

GRACO INC
Form 10-Q
October 22, 2014
Table of Contents

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 26, 2014**

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 - 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 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).

Yes X No _____

Edgar Filing: GRACO INC - Form 10-Q

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

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

59,469,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of October 15, 2014.

Table of Contents

INDEX

| | <u>Page Number</u> |
|--|--------------------|
| PART I FINANCIAL INFORMATION | |
| Item 1. <u>Financial Statements</u> | |
| <u>Consolidated Statements of Earnings</u> | 3 |
| <u>Consolidated Statements of Comprehensive Income</u> | 3 |
| <u>Consolidated Balance Sheets</u> | 4 |
| <u>Consolidated Statements of Cash Flows</u> | 5 |
| <u>Notes to Consolidated Financial Statements</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 24 |
| Item 4. <u>Controls and Procedures</u> | 24 |
| PART II OTHER INFORMATION | |
| Item 1A. <u>Risk Factors</u> | 25 |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 26 |
| Item 6. <u>Exhibits</u> | 27 |

SIGNATURES

EXHIBITS

Table of Contents**PART I Item 1.****GRACO INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited) (In thousands except per share amounts)

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net Sales | \$ 302,614 | \$ 277,035 | \$ 915,125 | \$ 832,101 |
| Cost of products sold | 136,800 | 126,162 | 413,149 | 371,845 |
| Gross Profit | 165,814 | 150,873 | 501,976 | 460,256 |
| Product development | 13,785 | 12,508 | 40,349 | 37,396 |
| Selling, marketing and distribution | 47,466 | 44,297 | 143,311 | 132,207 |
| General and administrative | 25,656 | 24,342 | 78,856 | 74,213 |
| Operating Earnings | 78,907 | 69,726 | 239,460 | 216,440 |
| Interest expense | 4,566 | 4,450 | 13,830 | 13,837 |
| Other expense (income), net | (8,210) | (8,425) | (22,402) | (23,671) |
| Earnings Before Income Taxes | 82,551 | 73,701 | 248,032 | 226,274 |
| Income taxes | 23,000 | 17,600 | 71,500 | 60,200 |
| Net Earnings | \$ 59,551 | \$ 56,101 | \$ 176,532 | \$ 166,074 |
| Per Common Share | | | | |
| Basic net earnings | \$ 0.99 | \$ 0.91 | \$ 2.92 | \$ 2.71 |
| Diluted net earnings | \$ 0.97 | \$ 0.89 | \$ 2.85 | \$ 2.65 |
| Cash dividends declared | \$ 0.28 | \$ 0.25 | \$ 0.83 | \$ 0.75 |

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net Earnings | \$ 59,551 | \$ 56,101 | \$ 176,532 | \$ 166,074 |

Edgar Filing: GRACO INC - Form 10-Q

| | | | | |
|---|-----------|-----------|------------|------------|
| Other comprehensive income (loss) | | | | |
| Cumulative translation adjustment | (12,888) | 8,866 | (14,882) | 3,011 |
| Pension and postretirement medical liability adjustment | 1,463 | 2,304 | 3,876 | 7,090 |
| Income taxes | | | | |
| Pension and postretirement medical liability adjustment | (490) | (835) | (1,354) | (2,555) |
| Other comprehensive income (loss) | (11,915) | 10,335 | (12,360) | 7,546 |
| Comprehensive Income | \$ 47,636 | \$ 66,436 | \$ 164,172 | \$ 173,620 |

See notes to consolidated financial statements.

Table of Contents

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

| | Sep 26, 2014 | Dec 27, 2013 |
|---|---------------------|---------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 28,737 | \$ 19,756 |
| Accounts receivable, less allowances of \$6,900 and \$6,300 | 214,670 | 183,293 |
| Inventories | 149,023 | 133,787 |
| Deferred income taxes | 21,338 | 18,827 |
| Investment in businesses held separate | 421,767 | 422,297 |
| Other current assets | 8,976 | 14,633 |
| Total current assets | 844,511 | 792,593 |
| Property, Plant and Equipment | | |
| Cost | 429,430 | 407,887 |
| Accumulated depreciation | (269,835) | (256,170) |
| Property, plant and equipment, net | 159,595 | 151,717 |
| Goodwill | 221,737 | 189,967 |
| Other Intangible Assets, net | 153,206 | 147,940 |
| Deferred Income Taxes | 22,787 | 20,366 |
| Other Assets | 25,982 | 24,645 |
| Total Assets | \$ 1,427,818 | \$ 1,327,228 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Current Liabilities | | |
| Notes payable to banks | \$ 6,161 | \$ 9,584 |
| Trade accounts payable | 37,612 | 34,282 |
| Salaries and incentives | 36,071 | 38,939 |
| Dividends payable | 16,500 | 16,881 |
| Other current liabilities | 63,569 | 69,167 |
| Total current liabilities | 159,913 | 168,853 |
| Long-term Debt | 508,750 | 408,370 |
| Retirement Benefits and Deferred Compensation | 93,480 | 94,705 |
| Deferred Income Taxes | 19,634 | 20,935 |

Edgar Filing: GRACO INC - Form 10-Q

| | | |
|---|----------------|----------------|
| Shareholders' Equity | | |
| Common stock | 59,672 | 61,003 |
| Additional paid-in-capital | 374,628 | 347,058 |
| Retained earnings | 270,450 | 272,653 |
| Accumulated other comprehensive income (loss) | (58,709) | (46,349) |
| Total shareholders' equity | 646,041 | 634,365 |
| | | |
| Total Liabilities and Shareholders' Equity | \$ 1,427,818 | \$ 1,327,228 |

See notes to consolidated financial statements.

