

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549

**FORM 10-K**

- Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 27, 2002 or
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

**Commission File No. 001-9249**

**Graco Inc.**

(Exact name of Registrant as specified in its charter)

Minnesota  
(State or other jurisdiction of incorporation or organization)

41-0285640  
(I.R.S. Employer Identification No.)

**88 –11th Avenue Northeast  
Minneapolis, MN 55413**  
(Address of principal executive offices) (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:  
Common Stock, par value \$1.00 per share  
Preferred Share Purchase Rights  
Shares registered on the New York Stock Exchange.

Securities registered pursuant to Section 12(g) of the Act:  
None

As of March 6, 2003, 47,753,767 shares of Common Stock were outstanding.

Indicate by a 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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K

The aggregate market value of approximately 45,055,545 shares held by non-affiliates of the registrant was approximately \$1.1 billion on June 28, 2002.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's definitive Proxy Statement for its Annual Meeting of Shareholders to be held on May 6, 2003, are incorporated by reference into Part III, as specifically set forth in said Part III.

**GRACO INC.**

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**ON FORM 10-K**

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**NOTE: Certain exhibits listed in the Index to Exhibits beginning on page 42, and filed with the Securities and Exchange Commission, have been omitted. Copies of such exhibits may be obtained upon written request directed to:**

**Treasurer  
Graco Inc.  
P.O. Box 1441  
Minneapolis, Minnesota  
55440-1441**

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## **PART I**

### **Item 1. Business**

#### **General Information**

Graco Inc. ("Graco" or "the Company") supplies technology and expertise for the management of fluids in both industrial and commercial applications. The Company's products help customers solve difficult manufacturing problems, increase productivity, improve quality, conserve energy, save expensive material, control environmental emissions and reduce labor costs. Graco is the successor to Gray Company, Inc., which was incorporated in 1926 as a manufacturer of automobile lubrication equipment, and became a public company in 1969.

Headquartered in Minneapolis, Minnesota, Graco serves customers around the world in the manufacturing, process, construction and maintenance industries. It designs, manufactures and markets systems and equipment to move, measure, mix, proportion, control, dispense and spray a wide variety of fluids and viscous materials.

Among Graco's strategic objectives is that of being the highest quality, lowest cost, most responsive supplier in the world for its principal products. In working to achieve this goal, Graco has organized its manufacturing operations into factories focused on its operating segments. Graco's strategic objectives include generating at least 30 percent of each year's sales from products introduced in the last three years, generating at least 5 percent of each year's sales from markets entered in the last three years, expanding its distribution network and pursuing focused acquisitions.

Investors may obtain access free of charge to the Graco Inc. annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports by visiting the Graco website at [www.graco.com](http://www.graco.com). These reports will be available as soon as reasonably practicable following electronic filing with or furnishing to the Securities and Exchange Commission.

#### **Operating Segment Information**

Graco's businesses are classified by management into three operating segments: (1) Industrial/Automotive Equipment, (2) Contractor Equipment, and (3) Lubrication Equipment. Financial information concerning these operating segments is set forth in Part II, Item 7, at page 11, and in Note B to the Consolidated Financial Statements.

#### **Industrial/Automotive Equipment**

Graco's Industrial/Automotive Equipment segment focuses its product design and marketing efforts on four key areas of application: sealants and adhesives, process, liquid finishing and protective coatings. The markets served include firms that manufacture, assemble and repair automobiles and components, wood products, railcars, ships and other marine equipment, aircraft and other aerospace equipment, farm and construction equipment, truck, bus and recreational vehicles, and approximately thirty other industries.

Products offered by the Industrial/Automotive Equipment segment include air, electric and hydraulic-powered pumps that pressurize and transfer paints, stains, chemicals, sealants, adhesives, food, and other viscous materials through various application devices, including air, airless, air-assisted airless, electrostatic, and HVLP (high volume-low pressure) spray guns. Fluid pressures ranging from 20 to more than 7,250 pounds per

square inch and flow rates from under 1 gallon to 275 gallons per minute are available. Sealant and adhesive, paint circulating and plural component packages and modules, and a complete line of parts and accessories are also offered.

