<hr/>

See notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>
<b>Cash Flows from Operating Activities</b>		
Net Earnings	\$ 117,178	\$ 114,149
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	20,770	19,031
Deferred income taxes	(3,059)	(5,975)
Share-based compensation	6,297	6,508
Excess tax benefit related to share-based payment arrangements	(4,154)	(2,500)
Change in:		
Accounts receivable	(7,383)	(3,965)
Inventories	(907)	(14,487)
Trade accounts payable	(1,477)	2,383
Salaries, wages and commissions	(7,697)	(1,484)
Retirement benefits and deferred compensation	(1,848)	299
Other accrued liabilities	6,150	2,328
Other	(1,589)	702

	-		-
<b>Net cash provided by operating activities</b>	<u>122,281</u>		<u>116,989</u>
	-		-
<b>Cash Flows from Investing Activities</b>			
Property, plant and equipment additions	(28,207)		(22,117)
Proceeds from sale of property, plant and equipment	207		101
Investment in life insurance	(1,499)		
Capitalized software and other intangible asset additions	(43)		(200)
Acquisition of business, net of cash acquired			(31,067)
	-		-
<b>Net cash used in investing activities</b>	<u>(29,542)</u>		<u>(53,283)</u>
	-		-
<b>Cash Flows from Financing Activities</b>			
Borrowings on notes payable and lines of credit	100,210		42,834
Payments on notes payable and lines of credit	(101,914)		(29,320)
Borrowings on long-term line of credit	85,680		
Excess tax benefit related to share-based payment arrangements	4,154		2,500
Common stock issued	22,545		11,540
Common stock retired	(164,910)		(69,754)
Cash dividends paid	(32,800)		(29,679)
	-		-
<b>Net cash provided by (used in) financing activities</b>	<u>(87,035)</u>		<u>(71,879)</u>
	-		-
Effect of exchange rate changes on cash	(1,804)		(1,299)
	-		-
Net increase (decrease) in cash and cash equivalents	3,900		(9,472)
Cash and cash equivalents			
Beginning of year	5,871		18,664
	-		-
End of period	<u>\$ 9,771</u>		<u>\$ 9,192</u>
	-		-

See notes to consolidated financial statements.

## GRACO INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

- The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 28, 2007 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 28, 2007 and September 29, 2006, and cash flows for the thirty-nine weeks ended September 28, 2007 and September 29, 2006 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 September 28, 2007, 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 consolidated financial statements and notes thereto included in the Company's 2006 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):

	<u>Thirteen Weeks Ended</u>		<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>
Net earnings available to common shareholders	\$ 39,263	\$ 37,392	\$ 117,178	\$ 114,149
Weighted average shares outstanding for basic earnings per share	64,797	67,576	65,836	68,042
Dilutive effect of stock options computed using the treasury stock method and the average market price	921	1,135	998	1,151
Weighted average shares outstanding for diluted earnings per share	65,718	68,711	66,834	69,193
Basic earnings per share	\$ 0.61	\$ 0.55	\$ 1.78	\$ 1.68
Diluted earnings per share	\$ 0.60	\$ 0.54	\$ 1.75	\$ 1.65

Stock options to purchase 1,043,000 and 1,030,000 shares were outstanding as of September 28, 2007 and September 29, 2006, respectively, but were not included in the computations of diluted earnings per share because the effect of including them would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirty-nine weeks ended September 28, 2007 is shown below (in thousands, except per share amounts):

	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Options Exercisable</u>	<u>Weighted Average Exercise Price</u>
Outstanding, December 29, 2006	3,956	\$ 24.79	2,272	\$ 16.94
Granted	648	41.23		
Exercised	(779)	19.63		
Canceled	(371)	39.01		
Outstanding, September 28, 2007	<u>3,454</u>	<u>\$ 27.51</u>	<u>2,278</u>	<u>\$ 21.44</u>

The aggregate intrinsic value of exercisable option shares was \$40.5 million as of September 28, 2007, with a weighted average contractual term of 4.8 years. There were approximately 3.4 million vested share options and share options expected to vest as of September 28, 2007, with an aggregate intrinsic value of \$42.1 million, a weighted average exercise price of \$27.23 and a weighted average contractual term of 6.0 years.

Information related to options exercised in the first nine months of 2007 and 2006 follows (in thousands):

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>
Cash received	\$15,290	\$4,516
Aggregate intrinsic value	16,625	8,204

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Tax benefit realized	6,200	3,000
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The Company recognized year-to-date share-based compensation of \$6.3 million in 2007 and \$6.5 million in 2006. As of September 28, 2007, there was \$10.6 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 2.2 years.

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

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>
Expected life in years	6.0	6.3
Interest rate	4.7%	4.6%
Volatility	26.1%	27.8%
Dividend yield	1.6%	1.4%
Weighted average fair value per share	\$12.01	\$12.97

Under the Company's Employee Stock Purchase Plan, the Company issued 202,000 shares in 2007 and 204,000 shares in 2006. 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:

	<u>Thirty-nine Weeks Ended</u>	
	<u>Sep 28, 2007</u>	<u>Sep 29, 2006</u>
Expected life in years	1.0	1.0
Interest rate	4.9%	4.6%
Volatility	24.4%	24.0%
Dividend yield	1.6%	