GRACO INC
Form 10-Q
July 23, 2014
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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 27, 2014**

Commission File Number: 001-09249

GRACO INC.
(Exact name of registrant as specified in its charter)

Minnesota	41-0285640
(State of incorporation)	(I.R.S. Employer Identification Number)

88 - 11th Avenue N.E.

Minneapolis, Minnesota	55413
(Address of principal executive offices)	(Zip Code)

(612) 623-6000
(Registrant s telephone number, including area code)

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

Yes X No _____

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 _____

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	X	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

60,083,000 shares of the Registrant s Common Stock, $1.00 par value, were outstanding as of July 16, 2014.

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PART I Item 1.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited) (In thousands except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net Sales	$ 322,549	$ 286,020	$ 612,511	$ 555,066
Cost of products sold	145,699	127,281	276,349	245,683
Gross Profit	176,850	158,739	336,162	309,383
Product development	13,405	12,467	26,564	24,888
Selling, marketing and distribution	49,503	44,556	95,845	87,910
General and administrative	28,094	26,499	53,200	49,871
Operating Earnings	85,848	75,217	160,553	146,714
Interest expense	4,676	4,625	9,264	9,387
Other expense (income), net	(10,764)	(10,851)	(14,192)	(15,246)
Earnings Before Income Taxes	91,936	81,443	165,481	152,573
Income taxes	25,700	23,600	48,500	42,600
Net Earnings	$ 66,236	$ 57,843	$ 116,981	$ 109,973
Per Common Share				
Basic net earnings	$ 1.10	$ 0.94	$ 1.93	$ 1.80
Diluted net earnings	$ 1.07	$ 0.92	$ 1.88	$ 1.76
Cash dividends declared	$ 0.28	$ 0.25	$ 0.55	$ 0.50

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net Earnings	$ 66,236	$ 57,843	$ 116,981	$ 109,973
Other comprehensive income (loss)				

Cumulative translation adjustment	(1,908)	2,632	(1,994)	(5,855)
Pension and postretirement medical liability adjustment	1,225	2,330	2,413	4,786
Income taxes				
Pension and postretirement medical liability adjustment	(436)	(842)	(864)	(1,720)
Other comprehensive income (loss)	(1,119)	4,120	(445)	(2,789)
Comprehensive Income	$ 65,117	$ 61,963	$ 116,536	$ 107,184

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

	June 27, 2014	Dec 27, 2013
ASSETS		
Current Assets		
Cash and cash equivalents	$ 29,568	$ 19,756
Accounts receivable, less allowances of $6,600 and $6,300	229,224	183,293
Inventories	147,060	133,787
Deferred income taxes	21,096	18,827
Investment in businesses held separate	421,767	422,297
Other current assets	10,745	14,633
Total current assets	859,460	792,593
Property, Plant and Equipment		
Cost	424,822	407,887
Accumulated depreciation	(265,769)	(256,170)
Property, plant and equipment, net	159,053	151,717
Goodwill	226,537	189,967
Other Intangible Assets, net	162,898	147,940
Deferred Income Taxes	22,632	20,366
Other Assets	26,297	24,645
Total Assets	$ 1,456,877	$ 1,327,228
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Notes payable to banks	$ 12,599	$ 9,584
Trade accounts payable	42,740	34,282
Salaries and incentives	30,205	38,939
Dividends payable	16,583	16,881
Other current liabilities	63,039	69,167
Total current liabilities	165,166	168,853
Long-term Debt	522,760	408,370
Retirement Benefits and Deferred Compensation	94,863	94,705
Deferred Income Taxes	20,776	20,935

Shareholders Equity		
Common stock	60,181	61,003
Additional paid-in-capital	368,865	347,058
Retained earnings	271,060	272,653
Accumulated other comprehensive income (loss)	(46,794)	(46,349)
Total shareholders equity	653,312	634,365
Total Liabilities and Shareholders Equity	$ 1,456,877	$ 1,327,228