Industrial/Automotive equipment is sold worldwide through general and specialized distributors and integrators. Distributors promote and sell the equipment, provide product application expertise, and offer on-site service, technical support and integration capabilities. Integrators implement large individual installations in manufacturing plants where products and services from a number of different vendors are aggregated into a single system.

Products marketed by the Industrial/Automotive Equipment segment are manufactured in Minneapolis, Minnesota and Sioux Falls, South Dakota. Assembly of certain products for the European market is performed in Maasmechelen, Belgium.

Important drivers of product development in the Industrial/Automotive Equipment segment are the desire by customers to control costs by reducing the amount of material used, the desire to improve quality and increase productivity by automating production processes, and the need to reduce volatile organic compounds ("VOCs") emissions in order to meet environmental regulations.

Graco is developing new products for the global marketplace and expanding its distribution throughout the world in order to achieve optimum market coverage.

**Recent Developments.** In October 2002, Graco introduced the Xtreme™ Mix plural-component airless spray electronic proportioner. This proportioner is mobile and easy to use; a change of ratio takes seconds. Its high pressure rating (up to 7250 psi; 500 bar) permits it to handle abrasive high viscosity protective coatings and long hose lengths. Shutdown and alarm features prevent spraying off-ratio material. It is the first electronic proportioner of its kind for the shipbuilding, marine and offshore corrosion protection, railcar manufacturing and repair, and container manufacturing markets. It is easily customized by qualified distributors for specific end uses. The XTR™ airless spray gun was released with the Xtreme proportioner. This spray gun, with a compact, ergonomic design, high pressure output, and larger fluid passages, is designed to handle tough high-solids materials.

The Viscon® HP Fluid Heater was released in 2002. It is a high pressure (up to 7250 psi; 500 bar) high output fluid heater that maintains consistent temperature and fluid viscosity for uniform application of viscous materials in hazardous locations. It can also be used in conjunction with a new water-jacketed hose.

A line of Husky™ air-operated diaphragm pumps (1-1/2, 2 and 2-1/2 inch) was released in 2002 for use in the food industry. These stainless steel pumps, which are FDA-compliant, represent the Company's entry into the market for food-grade diaphragm pumps.

During 2002, separate manufacturing organizations for the Industrial/Automotive and Lubrication segments were created. Both operations are located in the Company's Riverside plant in Minneapolis, Minnesota. The rearrangement required by this new structure was begun in 2002 and should be completed during the second quarter of 2003.

Graco closed its manufacturing facility in Bielefeld, Germany in the summer of 2002. Some product lines manufactured there were discontinued and the rest were transferred to the manufacturing facilities in Minneapolis, Minnesota.

During 2002, the North American sales force was reorganized to align its activities more closely with the segment's marketing application focus. Sales personnel have been assigned to one of four key areas of application: sealants and adhesives, process, liquid finishing, and protective coatings and will be pursuing sales from customers (distributors and end users) in their area of expertise.

In December 2000, Graco received TE 9000 certification. Automotive manufacturers established the TE 9000 supplement to ISO 9000 in the mid-1990's, to ensure that the machine tools they buy would perform as required. In order to obtain TE 9000 certification, suppliers must demonstrate that they are pursuing a plan that will meet customer requirements for product quality, reliability, maintainability and durability. Certification allows Graco to maintain its preferred business association with these customers.

## **Contractor Equipment**

Graco's Contractor Equipment segment designs and markets sprayers for the application of paint and other architectural coatings, and for the high-pressure cleaning of equipment and structures. The segment offers its equipment to distributors selling to contractors in the painting, roofing, texture, corrosion control and line striping markets. The segment offers equipment which gives contractors the opportunity to produce a high quality finish at high production rates with sprayers that are durable and easy to use.

The segment's primary product lines are airless paint sprayers and associated parts and accessories, such as hoses, spray guns, filters, valves and tips. Also offered are pressure washers and specialized spraying equipment for the application of roofing materials, texture coatings and traffic paint. Fluid pressures ranging from 5 to more than 4,000 pounds per square inch and flow rates up to 4 gallons per minute are available. Pumps powered by electricity, air, and gasoline are available. HVLP (high volume-low pressure) equipment provides the ability to spray with reduced overspray, a benefit where regulation of volatile emissions has increased. Replacement and maintenance parts, such as packings and seals, which must be replaced periodically in order to maintain efficiency and prevent loss of material, are also offered for sale.