Table of Contents

GRACO INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

| | Thirty-nine Weeks Ended | |
|--|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 |
| Cash Flows From Operating Activities | | |
| Net Earnings | \$ 176,532 | \$ 166,074 |
| Adjustments to reconcile net earnings to net cash provided by operating activities | | |
| Depreciation and amortization | 27,621 | 27,748 |
| Deferred income taxes | (7,079) | (5,873) |
| Share-based compensation | 13,810 | 11,178 |
| Excess tax benefit related to share-based payment arrangements | (3,700) | (5,100) |
| Change in | | |
| Accounts receivable | (31,632) | (23,685) |
| Inventories | (12,889) | (11,012) |
| Trade accounts payable | 2,058 | 2,771 |
| Salaries and incentives | (3,323) | 114 |
| Retirement benefits and deferred compensation | 3,813 | 9,819 |
| Other accrued liabilities | 7,661 | 11,189 |
| Other | (2,468) | (2,188) |
| Net cash provided by operating activities | 170,404 | 181,035 |
| Cash Flows From Investing Activities | | |
| Property, plant and equipment additions | (25,284) | (15,218) |
| Acquisition of businesses, net of cash acquired | (65,219) | - |
| Proceeds from sale of assets | - | 1,600 |
| Investment in businesses held separate | 530 | 4,516 |
| Other | (991) | (770) |
| Net cash used in investing activities | (90,964) | (9,872) |
| Cash Flows From Financing Activities | | |
| Borrowings (payments) on short-term lines of credit, net | (3,611) | 1,265 |
| Borrowings on long-term line of credit | 485,230 | 313,560 |
| Payments on long-term line of credit | (384,850) | (465,725) |
| Payments of debt issuance costs | (890) | - |
| Excess tax benefit related to share-based payment arrangements | 3,700 | 5,100 |
| Common stock issued | 21,987 | 33,598 |
| Common stock repurchased | (141,857) | (28,438) |
| Cash dividends paid | (50,007) | (45,834) |

| | | |
|---|--------------|-----------------|
| Net cash provided by (used in) financing activities | (70,298) | (186,474) |
| Effect of exchange rate changes on cash | (161) | 1,458 |
| Net increase (decrease) in cash and cash equivalents | 8,981 | (13,853) |
| Cash and cash equivalents | | |
| Beginning of year | 19,756 | 31,120 |
| End of period | \$ 28,737 | \$ 17,267 |

See notes to consolidated financial statements.

Table of Contents**GRACO INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 26, 2014 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 26, 2014 and September 27, 2013, and cash flows for the thirty-nine weeks ended September 26, 2014 and September 27, 2013 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 the Company as of September 26, 2014, 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 2013 Annual Report on Form 10-K.

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

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net earnings available to common shareholders | \$ 59,551 | \$ 56,101 | \$ 176,532 | \$ 166,074 |
| Weighted average shares outstanding for basic earnings per share | 59,928 | 61,333 | 60,401 | 61,222 |
| Dilutive effect of stock options computed using the treasury stock method and the average market price | 1,614 | 1,663 | 1,602 | 1,526 |
| Weighted average shares outstanding for diluted earnings per share | 61,542 | 62,996 | 62,003 | 62,748 |
| Basic earnings per share | \$ 0.99 | \$ 0.91 | \$ 2.92 | \$ 2.71 |
| Diluted earnings per share | \$ 0.97 | \$ 0.89 | \$ 2.85 | \$ 2.65 |

Table of Contents

Stock options to purchase 617,000 and 387,000 shares were not included in the September 26, 2014 and September 27, 2013 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 thirty-nine weeks ended September 26, 2014 is shown below (in thousands, except per share amounts):

| | Option Shares | Weighted Average Exercise Price | Options Exercisable | Weighted Average Exercise Price |
|---------------------------------|------------------|--|------------------------|--|
| Outstanding, December 27, 2013 | 5,149 | \$ 41.03 | 3,311 | \$ 33.20 |
| Granted | 475 | 74.62 | | |
| Exercised | (358) | 34.15 | | |
| Canceled | (32) | 60.39 | | |
| Outstanding, September 26, 2014 | 5,234 | \$ 44.44 | 3,549 | \$ 34.96 |

The Company recognized year-to-date share-based compensation of \$13.8 million in 2014 and \$11.2 million in 2013. As of September 26, 2014, there was \$16.1 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.8 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:

| | Thirty-nine Weeks Ended | |
|---------------------------------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 |
| Expected life in years | 6.5 | 6.5 |
| Interest rate | 2.0 % | 1.2 % |
| Volatility | 36.1 % | 36.3 % |
| Dividend yield | 1.5 % | 1.7 % |
| Weighted average fair value per share | \$ 24.83 | \$ 18.29 |

Table of Contents

Under the Company's Employee Stock Purchase Plan, the Company issued 193,000 shares in 2014 and 197,000 shares in 2013. 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:

| | Thirty-nine Weeks Ended | |
|---------------------------------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 |
| Expected life in years | 1.0 | 1.0 |
| Interest rate | 0.1 % | 0.2 % |
| Volatility | 21.4 % | 26.0 % |
| Dividend yield | 1.4 % | 1.7 % |
| Weighted average fair value per share | \$ 17.81 | \$ 14.16 |

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Pension Benefits | | | | |
| Service cost | \$ 1,707 | \$ 1,948 | \$ 5,146 | \$ 5,538 |
| Interest cost | 3,909 | 3,627 | 11,985 | 10,625 |
| Expected return on assets | (5,311) | (4,625) | (15,941) | (13,874) |
| Amortization and other | 1,341 | 2,964 | 4,029 | 8,256 |
| Net periodic benefit cost | \$ 1,646 | \$ 3,914 | \$ 5,219 | \$ 10,545 |
| Postretirement Medical | | | | |
| Service cost | \$ 115 | \$ 160 | \$ 365 | \$ 470 |
| Interest cost | 181 | 228 | 736 | 721 |
| Amortization | (229) | (32) | (483) | (134) |
| Net periodic benefit cost | \$ 67 | \$ 356 | \$ 618 | \$ 1,057 |