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 27, 2014	June 28, 2013
Cash Flows From Operating Activities		
Net Earnings	$ 116,981	$ 109,973
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	18,327	18,637
Deferred income taxes	(5,710)	(5,073)
Share-based compensation	9,818	7,762
Excess tax benefit related to share-based payment arrangements	(2,300)	(3,300)
Change in		
Accounts receivable	(42,019)	(27,349)
Inventories	(9,806)	(12,393)
Trade accounts payable	6,219	4,541
Salaries and incentives	(9,670)	(5,635)
Retirement benefits and deferred compensation	2,749	6,113
Other accrued liabilities	3,916	7,646
Other	(4,476)	(761)
Net cash provided by operating activities	84,029	100,161
Cash Flows From Investing Activities		
Property, plant and equipment additions	(17,062)	(9,423)
Acquisition of businesses, net of cash acquired	(65,219)	-
Proceeds from sale of assets	-	1,600
Investment in businesses held separate	530	835
Other	(599)	(112)
Net cash used in investing activities	(82,350)	(7,100)
Cash Flows From Financing Activities		
Borrowings (payments) on short-term lines of credit, net	2,659	(172)
Borrowings on long-term line of credit	325,665	198,645
Payments on long-term line of credit	(211,275)	(289,335)
Payments of debt issuance costs	(890)	-
Excess tax benefit related to share-based payment arrangements	2,300	3,300
Common stock issued	17,792	25,975
Common stock repurchased	(93,820)	(6,334)
Cash dividends paid	(33,485)	(30,504)

Net cash provided by (used in) financing activities		8,946		(98,425)
Effect of exchange rate changes on cash		(813)		1,813
Net increase (decrease) in cash and cash equivalents		9,812		(3,551)
Cash and cash equivalents				
Beginning of year		19,756		31,120
End of period	$	29,568	$	27,569

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 27, 2014 and the related statements of earnings for the thirteen and twenty-six weeks ended June 27, 2014 and June 28, 2013, and cash flows for the twenty-six weeks ended June 27, 2014 and June 28, 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 June 27, 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		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net earnings available to common shareholders	$ 66,236	$ 57,843	$ 116,981	$ 109,973
Weighted average shares outstanding for basic earnings per share	60,453	61,371	60,637	61,166
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,575	1,470	1,596	1,458
Weighted average shares outstanding for diluted earnings per share	62,028	62,841	62,233	62,624
Basic earnings per share	$ 1.10	$ 0.94	$ 1.93	$ 1.80

Diluted earnings per share	$ 1.07	$ 0.92	$ 1.88	$ 1.76

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Stock options to purchase 876,000 and 568,000 shares were not included in the June 27, 2014 and June 28, 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 twenty-six weeks ended June 27, 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	(238)	34.09		
Canceled	(14)	68.03		
Outstanding, June 27, 2014	5,372	$ 44.25	3,667	$ 34.89

The Company recognized year-to-date share-based compensation of $9.8 million in 2014 and $7.8 million in 2013. As of June 27, 2014, there was $19.1 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.9 years.

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

	Twenty-six Weeks Ended	
	June 27, 2014	June 28, 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

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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:

	Twenty-six Weeks Ended	
	June 27, 2014	June 28, 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		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Pension Benefits				
Service cost	$ 1,697	$ 1,789	$ 3,439	$ 3,590
Interest cost	3,940	3,429	8,076	6,998
Expected return on assets	(5,211)	(4,535)	(10,630)	(9,249)
Amortization and other	1,355	2,789	2,688	5,292
Net periodic benefit cost	$ 1,781	$ 3,472	$ 3,573	$ 6,631
Postretirement Medical				
Service cost	$ 125	$ 155	$ 250	$ 310
Interest cost	278	247	555	493
Amortization	(126)	(50)	(254)	(102)
Net periodic benefit cost	$ 277	$ 352	$ 551	$ 701