The equipment is sold primarily through retail stores which sell paint and other coatings, and secondarily through general equipment distributors. In 2002, sales to The Sherwin-Williams Company, a paint manufacturer and retailer, were 10% of the Company's consolidated sales. Graco markets a limited line of sprayers through the home center channel. In 2002, sales to The Home Depot, a home center retailer, totaled 11% of the Company's consolidated sales. Graco sales personnel sell Graco-branded equipment to the professional paint store, home center and rental agency channels. The ASM product line of airless paint sprayers and spray guns, pressure washers and parts and accessories is promoted to these same channels largely through independent sales representatives.

Products for the contractor equipment markets are manufactured in Rogers and Minneapolis, Minnesota, and Sioux Falls, South Dakota.

**Recent Developments.** In 2002, Graco upgraded the entire GMax™ line of gas-powered airless sprayers. This sprayer line, which has models which can spray all types of materials from stains to mastics, now has the SmartControl™, a microprocessor that precisely controls fluid pressure, with an interactive digital display, containing a pressure monitor, job and lifetime gallon counters, and the Watchdog™ Pump Protection System, which automatically shuts down the pump when material runs out. An optional AutoClean™ accessory kit is available to stop the pump automatically after the system has been cleaned. Additional features of this innovative sprayer include an EasyOut™ filter which cleans from the inside out, an Endurance™ piston pump with a life up to 3 times longer than chromed stainless steel rods, and a convertible model which allows easy conversion from a gas to a DC electric-powered sprayer.

The GH™ 200 Convertible, a new two gallon per minute gas-hydraulic airless sprayer, was released in 2002. This sprayer, which can easily be converted from gas-powered to electric-powered, broadens Graco's offering of gas-hydraulic sprayers and addresses competitive pressure at this flow and pressure rate. Graco's hydraulic motor is simple to disassemble and repair and has significantly fewer components than the competition.

The SpackMax™, a high-production airless texture sprayer, was released in the spring of 2002. This sprayer, with increased flow, represents an extension of the Mark V texture airless sprayer line and was designed specifically for the heavy interior coatings used in Europe.

## **Lubrication Equipment**

Graco's Lubrication Equipment segment designs and markets products for the lubrication and maintenance of vehicles and other equipment. The markets for the segment's products include fast oil change facilities, service garages, fleet service centers, automobile dealerships, and industrial lubrication. The purchase of vehicle lubrication equipment is often funded by major oil companies for their customers as a marketing tool.

The Lubrication Equipment segment offers a full line of lubrication pumps (air and hydraulic-powered), hose reels, meters and dispense valves, fluid management systems, equipment for handling used oil, automatic lubrication equipment, and parts and accessories.

Products are distributed primarily through independent distributors worldwide, which are serviced by a network of independent sales representatives and direct sales generalists in foreign markets.

Products for the Lubrication Equipment markets are manufactured in Minneapolis, Minnesota. During 2002, separate manufacturing organizations for the Industrial/Automotive and Lubrication segments were created. Both operations are located in the Company's Riverside plant in Minneapolis, Minnesota. The rearrangement required by this new structure was begun in 2002 and should be completed during the second quarter of 2003.

**Recent Developments.** During 2002, several automotive warehouse distributors began offering the Graco line of lubrication products. These stores target the market for non-OEM automotive parts and accessories.

The Matrix™ Total Fluid Management System™ was introduced in late 2002. The Matrix System provides wireless automated tracking and monitoring of vehicle fluids for car dealerships, fleet servicing centers, fast oil change centers and general vehicle servicing. Wireless transmission and reception of meter and tank level information saves time, money and material by providing accurate dispense histories, easy to use components, and precise measurement and control.

Two grease dispensers, the EZ-Shot™ battery-powered grease gun, and the Accu-Shot™ electronic grease meter, were released in 2002. The ergonomically-designed cordless EZ-Shot dispenses a measured quantity of grease. The Accu-Shot, which permits metered grease dispense, contains advanced battery-powered electronic controls and a re-settable LCD electronic display.