Table of Contents

5. Changes in components of accumulated other comprehensive income (loss), net of tax were (in thousands):

| | Pension and Post- retirement Medical | Cumulative Translation Adjustment | Total |
|--|---|---|--------------------|
| Thirteen Weeks Ended September 27, 2013 | | | |
| Beginning balance | \$ (76,650) | \$ (9,884) | \$ (86,534) |
| Other comprehensive income before reclassifications | - | 8,866 | 8,866 |
| Amounts reclassified from accumulated other comprehensive income | 1,469 | - | 1,469 |
| Ending balance | \$ (75,181) | \$ (1,018) | \$ (76,199) |
| Thirteen Weeks Ended September 26, 2014 | | | |
| Beginning balance | \$ (48,583) | \$ 1,789 | \$ (46,794) |
| Other comprehensive income before reclassifications | - | (12,888) | (12,888) |
| Amounts reclassified from accumulated other comprehensive income | 973 | - | 973 |
| Ending balance | \$ (47,610) | \$ (11,099) | \$ (58,709) |
| Thirty-nine Weeks Ended September 27, 2013 | | | |
| Beginning balance | \$ (79,716) | \$ (4,029) | \$ (83,745) |
| Other comprehensive income before reclassifications | - | 3,011 | 3,011 |
| Amounts reclassified from accumulated other comprehensive income | 4,535 | - | 4,535 |
| Ending balance | \$ (75,181) | \$ (1,018) | \$ (76,199) |
| Thirty-nine Weeks Ended September 26, 2014 | | | |
| Beginning balance | \$ (50,132) | \$ 3,783 | \$ (46,349) |
| Other comprehensive income before reclassifications | - | (14,882) | (14,882) |
| Amounts reclassified from accumulated other comprehensive income | 2,522 | - | 2,522 |
| Ending balance | \$ (47,610) | \$ (11,099) | \$ (58,709) |

Table of Contents

Amounts related to pension and postretirement medical adjustments are reclassified to pension cost, which is allocated to cost of products sold and operating expenses based on salaries and wages, approximately as follows (in thousands):

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Cost of products sold | \$ 536 | \$ 824 | \$ 1,412 | \$ 2,577 |
| Product development | 234 | 368 | 616 | 1,131 |
| Selling, marketing and distribution | 427 | 663 | 1,116 | 1,987 |
| General and administrative | 266 | 449 | 732 | 1,395 |
| Total before tax | \$ 1,463 | \$ 2,304 | \$ 3,876 | \$ 7,090 |
| Income tax (benefit) | (490) | (835) | (1,354) | (2,555) |
| Total after tax | \$ 973 | \$ 1,469 | \$ 2,522 | \$ 4,535 |

6. The Company has three reportable segments: Industrial (which aggregates five operating segments), Contractor and Lubrication. Sales and operating earnings by segment were as follows (in thousands):

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---------------------------------|----------------------|-------------------|-------------------------|-------------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net Sales | | | | |
| Industrial | \$ 174,251 | \$ 156,654 | \$ 532,440 | \$ 480,500 |
| Contractor | 99,414 | 92,942 | 295,441 | 269,068 |
| Lubrication | 28,949 | 27,439 | 87,244 | 82,533 |
| Total | \$ 302,614 | \$ 277,035 | \$ 915,125 | \$ 832,101 |
| Operating Earnings | | | | |
| Industrial | \$ 54,959 | \$ 49,429 | \$ 167,737 | \$ 156,178 |
| Contractor | 23,358 | 21,459 | 69,897 | 62,370 |
| Lubrication | 6,369 | 5,497 | 19,803 | 17,285 |
| Unallocated corporate (expense) | (5,779) | (6,659) | (17,977) | (19,393) |
| Total | \$ 78,907 | \$ 69,726 | \$ 239,460 | \$ 216,440 |

Assets by segment were as follows (in thousands):

| | Sep 26, 2014 | Dec 27, 2013 |
|------------|-----------------|-----------------|
| Industrial | \$ 651,060 | \$ 591,135 |

Edgar Filing: GRACO INC - Form 10-Q

| | | |
|-----------------------|---------------------|---------------------|
| Contractor | 185,280 | 152,300 |
| Lubrication | 82,933 | 82,503 |
| Unallocated corporate | 508,545 | 501,290 |
| Total | \$ 1,427,818 | \$ 1,327,228 |

Table of Contents

Geographic information follows (in thousands):

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|---|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net sales (based on customer location) | | | | |
| United States | \$ 150,015 | \$ 132,503 | \$ 440,097 | \$ 383,756 |
| Other countries | 152,599 | 144,532 | 475,028 | 448,345 |
| Total | \$ 302,614 | \$ 277,035 | \$ 915,125 | \$ 832,101 |

| | Sep 26, 2014 | Dec 27, 2013 |
|-------------------|-----------------|-----------------|
| Long-lived assets | | |
| United States | \$ 130,021 | \$ 120,262 |
| Other countries | 29,574 | 31,455 |
| Total | \$ 159,595 | \$ 151,717 |

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

| | Sep 26, 2014 | Dec 27, 2013 |
|--|-----------------|-----------------|
| Finished products and components | \$ 77,136 | \$ 65,963 |
| Products and components in various stages of completion | 42,943 | 41,458 |
| Raw materials and purchased components | 72,613 | 69,051 |
| | 192,692 | 176,472 |
| Reduction to LIFO cost | (43,669) | (42,685) |
| Total | \$ 149,023 | \$ 133,787 |

Table of Contents

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

| | Estimated Life (years) | Cost | Accumulated Amortization | Foreign Currency Translation | Book Value |
|---|------------------------------|------------|-----------------------------|------------------------------------|---------------|
| September 26, 2014 | | | | | |
| Customer relationships | 3 - 14 | \$ 118,975 | \$ (19,274) | \$ (3,730) | \$ 95,971 |
| Patents, proprietary technology and product documentation | 5 - 11 | 18,125 | (6,684) | (382) | 11,059 |
| Trademarks, trade names and other | 5 | 175 | (35) | - | 140 |
| | | 137,275 | (25,993) | (4,112) | 107,170 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 47,800 | - | (1,764) | 46,036 |
| Total | | \$ 185,075 | \$ (25,993) | \$ (5,876) | \$ 153,206 |