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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			
June 28, 2013			
Beginning balance	$ (78,138)	$ (12,516)	$ (90,654)
Other comprehensive income before reclassifications	-	2,632	2,632
Amounts reclassified from accumulated other comprehensive income	1,488	-	1,488
Ending balance	$ (76,650)	$ (9,884)	$ (86,534)
Thirteen Weeks Ended			
June 27, 2014			
Beginning balance	$ (49,372)	$ 3,697	$ (45,675)
Other comprehensive income before reclassifications	-	(1,908)	(1,908)
Amounts reclassified from accumulated other comprehensive income	789	-	789
Ending balance	$ (48,583)	$ 1,789	$ (46,794)
Twenty-six Weeks Ended			
June 28, 2013			
Beginning balance	$ (79,716)	$ (4,029)	$ (83,745)
Other comprehensive income before reclassifications	-	(5,855)	(5,855)
Amounts reclassified from accumulated other comprehensive income	3,066	-	3,066
Ending balance	$ (76,650)	$ (9,884)	$ (86,534)
Twenty-six Weeks Ended			
June 27, 2014			
Beginning balance	$ (50,132)	$ 3,783	$ (46,349)
Other comprehensive income before reclassifications	-	(1,994)	(1,994)
Amounts reclassified from accumulated other comprehensive income	1,549	-	1,549

Ending balance	$ (48,583)	$ 1,789	$ (46,794)

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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		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Cost of products sold	$ 440	$ 844	$ 876	$ 1,753
Product development	195	370	382	763
Selling, marketing and distribution	354	658	689	1,324
General and administrative	236	458	466	946
Total before tax	$ 1,225	$ 2,330	$ 2,413	$ 4,786
Income tax (benefit)	(436)	(842)	(864)	(1,720)
Total after tax	$ 789	$ 1,488	$ 1,549	$ 3,066

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		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net Sales				
Industrial	$ 181,763	$ 159,671	$ 358,189	$ 323,846
Contractor	111,121	98,498	196,027	176,126
Lubrication	29,665	27,851	58,295	55,094
Total	$ 322,549	$ 286,020	$ 612,511	$ 555,066
Operating Earnings				
Industrial	$ 57,563	$ 51,530	$ 112,778	$ 106,749
Contractor	28,289	24,479	46,539	40,911
Lubrication	6,901	6,647	13,434	11,788
Unallocated corporate (expense)	(6,905)	(7,439)	(12,198)	(12,734)
Total	$ 85,848	$ 75,217	$ 160,553	$ 146,714

Assets by segment were as follows (in thousands):

	June 27, 2014	Dec 27, 2013
Industrial	$ 673,111	$ 591,135
Contractor	187,750	152,300
Lubrication	81,839	82,503
Unallocated corporate	514,177	501,290
Total	$ 1,456,877	$ 1,327,228

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Geographic information follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net sales (based on customer location)				
United States	$ 156,160	$ 135,173	$ 290,082	$ 251,254
Other countries	166,389	150,847	322,429	303,812
Total	$ 322,549	$ 286,020	$ 612,511	$ 555,066

	June 27, 2014	Dec 27, 2013
Long-lived assets		
United States	$ 128,264	$ 120,262
Other countries	30,789	31,455
Total	$ 159,053	$ 151,717

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

	June 27, 2014	Dec 27, 2013
Finished products and components	$ 72,945	$ 65,963
Products and components in various stages of completion	43,550	41,458
Raw materials and purchased components	73,897	69,051
	190,392	176,472
Reduction to LIFO cost	(43,332)	(42,685)
Total	$ 147,060	$ 133,787

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

	Estimated Life (years)	Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
June 27, 2014					
Customer relationships	3 - 14	$ 118,975	$ (17,088)	$ 730	$ 102,617
Patents, proprietary technology and product documentation	5 - 11	18,125	(6,232)	49	11,942
Trademarks, trade names and other	5	175	(27)	-	148
		137,275	(23,347)	779	114,707
Not Subject to Amortization:					
Brand names		47,800	-	391	48,191
Total		$ 185,075	$ (23,347)	$ 1,170	$ 162,898
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 $2.7 million in 2014 and $3.2 million in 2013, and for the year-to-date was $5.8 million in 2014 and $6.6 million in 2013. Estimated annual amortization expense is as follows: $11.2 million in 2014, $10.7 million in 2015, $10.4 million in 2016, $10.2 million in 2017, $10.1 million in 2018 and $67.9 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	(770)	-	-	(770)
Ending balance	$ 194,308	$ 12,732	$ 19,497	$ 226,537

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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 will expand and complement 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.