During 2002 the Lubrication Equipment segment began a targeted approach to the industrial lubrication channel through a select group of independent sales representatives.

## **Marketing and Distribution**

Graco sells its full line of products in each of the following major geographic markets: the Americas (North, Central and South America), Europe (including the Middle East and Africa), and Asia Pacific. Graco provides worldwide marketing, product design and application assistance to each of these geographic markets.

Graco sells its equipment worldwide principally through independent distributors. In Japan, Korea and Europe, Graco equipment is sold to distributors through sales subsidiaries. In the People's Republic of China, a subsidiary sells a limited line of contractor equipment and some industrial/automotive equipment to local distributors. Manufacturers' representatives are used in the Lubrication Equipment and the Contractor Equipment segments.

It is the Company's goal to generate at least 5 percent of each year's revenues from sales in markets entered in the last three years. The home center channel, into which the Contractor Equipment Division introduced the Magnum line of airless sprayers in 2000, is an example of the Company's efforts to reach this goal.

In 2002, Graco's net sales in the Americas were \$346 million or approximately 71 percent of the Company's consolidated net sales; in Europe net sales were \$88 million or approximately 18 percent; and in the Asia Pacific Region, net sales were \$53 million or approximately 11 percent.

## **Research, Product Development and Technical Services**

Graco's research, development and engineering activities are organized by operating segment. The engineering group in each segment focuses on new product design, product improvements, applied engineering and strategic technologies for its specific customer base. In each of the last four years, the Company exceeded its goal of generating at least 30 percent of each year's sales from products introduced in the prior three years. All major research and development activities are conducted in facilities located in Minneapolis, and Rogers, Minnesota. Total research and development expenditures were \$18 million, \$21 million and \$20 million for 2002, 2001 and 2000 respectively.

## **Intellectual Property**

Graco owns a number of patents and has patent applications pending both in the United States and in other countries, licenses its patents to others, and is licensed under patents owned by others. In the opinion of the Company, its business is not materially dependent upon any one or more of these patents or licenses. The Company also owns a number of trademarks in the United States and foreign countries, including the registered trademarks for "GRACO," several forms of a capital "G" and various product trademarks which are material to the business of the Company, inasmuch as they identify Graco and its products to its customers.

## **Competition**

Graco faces substantial competition in all of its markets. The nature and extent of this competition varies in different markets due to the depth and breadth of the Company's product lines. Product quality, reliability, design, customer support and service, specialized engineering and pricing are the major competitive factors. Although no competitor duplicates all of Graco's products, some competitors are larger than the Company, both in terms of sales of directly competing products and in terms of total sales and financial resources. The Company faces competitors with different cost structures and expectations of profitability. Graco believes it is one of the world's leading producers of high-quality specialized fluid management equipment. It is impossible to determine its relative market position, because of the absence of reliable industry-wide third-party data.

## Environmental Protection

The Company's compliance with federal, state and local environmental laws and regulations did not have a material effect upon the capital expenditures, earnings or competitive position of the Company during the fiscal year ending December 27, 2002.

## Employees

As of December 27, 2002, the Company employed approximately 1,700 persons on a full-time basis. Of this total, approximately 230 were employees based outside the United States, and 740 were hourly factory workers in the United States. None of the Company's U.S. employees is covered by a collective bargaining agreement. Various national industry-wide labor agreements apply to certain employees in Europe. Compliance with such agreements has no material effect on the Company or its operations.

## Item 2. Properties

As of December 27, 2002, the Company's principal operations that occupy more than 10,000 square feet were conducted in the following facilities:

<u>Type of Facility</u>	<u>Location</u>	<u>Gross Square Footage</u>
<b><u>Owned</u></b>		
Manufacturing/Warehouse/Office	Minneapolis, Minnesota	405,000
Manufacturing/Warehouse/Office/ Contractor R&D and Marketing	Rogers, Minnesota	333,000
Manufacturing/Office	Minneapolis, Minnesota	202,000
Corporate Headquarters/Lubrication and Industrial/Automotive R&D and Marketing	Minneapolis, Minnesota	139,000
Manufacturing/Office	Sioux Falls, South Dakota	127,000
European Headquarters/Warehouse	Maasmechelen, Belgium	75,000
<b><u>Leased</u></b>		
Manufacturing/Office	Bielefeld, Germany	69,000 <sup>1</sup>
Office	Yokohama, Japan (1 facility)	18,500
Office	Plymouth, Michigan	21,000
Office/Warehouse	Gwangju-Gun, Korea (2 facilities)	11,000

<sup>1</sup> Manufacturing operations in Bielefeld, Germany ceased at the end of June 2002. The lease for the facility expired on December 31, 2002.