December 27, 2013

| | | | | | |
|---|--------|------------|-------------|----------|------------|
| Customer relationships | 3 - 14 | \$ 121,205 | \$ (26,377) | \$ 1,458 | \$ 96,286 |
| Patents, proprietary technology and product documentation | 3 - 11 | 16,125 | (5,869) | 118 | 10,374 |
| Trademarks, trade names and other | 5 | 175 | (9) | - | 166 |
| | | 137,505 | (32,255) | 1,576 | 106,826 |
| Not Subject to Amortization: | | | | | |
| Brand names | | 40,400 | - | 714 | 41,114 |
| Total | | \$ 177,905 | \$ (32,255) | \$ 2,290 | \$ 147,940 |

Amortization of intangibles for the quarter was \$2.6 million in 2014 and \$3.1 million in 2013, and for the year-to-date was \$8.5 million in 2014 and \$9.6 million in 2013. Estimated annual amortization expense is as follows: \$11.0 million in 2014, \$10.3 million in 2015, \$10.0 million in 2016, \$9.7 million in 2017, \$9.7 million in 2018 and \$65.0 million thereafter.

Changes in the carrying amount of goodwill in 2014 were as follows (in thousands):

| | Industrial | Contractor | Lubrication | Total |
|--------------------------------------|------------|------------|-------------|------------|
| Beginning balance | \$ 157,738 | \$ 12,732 | \$ 19,497 | \$ 189,967 |
| Additions from business acquisitions | 37,340 | - | - | 37,340 |
| Foreign currency translation | (5,570) | - | - | (5,570) |

Edgar Filing: GRACO INC - Form 10-Q

| | | | | |
|----------------|------------|-----------|-----------|------------|
| Ending balance | \$ 189,508 | \$ 12,732 | \$ 19,497 | \$ 221,737 |
|----------------|------------|-----------|-----------|------------|

Table of Contents

In the first quarter of 2014, the Company paid \$65 million cash to acquire a manufacturer of fluid management solutions for environmental monitoring and remediation, markets where Graco had little or no previous exposure. The acquired business expands and complements the Company's Industrial segment. The purchase price was allocated based on estimated fair values, including \$37 million of goodwill, \$22 million of other identifiable intangible assets and \$6 million of net tangible assets.

See note 14 for information on another business acquisition completed subsequent to the end of the third quarter.

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

| | Sep 26, 2014 | Dec 27, 2013 |
|--|-----------------|-----------------|
| Accrued self-insurance retentions | \$ 6,993 | \$ 6,381 |
| Accrued warranty and service liabilities | 7,628 | 7,771 |
| Accrued trade promotions | 6,360 | 7,245 |
| Payable for employee stock purchases | 6,731 | 7,908 |
| Customer advances and deferred revenue | 9,772 | 11,693 |
| Income taxes payable | 2,445 | 4,561 |
| Other | 23,640 | 23,608 |
| Total other current liabilities | \$ 63,569 | \$ 69,167 |

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):

| | Thirty-nine Weeks Ended Sep 26, 2014 | Year Ended Dec 27, 2013 |
|---------------------------------|---|-------------------------------|
| Balance, beginning of year | \$ 7,771 | \$ 7,943 |
| Assumed in business acquisition | 12 | - |
| Charged to expense | 4,531 | 6,119 |
| Margin on parts sales reversed | 1,691 | 3,819 |
| Reductions for claims settled | (6,377) | (10,110) |
| Balance, end of period | \$ 7,628 | \$ 7,771 |

Table of Contents

10. Assets and liabilities measured at fair value on a recurring basis and fair value measurement level were as follows (in thousands):

| | Level | Sep 26, 2014 | Dec 27, 2013 |
|--|-------|-----------------|-----------------|
| Assets | | | |
| Cash surrender value of life insurance | 2 | \$ 13,004 | \$ 12,611 |
| Forward exchange contracts | 2 | 39 | 291 |
| Total assets at fair value | | \$ 13,043 | \$ 12,902 |
| Liabilities | | | |
| Deferred compensation | 2 | \$ 2,589 | \$ 2,296 |
| Forward exchange contracts | 2 | - | - |
| Total liabilities at fair value | | \$ 2,589 | \$ 2,296 |

Contracts insuring the lives of certain employees who are eligible to participate in certain non-qualified pension and deferred compensation plans are held in trust. Cash surrender value of the contracts is based on performance measurement funds that shadow the deferral investment allocations made by participants in certain deferred compensation plans. The deferred compensation liability balances are valued based on amounts allocated by participants to the underlying performance measurement funds.

Long-term notes payable with fixed interest rates have a carrying amount of \$300 million and an estimated fair value of \$320 million as of September 26, 2014 and \$320 million as of December 27, 2013. The fair value of variable rate borrowings approximates carrying value. The Company uses significant other observable inputs to estimate fair value (level 2 of the fair value hierarchy) 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.

11. In April 2012, the Company completed the purchase of the finishing businesses of Illinois Tool Works Inc. (ITW). The acquisition included powder finishing and liquid finishing equipment operations, technologies and brands (separately, the Powder Finishing and Liquid Finishing businesses). Results of the Powder Finishing businesses have been included in the Industrial segment since the date of acquisition. Pursuant to a March 2012 order, the Liquid Finishing businesses were to be held separate from the rest of Graco's businesses while the United States Federal Trade Commission (FTC) considered a settlement with Graco and determined which portions of the Liquid Finishing business Graco must divest.