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

	June 27, 2014	Dec 27, 2013
Accrued self-insurance retentions	$ 6,755	$ 6,381
Accrued warranty and service liabilities	7,749	7,771
Accrued trade promotions	5,154	7,245
Payable for employee stock purchases	4,399	7,908
Customer advances and deferred revenue	11,209	11,693
Income taxes payable	4,227	4,561
Other	23,546	23,608
Total other current liabilities	$ 63,039	$ 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):

	Twenty-six Weeks Ended June 27, 2014	Year Ended Dec 27, 2013
Balance, beginning of year	$ 7,771	$ 7,943
Assumed in business acquisition	12	-
Charged to expense	3,038	6,119
Margin on parts sales reversed	1,178	3,819
Reductions for claims settled	(4,250)	(10,110)
Balance, end of period	$ 7,749	$ 7,771

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

	Level	June 27, 2014	Dec 27, 2013
Assets			
Cash surrender value of life insurance	2	$ 13,331	$ 12,611
Forward exchange contracts	2	-	291
Total assets at fair value		$ 13,331	$ 12,902
Liabilities			
Deferred compensation	2	$ 2,580	$ 2,296
Forward exchange contracts	2	302	-
Total liabilities at fair value		$ 2,882	$ 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 June 27, 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. On April 2, 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.

In May 2012, the United States Federal Trade Commission (FTC) issued a proposed decision and order which requires Graco to sell the Liquid Finishing business assets no later than 180 days from the date the order becomes final. The FTC continues to work on resolving issues related to a proposed final decision and order.

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

The Company does not have a controlling interest in the Liquid Finishing businesses, nor is it able to exert significant influence over those businesses. Consequently, the Company s investment in the shares of the Liquid Finishing businesses has been

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reflected as a cost-method investment on the Consolidated Balance Sheets, 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 after-tax earnings of Liquid Finishing and included in other expense (income) on the Consolidated Statements of Earnings. Dividends received in 2014 totaled $11 million in the second quarter and $15 million year-to-date. Dividends received in 2013 totaled $11 million in the second quarter and $15 million year-to-date. Once the FTC issues its final decision and order, and 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 June 27, 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		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net Sales	$ 68,953	$ 71,845	$ 139,462	$ 135,043
Operating Earnings	14,608	16,398	29,894	29,978

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.

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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 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

On April 2, 2012, the Company completed the purchase of the finishing businesses of ITW. The acquisition included Powder Finishing and Liquid Finishing equipment operations, technologies and brands. Results of the Powder Finishing business 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 businesses Graco must divest.

In May 2012, the FTC issued a proposed decision and order which requires Graco to sell the Liquid Finishing business assets, including certain 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 continues to work on resolving issues related to a proposed final decision and order.

The Company has retained the services of an investment bank to help it market the Liquid Finishing businesses 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 Company does not control the Liquid Finishing businesses, nor is it able to exert influence over those businesses. Consequently, the Company s investment in the shares of the Liquid Finishing businesses has been reflected as a cost-method investment, and its financial results have not been consolidated with those of the Company.

As a cost-method investment, 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 $11 million in the second quarter and $15 million year-to-date, consistent with the amounts received in comparable periods of

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2013. Once the FTC issues its final decision and order, and 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 June 27, 2014, the Company evaluated its investment in Liquid Finishing and determined that there was 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 27, 2014	June 28, 2013	% Change	June 27, 2014	June 28, 2013	% Change
Net Sales	$ 322.5	$ 286.0	13%	$ 612.5	$ 555.1	10%
Operating Earnings	$ 85.8	$ 75.2	14%	$ 160.6	$ 146.7	9%
Net Earnings	$ 66.2	$ 57.8	15%	$ 117.0	$ 110.0	6%
Diluted Net Earnings per Common Share	$ 1.07	$ 0.92	16%	$ 1.88	$ 1.76	7%

Sales for the second quarter increased in all reportable segments and regions, with double-digit percentage growth in Industrial and Contractor segments. Year-to-date sales increased in all segments and regions except for Asia Pacific, where sales were flat compared to last year.

Changes in product mix and lower margins from acquired operations contributed to a decrease in gross margin rate for both the quarter and the year-to-date.