The Company leases space for liaison offices and a warehouse in the People's Republic of China.

Graco's facilities are in satisfactory condition, suitable for their respective uses and are sufficient and adequate to meet current needs. The Company has made the decision to tear down the Main Plant manufacturing/office facility in Minneapolis. Manufacturing operations conducted in this plant are being moved to existing facilities in the Minneapolis metropolitan area and office functions will be moved to a new building scheduled for construction on the Minneapolis campus. Manufacturing capacity exceeded business demand in 2002. Production requirements in the immediate future are expected to be met through existing production capabilities, efficiency and productivity improvements, and the use of available subcontract services.

## Item 3. Legal Proceedings

The Company is engaged in routine litigation incident to its business, which management believes will not have a material adverse effect upon its operations or consolidated financial position.

## Item 4. Submission of Matters to a Vote of Security Holders

No issues were submitted to a vote of security holders during the fourth quarter of 2002.

## Executive Officers of the Company

The following are all the executive officers of the Company as of March 6, 2003.

**David A. Roberts, 55**, is President and Chief Executive Officer of the Company, a position he has held since June 25, 2001. Prior to joining Graco, from 1996 to June 2001 he was Group Vice President of the Marmon Group, where he had responsibility for a group of companies with approximately \$600 million in revenue and products including grocery store refrigeration, retail store fixtures and fast food restaurant equipment. Mr. Roberts has been a director of Graco since June 2001.

**Karen Park Gallivan, 46**, became Vice President, Human Resources on January 6, 2003. Prior to joining Graco, she was Vice President of Human Resources & Communications at Syngenta Seeds Inc. from January 1999 through December 2002. From 1992 to January 1999, she was Vice President, Human Resources, Communications and General Counsel at Novartis Nutrition Corporation.

**James A. Graner, 58**, became Vice President and Controller in February 1994. He was Treasurer from May 1993 to February 1994. Prior to becoming Treasurer, he held various managerial positions in the treasury, accounting and information systems departments. He joined the Company in 1974.

**Dale D. Johnson, 48**, became Vice President, Contractor Equipment Division on March 19, 2001. From January 14, 2000 to March 18, 2001 he served as President and Chief Operating Officer. From December 1996 to January 2000 he was Vice President, Contractor Equipment Division. Prior to becoming the Director of Marketing, Contractor Equipment Division in June 1996, he held various marketing and sales positions in the Contractor Equipment Division and the Industrial Equipment Division. He joined the Company in 1976.

**D. Christian Koch, 38**, became Vice President, Lubrication Equipment Division, effective February 15, 2000. From August 1999 to February 2000, he was the Director, Industrial Global Sales and Marketing. From December 1998 to August 1999 he was Director, Lubrication Marketing. Prior to joining the Company in December 1998, he was employed by H.B. Fuller Company, where he held various positions, including President and Division Manager of TEC Incorporated and Vice President and Business Unit Manager of Foster Products Corporation. (Mr. Koch is not related to David A. Koch, Director and Chairman Emeritus.)

**David M. Lowe, 47**, became Vice President and General Manager, European Operations, effective September 1, 1999. He was Vice President, Lubrication Equipment Division from December 1996 to September 1999. From February 1995 to December 1996 he was Treasurer. Mr. Lowe joined the Company in 1995.

**Robert M. Mattison, 55**, became Vice President, General Counsel and Secretary, in January 1992, a position which he holds today. He joined the Company in 1992.