Subsequent to the end of the third quarter of 2014, the FTC approved a final decision and order that became effective on October 9, 2014. Pursuant to the final order, Graco must sell the Liquid Finishing business assets within 180 days of the effective date. On October 8, 2014, the Company announced it had signed a definitive agreement to sell the Liquid Finishing business assets for \$590 million cash, subject to regulatory approval and other customary closing conditions. The sale transaction is expected to close no later than the first quarter of 2015, in compliance with the FTC's final decision and order. Graco will continue to hold the Liquid Finishing businesses separate and maintain them as viable and competitive until the sale process is complete.

Table of Contents

The Liquid Finishing business assets are held as a cost-method investment on the Consolidated Balance Sheets. Income is recognized based on dividends received from after-tax earnings of Liquid Finishing and included in other expense (income) on the Consolidated Statements of Earnings. Dividends received in 2014 totaled \$9 million in the third quarter and \$24 million year-to-date, consistent with amounts received in the comparable periods of 2013. Once the Company completes the sale of its investment, there will be no further dividends from Liquid Finishing.

The Company evaluates its cost-method investment for other-than-temporary impairment at each reporting period. As of September 26, 2014, the Company evaluated its investment in Liquid Finishing and determined that there was no impairment.

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net Sales | \$ 68,746 | \$ 75,879 | \$ 208,208 | \$ 210,922 |
| Operating Earnings | 13,733 | 16,734 | 43,627 | 46,712 |

12. On June 26, 2014, the Company executed an amendment to its revolving credit agreement, extending the expiration date to June 26, 2019, and increasing the amount of credit available to \$500 million, a \$50 million increase.

Under the amended agreement, the base rate applied to borrowings is an annual rate equal to a margin ranging from zero percent to 0.875 percent (down from zero to 1 percent under the prior agreement), depending on the Company's cash flow leverage ratio, plus the highest of (i) the bank's prime rate, (ii) the federal funds rate plus 0.5 percent or (iii) one-month LIBOR plus 1.5 percent. In general, LIBOR-based loans bear interest at LIBOR plus 1 percent to 1.875 percent (down from 1 to 2 percent), depending on the Company's cash flow leverage ratio.

Fees on the undrawn amount of the loan commitment decreased to a range of 0.15 percent to 0.30 percent (down from 0.15 percent to 0.40 percent), depending on the Company's cash flow leverage ratio.

13. In May 2014, the Financial Accounting Standards Board issued a final standard on revenue from contracts with customers. The new standard sets forth a single comprehensive model for recognizing and reporting revenue. The new standard is effective for the Company in its fiscal year 2017, and permits the use of either a retrospective or a cumulative effect transition method. The Company is evaluating the effect of the new standard on its consolidated financial statements and related disclosures, and has not yet selected a transition method.

Table of Contents

14. On October 1, 2014, the Company acquired the stock of Alco Valves Group (Alco) for £72 million cash, subject to normal post-closing purchase price adjustments. Alco is a United Kingdom (U.K.) based manufacturer of high quality, high pressure valves used in the oil and natural gas industry and in other industrial processes. Alco's products and business relationships will enhance Graco's position in the oil and natural gas industry and complement Graco's core competencies of designing and manufacturing advanced flow control technologies. Alco revenues for the most recent trailing twelve months were approximately £19 million. Results of Alco operations will be included in the Company's Industrial segment starting from the date of acquisition.

Table of Contents

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 and coating 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 in 2012

In April 2012, the Company completed the purchase of the finishing businesses of Illinois Tool Works Inc. (ITW). The acquisition included powder finishing and liquid finishing equipment operations, technologies and brands (separately, the Powder Finishing and Liquid Finishing businesses). Results of the Powder Finishing businesses have been included in the Industrial segment since the date of acquisition. Pursuant to a March 2012 order, the Liquid Finishing businesses were to be held separate from the rest of Graco's businesses while the United States Federal Trade Commission (FTC) considered a settlement with Graco and determined which portions of the Liquid Finishing business Graco must divest.

Subsequent to the end of the third quarter of 2014, the FTC approved a final decision and order that became effective on October 9, 2014. Pursuant to the final order, Graco must sell the Liquid Finishing business assets within 180 days of the effective date. On October 8, 2014, the Company announced it had signed a definitive agreement to sell the Liquid Finishing business assets for \$590 million cash, subject to regulatory approval and other customary closing conditions. The sale transaction is expected to close no later than the first quarter of 2015, in compliance with the FTC's final decision and order. Graco will continue to hold the Liquid Finishing businesses separate and maintain them as viable and competitive until the sale process is complete.

The Liquid Finishing business assets are held as a cost-method investment on the Consolidated Balance Sheets. Income is recognized based on dividends received from after-tax earnings of Liquid Finishing and included in other expense (income) on the Consolidated Statements of Earnings. Dividends received in 2014 totaled \$9 million in the third quarter and \$24 million year-to-date, consistent with amounts received in the comparable periods of 2013. Once the Company completes the sale of its investment, there will be no further dividends from Liquid Finishing.

The Company evaluates its cost-method investment for other-than-temporary impairment at each reporting period. As of September 26, 2014, the Company evaluated its investment in Liquid Finishing and determined that there was no impairment.

Table of Contents**Consolidated Results**

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

| | Thirteen Weeks Ended | | | Thirty-nine Weeks Ended | | |
|---------------------------------------|----------------------|-----------------|-------------|-------------------------|-----------------|-------------|
| | Sep 26, 2014 | Sep 27, 2013 | % Change | Sep 26, 2014 | Sep 27, 2013 | % Change |
| Net Sales | \$ 302.6 | \$ 277.0 | 9% | \$ 915.1 | \$ 832.1 | 10% |
| Operating Earnings | \$ 78.9 | \$ 69.7 | 13% | \$ 239.5 | \$ 216.4 | 11% |
| Net Earnings | \$ 59.6 | \$ 56.1 | 6% | \$ 176.5 | \$ 166.1 | 6% |
| Diluted Net Earnings per Common Share | \$ 0.97 | \$ 0.89 | 9% | \$ 2.85 | \$ 2.65 | 8% |

Sales increased in all reportable segments and regions for both the quarter and the year-to-date, with double-digit percentage growth in the Americas. In Asia Pacific, a double-digit percentage increase for the quarter from the Industrial segment pushed the region to positive year-to-date sales growth. Gross margin rate for the quarter was up slightly from last year and year-to-date gross margin rate was slightly lower than last year. Operating earnings for the quarter increased 13 percent on a 9 percent increase in sales, but a higher effective income tax rate led to a smaller (6 percent) increase in net earnings.