Expense leverage offset the effects of lower gross margin rates on operating earnings. Year-to-date operating earnings increased 9 percent, but a higher effective income tax rate led to a smaller increase in net earnings.

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The following table presents components of changes in sales:

	Quarter						
	Segment			Region			
	Industrial	Contractor	Lubrication	Americas	EMEA	Asia Pacific	Total
Volume and Price	6 %	12 %	7 %	10 %	7 %	4 %	8 %
Acquisitions	6 %	- %	- %	6 %	1 %	2 %	4 %
Currency	2 %	1 %	- %	(1)%	4 %	1 %	1 %
Total	14 %	13 %	7 %	15 %	12 %	7 %	13 %

	Year-to-Date						
	Segment			Region			
	Industrial	Contractor	Lubrication	Americas	EMEA	Asia Pacific	Total
Volume and Price	5 %	11 %	7 %	11 %	5 %	(2)%	7 %
Acquisitions	5 %	- %	- %	5 %	1 %	1 %	3 %
Currency	1 %	- %	(1)%	(1)%	4 %	- %	- %
Total	11 %	11 %	6 %	15 %	10 %	(1)%	10 %

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Americas[1]	$ 184.8	$ 160.7	$ 343.6	$ 298.9
EMEA[2]	79.7	70.9	153.1	139.8
Asia Pacific	58.0	54.4	115.8	116.4
Consolidated	$ 322.5	$ 286.0	$ 612.5	$ 555.1

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

[2] Europe, Middle East and Africa

Sales for the quarter increased 13 percent, including increases of 15 percent in the Americas, 12 percent in EMEA (8 percent at consistent translation rates) and 7 percent in Asia Pacific. Year-to-date sales increased 10 percent, including increases of 15 percent in the Americas and 10 percent in EMEA (6 percent at consistent translation rates). Sales were flat in Asia Pacific. Sales from operations acquired in the fourth quarter of 2013 and the first quarter of 2014 totaled $10 million for the quarter (contributing 4 percentage points of growth) and $17 million year-to-date (3 percentage

points of growth).

Gross profit margin, expressed as a percentage of sales, was 55 percent for both the quarter and year-to-date, down less than one percentage point from the comparable periods last year. Changes in product mix and lower margins in acquired operations contributed to the decrease in both the quarter and year-to-date. Non-recurring inventory-related purchase accounting effects of $1 million and lower margins in acquired operations accounted for nearly half of the year-to-date decrease.

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Total operating expenses for the quarter were $7 ½ million (9 percent) higher than second quarter last year. Year-to-date operating expenses were $13 million (8 percent) higher than last year. Expenses of acquired operations and spending on regional and product growth initiatives accounted for more than half of the increase for both the quarter and year-to-date. As a percentage of sales, total operating expenses for the quarter were 28 percent, down 1 percentage point from the second quarter last year and year-to-date operating expenses were down by one-half percentage point.

Other expense (income) included dividends received from the Liquid Finishing businesses that are held separate from the Company s other businesses. Such dividends totaled $11 million for the quarter and $15 million year-to-date, consistent with the comparable periods of last year.

The effective income tax rate of 28 percent for the quarter was 1 percentage point lower than the comparable period last year. The decrease resulted from higher foreign earnings that are taxed at lower rates than in the U.S., partially offset by the impact of the federal R&D credit not being renewed for 2014. The effective year-to-date income tax rate of 29 percent was 1 percentage point 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. The increase in the effective rate as a result of the expiration of the R&D credit for 2014 was partially offset by the impacts of higher foreign earnings taxed at lower rates than in the U.S. and additional benefit from U.S. business deductions.

Segment Results

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

Industrial

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net sales (in millions)				
Americas	$ 83.0	$ 70.2	$ 161.5	$ 136.4
EMEA	55.9	49.8	110.3	100.1
Asia Pacific	42.9	39.7	86.4	87.3
Total	$ 181.8	$ 159.7	$ 358.2	$ 323.8
Operating earnings as a percentage of net sales	32 %	32 %	31 %	33 %

Industrial segment sales for the quarter increased 14 percent, with increases of 18 percent in the Americas, 12 percent in EMEA (7 percent at consistent translation rates) and 8 percent in Asia Pacific. Year-to-date sales increased 11 percent with increases in the Americas and EMEA and a small decrease in Asia Pacific. First half results 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 $10 million to sales in this segment for the quarter and $17 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 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.