**Patrick J. McHale, 41**, became Vice President of Manufacturing, effective March 19, 2001. From February 2000 to March 2001 he served as Vice President, Contractor Equipment Division. Mr. McHale was Vice President, Lubrication Equipment Division, from September 1999 to February 2000. He was Contractor Equipment Manufacturing – Distribution Operations Manager from February 1998 to September 1999. From March 1997 to February 1998 he was Director of Michigan Operations. From February 1996 to March 1997 he was Contractor Equipment Manufacturing Operations Manager and from January 1994 to February 1996 he was the Sioux Falls Plant Manager. Mr. McHale joined the Company in 1989.

**Charles L. Rescorla, 51**, became Vice President of the Industrial/Automotive Equipment Division, effective March 19, 2001. From January 1995 through March 2001 he served as Vice President, Manufacturing and Distribution Operations. Prior to becoming the Director of Manufacturing in March 1994, he was the Director of Engineering, Industrial/Automotive Division, a position which he assumed in 1988 when he joined the Company.

**Mark W. Sheahan, 38**, became Vice President and Treasurer on December 11, 1998. Effective December 17, 1996, he became Treasurer. He joined the Company in 1995.

**Fred A. Sutter, 42**, became Vice President, Asia Pacific and Latin America, effective March 1, 1999. From March 1995 to February 28, 1999, he was Director of Industrial Marketing. He joined the Company in 1995.

The Board of Directors elected Messrs. Graner, Johnson, Koch, Lowe, Mattison, McHale, Rescorla, Roberts, Sheahan, and Sutter on May 7, 2002, and Ms. Gallivan on December 6, 2002, effective January 6, 2003, all to hold office until the next annual meeting of directors or until their successors are elected and qualify.

## PART II

### Item 5. Market for the Company's Common Stock and Related Shareholder Matters

*Graco Common Stock.* Graco common stock is traded on the New York Stock Exchange under the ticker symbol "GGG." As of March 6, 2003, the share price was \$25.82 and there were 47,753,767 shares outstanding and 2,600 common shareholders of record, which includes nominees or broker dealers holding stock on behalf of an estimated 6,000 beneficial owners.

#### Quarterly Financial Information (In thousands, except per share amounts)

2002	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	\$107,857	\$132,796	\$125,832	\$120,563
Gross profit	55,163	67,141	65,414	62,440
Net earnings	15,546	21,516	20,494	18,069
Per common share: <sup>1</sup>				
Basic net earnings	0.33	0.45	0.43	0.38
Diluted net earnings	0.32	0.44	0.42	0.37
Dividends declared	0.07	0.07	0.07	0.08
Stock price (per share)				
High	\$ 28.09	\$ 30.49	\$ 26.99	\$ 30.16
Low	24.50	25.14	22.90	23.35
Close <sup>2</sup>	27.23	25.14	24.80	28.65
Volume (# of shares)	6,645	8,077	8,891	7,922

2001	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	\$109,814	\$130,873	\$118,651	\$113,481
Gross profit	55,138	64,253	59,156	56,215
Net earnings	13,120	18,248	16,760	17,138
Per common share: <sup>1</sup>				
Basic net earnings	0.29	0.39	0.36	0.37

Diluted net earnings	0.28	0.39	0.35	0.36
Dividends declared	0.07	0.07	0.07	0.07
<hr/>				
Stock price (per share)				
High	\$ 19.50	\$ 22.00	\$ 23.51	\$ 26.03
Low	16.23	17.48	18.67	19.26
Close <sup>2</sup>	18.67	22.00	20.13	26.03
<hr/>				
Volume (# of shares)	4,436	6,215	4,584	6,672

1 All share and per share data has been restated for the three-for-two stock split declared on May 7, 2002 and distributed on June 6, 2002.

2 As of the last trading day of the calendar quarter.

## Item 6. Selected Financial Data

Graco Inc. & Subsidiaries (In thousands, except per share amounts)					
	2002	2001	2000	1999	1998
<hr/>					
Net sales	\$487,048	\$472,819	\$494,373	\$450,474	\$440,585
Net earnings	75,625	65,266	70,108	59,341	47,263
<hr/>					
Per common share:					
Basic net earnings	\$ 1.59	\$ 1.41	\$ 1.54	\$ 1.30	\$ 0.91
Diluted net earnings	1.57	1.38	1.51	1.27	0.89
<hr/>					
Total assets	\$355,850	\$276,113	\$238,544	\$236,033	\$233,702
Long-term debt (including current portion)	--	550	19,360	66,910	115,739
Cash dividends declared per common share <sup>1</sup>	0.30	0.27	0.25	0.21	0.19

1 All share and per share data has been restated for the three-for-two stock split declared on May 7, 2002 and distributed on June 6, 2002.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Results of Operations

The following discussion of the Company's financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements and other financial information included elsewhere in this report.