The following table presents components of changes in sales:

| | Quarter | | | | | | |
|------------------|------------|------------|-------------|----------|------|--------------|-------|
| | Segment | | | Region | | | |
| | Industrial | Contractor | Lubrication | Americas | EMEA | Asia Pacific | Total |
| Volume and Price | 4 % | 7 % | 6 % | 6 % | 3 % | 5 % | 6 % |
| Acquisitions | 6 % | - % | - % | 6 % | - % | 1 % | 3 % |
| Currency | 1 % | - % | - % | - % | 1 % | 1 % | - % |
| Total | 11 % | 7 % | 6 % | 12 % | 4 % | 7 % | 9 % |

| | Year-to-Date | | | | | | |
|------------------|--------------|------------|-------------|----------|------|--------------|-------|
| | Segment | | | Region | | | |
| | Industrial | Contractor | Lubrication | Americas | EMEA | Asia Pacific | Total |
| Volume and Price | 5 % | 10 % | 7 % | 10 % | 5 % | 1 % | 6 % |
| Acquisitions | 5 % | - % | - % | 5 % | - % | 1 % | 3 % |
| Currency | 1 % | - % | (1) % | (1) % | 3 % | - % | 1 % |
| Total | 11 % | 10 % | 6 % | 14 % | 8 % | 2 % | 10 % |

Table of Contents

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

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-----------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Americas ¹ | \$ 175.2 | \$ 156.1 | \$ 518.8 | \$ 455.0 |
| EMEA ² | 73.1 | 70.3 | 226.2 | 210.1 |
| Asia Pacific | 54.3 | 50.6 | 170.1 | 167.0 |
| Consolidated | \$ 302.6 | \$ 277.0 | \$ 915.1 | \$ 832.1 |

¹ North and South America, including the U.S.

² Europe, Middle East and Africa

Sales for the quarter increased 9 percent, including increases of 12 percent in the Americas, 4 percent in EMEA (3 percent at consistent translation rates) and 7 percent in Asia Pacific (6 percent at consistent translation rates). Year-to-date sales increased 10 percent, including increases of 14 percent in the Americas, 8 percent in EMEA (5 percent at consistent translation rates) and 2 percent in Asia Pacific. Sales from operations acquired in the fourth quarter of 2013 and the first quarter of 2014 totaled \$9 million for the quarter and \$26 million year-to-date, contributing 3 percentage points of growth in each of those periods.

Gross profit margin rate for the quarter was 55 percent, up slightly from the comparable period last year. Year-to-date gross margin rate was also 55 percent, slightly lower than last year due to the effects of purchase accounting, lower margins from acquired operations and changes in product mix.

Total operating expenses for the quarter were \$6 million (7 percent) higher than third quarter last year. Year-to-date operating expenses were \$19 million (8 percent) higher than last year. Increases for both the quarter and year-to-date are mostly due to expenses of acquired operations and spending on regional and product growth initiatives. As a percentage of sales, total operating expenses for both the quarter and year-to-date were down by one-half percentage point compared to comparable periods of last year.

Other expense (income) included dividends received from the Liquid Finishing businesses that are held separate from the Company's other businesses. Such dividends totaled \$9 million for the quarter and \$24 million year-to-date, consistent with the comparable periods of last year.

The effective income tax rate of 28 percent for the quarter was 4 percentage points higher than the comparable period last year. The increase resulted from the impacts of the federal R&D credit not being renewed for 2014 and the additional benefit from U.S. business credits in 2013. The effective year-to-date income tax rate of 29 percent was 2 percentage points higher than last year. Last year's rate included the favorable impact of the R&D credit that was renewed in 2013 retroactive to the beginning of 2012.

Table of Contents**Segment Results**

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

Industrial

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--------------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net sales (in millions) | | | | |
| Americas | \$ 78.8 | \$ 69.0 | \$ 240.2 | \$ 205.4 |
| EMEA | 54.1 | 51.5 | 164.4 | 151.6 |
| Asia Pacific | 41.4 | 36.2 | 127.8 | 123.5 |
| Total | \$ 174.3 | \$ 156.7 | \$ 532.4 | \$ 480.5 |

Operating earnings as a percentage of net sales

32 % 32 % 32 % 33 %

Industrial segment sales for the quarter increased 11 percent, with increases of 14 percent in the Americas, 5 percent in EMEA (3 percent at consistent translation rates) and 15 percent in Asia Pacific. Year-to-date sales increased 11 percent, with increases of 17 percent in the Americas, 8 percent in EMEA (5 percent at consistent translation rates) and 4 percent in Asia Pacific. Results for 2014 included the operations of QED Environmental Systems, acquired at the beginning of fiscal 2014, and EcoQuip, acquired at the end of fiscal 2013. Acquired operations contributed \$9 million to sales in this segment for the quarter and \$26 million year-to-date (6 percentage points of growth for the quarter and 5 percentage points for the year-to-date). Year-to-date operating margin rate for the Industrial segment decreased slightly compared to last year due to lower margins on acquired operations, including the impact of non-recurring acquisition-related inventory valuation adjustments, and other investments in regional and product expansion.