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Contractor

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net sales (in millions)				
Americas	$ 79.2	$ 69.9	$ 137.7	$ 121.4
EMEA	21.3	18.0	37.7	34.1
Asia Pacific	10.6	10.6	20.6	20.6
Total	$ 111.1	$ 98.5	$ 196.0	$ 176.1
Operating earnings as a percentage of net sales	25 %	25 %	24 %	23 %

Contractor segment sales for the quarter increased 13 percent, including increases of 13 percent in the Americas, 18 percent in EMEA (14 percent at consistent translation rates) and 1 percent in Asia Pacific. Year-to-date sales increased 11 percent with strong increases in the Americas and EMEA. Operating margin rates in the Contractor segment were slightly higher than the rates for the comparable periods last year. The favorable effects of higher sales volume and expense leverage were partially offset by unfavorable effects of product mix.

Lubrication

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 27, 2014	June 28, 2013	June 27, 2014	June 28, 2013
Net sales (in millions)				
Americas	$ 22.7	$ 20.6	$ 44.4	$ 41.1
EMEA	2.6	3.0	5.1	5.5
Asia Pacific	4.4	4.3	8.8	8.5
Total	$ 29.7	$ 27.9	$ 58.3	$ 55.1
Operating earnings as a percentage of net sales	23 %	24 %	23 %	21 %

Lubrication segment sales increased 7 percent for the quarter and 6 percent 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 $84 million in 2014 and $100 million in 2013. The first half increase in accounts receivable was $15 million higher in 2014 than the increase in 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 half of 2014 included $65 million for a business acquisition, $94 million for purchases of Company common stock and $33 million of dividends paid to shareholders.

In May 2012, the FTC issued a proposed decision and order which requires Graco to sell the Liquid Finishing business assets, including certain business activities related to the

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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 continues to work on resolving issues related to a proposed final decision and order.

The Company has retained the services of an investment bank to help it market the Liquid Finishing businesses and identify potential buyers. The Company believes its investment in the Liquid Finishing businesses, carried at a cost of $422 million, is not impaired.

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 businesses, including general funds, capital, working capital and reimbursement of losses. To the extent that the Liquid Finishing businesses generate funds in excess of financial resources needed, the Company has access to such funds consistent with practices in place prior to the acquisition. Since the date of acquisition, the Company received $55 million of dividends from current earnings of the Liquid Finishing businesses, including $15 million in the first half of 2014.

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 June 27, 2014, the Company had various lines of credit totaling $552 million, of which $317 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, including the needs of the Liquid Finishing businesses acquired in April 2012.

Outlook

After a solid first half of 2014, we are well positioned to achieve full-year growth in all segments and geographies. Our Contractor segment is poised to continue low double-digit growth in the Americas, benefitting from the recovery in the U.S. construction market. Stable macroeconomic conditions in developed economies and firming demand levels in the emerging markets of EMEA and China may provide upside to our outlook for mid-single-digit organic growth for the second half of the year.

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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 expect 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 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.

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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 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.

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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 2013 Annual Report on Form 10-K.

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)
Mar 29, 2014	Apr 25, 2014	190,000	$	73.98	190,000	4,230,623
Apr 26, 2014	May 23, 2014	200,000	$	72.62	200,000	4,030,623
May 24, 2014	Jun 27, 2014	236,463	$	75.20	236,463	3,794,160

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Item 6. Exhibits

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	Amendment No. 2 dated as of June 26, 2014 to Note Agreement dated as of March 11, 2011.
10.2	Omnibus Amendment, dated June 26, 2014, amending and restating the Credit Agreement among Graco Inc., the borrowing subsidiaries from time to time party thereto, the banks from time to time party thereto and U.S. Bank National Association, as administrative agent. (Incorporated by reference to Exhibit 10.1 to the Company s Report on Form 8-K filed July 1, 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 Second Quarter Earnings dated July 23, 2014.
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 23, 2014

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

Date: July 23, 2014

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

Date: July 23, 2014

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

and Information Systems
(Principal Accounting Officer)