The table below reflects sales by segment and geography for the three most recent fiscal years and the percentage changes in those sales for such years.

(In millions)	2002	2001	2000	% Increase (Decrease)	
				2002	2001
<b>Segment Sales:</b>					
Industrial/Automotive Equipment	\$204.2	\$199.5	\$228.0	2	(12)
Contractor Equipment	238.0	225.1	221.5	6	2
Lubrication Equipment	44.8	48.2	44.9	(7)	7
<hr/>					
Consolidated	\$487.0	\$472.8	\$494.4	3	(4)
<hr/>					
<b>Geographic Sales:</b>					
Americas	\$345.7	\$341.0	\$359.9	1	(5)
Europe	88.3	82.4	84.7	7	(3)
Asia Pacific	53.0	49.4	49.8	7	(1)
<hr/>					
Consolidated	\$487.0	\$472.8	\$494.4	3	(4)

The table below reflects the percentage relationship between income and expense items included in the Consolidated Statements of Earnings for the three most recent fiscal years and the percentage changes in those items for such years.

	As a Percentage of Net Sales			% Increase (Decrease)	
	2002	2001	2000	2002	2001
<b>Net Sales</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>3</b>	<b>(4)</b>
Cost of products sold	48.6	50.3	49.3	--	(2)
Product development	3.7	4.5	4.0	(13)	4
Selling, marketing and distribution	17.8	17.0	17.5	7	(7)

General and administrative	6.7	7.0	6.7	(2)	1
Operating profit	23.2	21.2	22.5	13	(10)
Interest expense	0.2	0.3	0.8	(51)	(70)
Other expense, net	0.1	0.3	0.3	(65)	22
Earnings before income taxes	22.9	20.6	21.4	15	(8)
Income taxes	7.4	6.8	7.2	12	(10)
<b>Net Earnings</b>	<b>15.5</b>	<b>13.8</b>	<b>14.2</b>	<b>16</b>	<b>(7)</b>

**2002 Compared to 2001.** The Company reported net sales in 2002 of \$487.0 million, an increase of 3 percent from the prior year. Sales increased 2 percent in the Industrial/Automotive segment and 6 percent in the Contractor Equipment segment, while Lubrication Equipment segment sales declined 7 percent. In the Americas, sales were \$345.7 million, up 1 percent from 2001. In Europe, 2002 sales were \$88.3 million, up 7 percent from 2001 in U.S. dollars and up 2 percent in local currencies. In Asia Pacific, sales were \$53.0 million, up 7 percent from 2001 in U.S. dollars and up 8 percent in local currencies.

Sales for the Industrial/Automotive segment were \$204.2 million, up 2 percent from \$199.5 million reported in 2001. For the year, sales in the Americas were down 2 percent from 2001. This decline can be attributed to the continued soft demand for industrial capital equipment in North America, although there was some modest growth in the second half of the year. In Europe, 2002 sales were up 7 percent from 2001 in U.S. dollars and up 2 percent in local currencies. There was very little underlying economic growth in the major European countries during 2002. The growth in this segment came primarily from successful new product introductions, and new automotive projects using sealant and adhesive equipment. In Asia Pacific, sales were up 7 percent in both U.S. dollars and local currencies. There was underlying growth in all of the major countries except Japan, which remains weak. New product introductions, higher demand for technology products and new automotive projects helped to drive the incremental sales gains versus 2001.