Contractor

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|--------------------------------|----------------------|--------------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net sales (in millions) | | | | |
| Americas | \$ 73.7 | \$ 67.1 | \$ 211.4 | \$ 188.5 |
| EMEA | 16.4 | 16.6 | 54.1 | 50.8 |
| Asia Pacific | 9.3 | 9.2 | 29.9 | 29.8 |
| Total | \$ 99.4 | \$ 92.9 | \$ 295.4 | \$ 269.1 |

Operating earnings as a percentage of net sales

23 % 23 % 24 % 23 %

Contractor segment sales for the quarter increased 7 percent, primarily from increases in the Americas. Year-to-date sales increased 10 percent with increases in the Americas and EMEA. Year-to-date operating margin rate in the Contractor segment was slightly higher than the rate last year. The favorable effects of higher sales volume and expense leverage were partially offset by unfavorable effects of product mix.

Table of Contents

Lubrication

| | Thirteen Weeks Ended | | Thirty-nine Weeks Ended | |
|-------------------------|----------------------|-----------------|-------------------------|-----------------|
| | Sep 26, 2014 | Sep 27, 2013 | Sep 26, 2014 | Sep 27, 2013 |
| Net sales (in millions) | | | | |
| Americas | \$ 22.7 | \$ 20.0 | \$ 67.1 | \$ 61.1 |
| EMEA | 2.6 | 2.1 | 7.7 | 7.6 |
| Asia Pacific | 3.6 | 5.3 | 12.4 | 13.8 |
| Total | \$ 28.9 | \$ 27.4 | \$ 87.2 | \$ 82.5 |

Operating earnings as a percentage of net sales

22 % 20 % 23 % 21 %

Lubrication segment sales increased 6 percent for both the quarter and year-to-date, mostly from increases in the Americas. Higher sales volume, improved gross margin rate and expense leverage led to a higher year-to-date operating margin rate in the Lubrication segment.

Liquidity and Capital Resources

Net cash provided by operating activities was \$170 million in 2014 and \$181 million in 2013. The increase in accounts receivable was \$8 million higher in the first nine months of 2014 than the increase in the comparable period of 2013. Accounts receivable and inventory balances have increased since the end of 2013 due to increases in business activity. Significant uses of cash in the first nine months of 2014 included \$142 million for purchases of Company common stock, \$65 million for a business acquisition and \$50 million of dividends paid to shareholders. Net borrowings on the Company's revolving line of credit increased long-term debt by \$100 million since the end of 2013.

On October 1, 2014, the Company used proceeds from its revolving line of credit to acquire the stock of Alco Valves Group (Alco) for £72 million cash, subject to normal post-closing purchase price adjustments. Alco is a United Kingdom (U.K.) based manufacturer of high quality, high pressure valves used in the oil and natural gas industry and in other industrial processes. Alco's products and business relationships will enhance Graco's position in the oil and natural gas industry and complement Graco's core competencies of designing and manufacturing advanced flow control technologies. Alco revenues for the most recent trailing twelve months were approximately £19 million. Results of Alco operations will be included in the Company's Industrial segment starting from the date of acquisition.

Pursuant to a final order from the FTC that became effective on October 9, 2014, Graco must sell the Liquid Finishing business assets acquired in 2012 within 180 days of the effective date. Graco will continue to hold the Liquid Finishing businesses separate and maintain them as viable and competitive until a sale process is complete. The Liquid Finishing business assets are held as a cost-method investment on Graco's balance sheet, and income is recognized based on dividends received from current earnings. Since the date of acquisition, the Company received \$64 million of dividends from current earnings of the Liquid Finishing businesses, including \$24 million in the first nine months of 2014. Once the Company completes the sale of its investment, there will be no further dividends from Liquid Finishing.

On October 8, 2014, the Company announced it had signed a definitive agreement to sell the Liquid Finishing business assets for \$590 million cash, subject to regulatory approval and other

Table of Contents

customary closing conditions. The sale transaction is expected to close no later than the first quarter of 2015, in compliance with the FTC's final decision and order. Graco expects to use the proceeds from the sale of the Liquid Finishing assets for reduction of outstanding debt, ongoing share repurchases, and to make investments in strategic acquisitions that provide synergy opportunities.

On June 26, 2014, the Company executed an amendment to its revolving credit agreement, extending the expiration date to June 26, 2019, and increasing the amount of credit available to \$500 million, a \$50 million increase.

Under the amended agreement, the base rate applied to borrowings is an annual rate equal to a margin ranging from zero percent to 0.875 percent (down from zero to 1 percent under the prior agreement), depending on the Company's cash flow leverage ratio, plus the highest of (i) the bank's prime rate, (ii) the federal funds rate plus 0.5 percent or (iii) one-month LIBOR plus 1.5 percent. In general, LIBOR-based loans bear interest at LIBOR plus 1 percent to 1.875 percent (down from 1 to 2 percent), depending on the Company's cash flow leverage ratio. Fees on the undrawn amount of the loan commitment decreased to a range of 0.15 percent to 0.30 percent (down from 0.15 percent to 0.40 percent), depending on the Company's cash flow leverage ratio.

At September 26, 2014, the Company had various lines of credit totaling \$549 million, of which \$335 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 2014.

Outlook

We expect mid-single digit organic growth in the fourth quarter, consistent with the second half outlook announced previously. With the benefit of the three acquisitions that Graco has closed in the last year, including Alco Valves that was acquired in October, total company sales should grow at a double-digit pace in the final quarter of the year. We remain positive on the U.S. housing market and the U.S. economy, while macroeconomic conditions, ongoing geopolitical concerns and currency are expected to be a headwind in the EMEA region.

Table of Contents

SAFE HARBOR CAUTIONARY STATEMENT

The Company desires to take advantage of the safe harbor provisions regarding forward-looking statements of the Private Securities Litigation Reform Act of 1995 and is filing this Cautionary Statement in order to do so. From time to time various forms filed by our Company with the Securities and Exchange Commission, including our Form 10-K, our Form 10-Qs and Form 8-Ks, and other disclosures, including our 2013 Overview report, press releases, earnings releases, analyst briefings, conference calls and other written documents or oral statements released by our Company, may contain forward-looking statements. Forward-looking statements generally use words such as expect, foresee, anticipate, believe, project, should, estimate, will, and similar expressions, and reflect our Company's expectations concerning the future. All forecasts and projections are forward-looking statements. Forward-looking statements are based upon currently available information, but various risks and uncertainties may cause our Company's actual results to differ materially from those expressed in these statements. The Company undertakes no obligation to update these statements in light of new information or future events.

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: changes in laws and regulations; economic conditions in the United States and other major world economies; our Company's growth strategies, which include making acquisitions, investing in new products, expanding geographically and targeting new industries; whether we are able to effectively and timely complete a divestiture of the acquired Liquid Finishing businesses, which has not been completed and remains subject to FTC approval; political instability; new entrants who copy our products or infringe on our intellectual property; supply interruptions or delays; risks incident to conducting business internationally; the ability to meet our customers needs and changes in product demand; results of and costs associated with, litigation, administrative proceedings and regulatory reviews incident to our business; compliance with anti-corruption laws; the possibility of decline in purchases from few large customers of the Contractor segment; variations in activity in the construction and automotive industries; security breaches and natural disasters. Please refer to Item 1A of our Annual Report on Form 10-K for fiscal year 2013 for a more comprehensive discussion of these and other risk factors. These reports are available on the Company's website at www.graco.com/ir and the Securities and Exchange Commission's website at www.sec.gov. Shareholders, potential investors and other readers are urged to consider these factors in evaluating forward-looking statements and are cautioned not to place undue reliance on such forward-looking statements.

Investors should realize that factors other than those identified above and in Item 1A 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.

Table of Contents

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 2013 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, Controller and Information Systems, 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.

Table of Contents

PART II OTHER INFORMATION

Item 1A. Risk Factors

Except as noted below, there have been no material changes to the Company's risk factors from those disclosed in the Company's 2013 Annual Report on Form 10-K.

Divestiture - Our acquisition of the finishing businesses of ITW includes a requirement that we divest the acquired Liquid Finishing businesses, which has not been completed and remains subject to FTC approval.

In April 2012, the Company completed the purchase of the finishing businesses of Illinois Tool Works Inc. (ITW). The acquisition included powder finishing and liquid finishing equipment operations, technologies and brands (separately, the Powder Finishing and Liquid Finishing businesses). Results of the Powder Finishing businesses have been included in the Industrial segment since the date of acquisition. Pursuant to a March 2012 order, the Liquid Finishing businesses were to be held separate from the rest of Graco's businesses while the United States Federal Trade Commission (FTC) considered a settlement with Graco and determined which portions of the Liquid Finishing business Graco must divest. Subsequent to the end of the third quarter of 2014, the FTC approved a final decision and order that became effective on October 9, 2014. Pursuant to the final order, Graco must sell the Liquid Finishing business assets within 180 days of the effective date. On October 8, 2014, the Company announced it had signed a definitive agreement to sell the Liquid Finishing business assets for \$590 million cash, subject to regulatory approval and other customary closing conditions. The sale transaction is expected to close no later than the first quarter of 2015, in compliance with the FTC's final decision and order. Graco will continue to hold the Liquid Finishing businesses separate and maintain them as viable and competitive until the sale process is complete. We cannot be certain to what extent or when the required regulatory approval of a buyer and terms of the sale will be obtained, or whether the Company will be able to complete a divestiture in a time frame that is satisfactory to the FTC.

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

On September 14, 2012, 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, 2015.

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 due upon exercise of options or vesting of restricted stock.

Information on issuer purchases of equity securities follows:

| Period | | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period) |
|--------------|--------------|---|---------------------------------------|--|--|
| Jun 28, 2014 | Jul 25, 2014 | 189,748 | \$ 76.93 | 189,748 | 3,604,412 |
| Jul 26, 2014 | Aug 22, 2014 | 200,000 | \$ 75.44 | 200,000 | 3,404,412 |
| Aug 23, 2014 | Sep 26, 2014 | 240,000 | \$ 76.04 | 240,000 | 3,164,412 |

Table of Contents

Item 6. Exhibits

- 2.1¹ Agreement relating to the sale and purchase of the entire issued share capital of Xamol Limited to acquire Alco Valves Group, dated as of October 1, 2014 (excluding certain schedules and exhibits, which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request).
- 2.2 Asset Purchase Agreement, dated October 7, 2014, by and among Carlisle Companies Incorporated, Carlisle Fluid Technologies, Inc., Graco Inc. and Finishing Brands Holdings Inc. (excluding schedules and exhibits, which the Registrant agrees to furnish supplementally to the Securities and Exchange Commission upon request). (Incorporated by reference to Exhibit 2.1 to the Company's Report on Form 8-K filed on October 9, 2014.)
- 3.1 Restated Articles of Incorporation as amended June 13, 2014. (Incorporated by reference to Exhibit 3.1 to the Company's Report on Form 8-K filed June 16, 2014.)
- 3.2 Restated Bylaws as amended February 14, 2014. (Incorporated by reference to Exhibit 3.2 to the Company's 2013 Annual Report on Form 10-K.)
- 10.1 Decision and Order by the U.S. Federal Trade Commission in the matter of Graco Inc., Illinois Tool Works Inc. and ITW Finishing LLC. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 8-K filed on October 8, 2014.)
- 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.
- 99.1 Press Release Reporting Third Quarter Earnings dated October 22, 2014.
- 101 Interactive Data File.

¹ Certain portions of this exhibit have been omitted pursuant to a request for confidential treatment and have been filed separately with the Securities and Exchange Commission.

Table of Contents

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: October 22, 2014

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

Date: October 22, 2014

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

Date: October 22, 2014

By: /s/ Caroline M. Chambers
Caroline M. Chambers
Vice President, Corporate Controller

and Information Systems
(Principal Accounting Officer)