Sales for the Contractor Equipment segment were \$238.0 million, up 6 percent from \$225.1 million reported in 2001. For the year, sales in the Americas were up 5 percent from the previous year. Sales gains in the paint store channel as well as the home center channel drove the revenue increase in North America. In addition to new product introductions, the strong housing market and low interest rate environment helped stimulate demand for Contractor products in 2002. In Europe, 2002 sales were up 8 percent from 2001 in U.S. dollars and up 3 percent in local currencies. Growth in 2002 came from successful new product introductions and the addition of new sales outlets. The German construction market, which is the largest market for Contractor equipment in Europe, remained weak in 2002. In Asia Pacific, sales were up 17 percent in both U.S. dollars and local currencies from 2001. Growth in 2002 came from all of the major countries except Japan, which remains weak. In April, a new warehouse was opened in China primarily for Contractor Equipment products, targeted at smaller distributors.

Sales for the Lubrication Equipment segment were \$44.8 million, down 7 percent from \$48.2 million reported in 2001. The sales decline can be primarily attributed to new equipment installations at Sears and Wal-Mart and a large order for the Australian Army during 2001 that were not repeated in 2002.

The gross profit margin of 51.4 percent for 2002 increased 1.7 percentage points from the prior year. Gross margins improved in all three segments. The higher gross margins in 2002 were the result of many factors, including favorable productivity and material costs in manufacturing, product design changes, price increases, the positive impact of currency translations, and product mix.

Operating expenses as a percentage of sales for 2002 and 2001 were 28.2 percent and 28.5 percent, respectively. Operating expenses totaled \$137.3 million compared to \$134.6 million in 2001. The increase in operating expenses relative to the prior year reflects higher selling, marketing and distribution expenses, reduced somewhat by lower product development and general and administrative spending. The increases in selling, marketing and distribution expense were primarily due to higher incentives and promotion expenses related to improved results versus 2001. The reduction in product development expense was the result of actions taken in 2001 to improve efficiencies. Operating expenses for 2002 and 2001 include contributions to the Graco Foundation totaling \$1.5 million and \$1.6 million, respectively.

The Company recorded pension income of \$0.3 million in 2002 versus \$2.6 million in 2001. These amounts resulted from recognition of prior years investment gains attributable to pension plan assets. Pension expense/income is recorded in cost of products sold and operating expense based on salaries and wages.

Operating earnings in 2002 increased \$12.7 million, or 13 percent, from the prior year. This was the result of higher profits in the Industrial/Automotive and Contractor Equipment segments, offset somewhat by a decline in profits in Lubrication Equipment. 2001 operating earnings include restructuring costs totaling approximately \$1.4 million before income taxes. These restructuring costs were for severance and lease termination fees related to closing a facility in Germany and relocating production to Maasmechelen, Belgium and Minneapolis, Minnesota. By segment, before unallocated corporate expense, operating earnings for the Industrial/Automotive Equipment segment increased 11 percent, and improved by 2.1 percentage points as a percentage of sales. Higher sales, improved gross margins, favorable exchange rates and reduced product development spending all contributed to these results. Contractor Equipment operating earnings increased 14 percent, and improved by 1.6 percentage points as a percentage of sales. Higher sales and improved gross margins more than offset the higher spending in this segment. Operating earnings for the Lubrication Equipment segment decreased 21 percent, and declined by 3.7 percentage points as a percentage of sales. Lower sales and increased spending offset the benefits of a higher gross margin in this segment.

Interest expense decreased \$0.6 million, or 51 percent, due to lower debt levels throughout the year. Other expense decreased to \$0.5 million in 2002 compared to \$1.5 million last year, primarily due to increased interest income.

The Company's net effective tax rate of 32 percent in 2002 and 33 percent in 2001 is lower than the U.S. federal statutory rate of 35 percent, due primarily to earnings from sales outside the U.S. being taxed at rates lower than the federal statutory rate.

Total backlog at the end of 2002 was \$13 million versus \$12 million at the end of last year. The Company's backlog is typically small and is not a good indicator of future business levels.

**2001 Compared to 2000.** The Company reported net sales in 2001 of \$472.8 million, down 4 percent from the prior year. The decline in sales was the result of poor economic conditions and soft demand for industrial capital equipment in North America, which had an adverse impact on Industrial/Automotive sales. Sales increases in both the Contractor and Lubrication Equipment segments were not enough to offset the large

decline in Industrial/Automotive equipment. In the Americas, sales were \$341.0 million, down 5 percent from 2000. In Europe, 2001 sales were \$82.4 million, down 3 percent from 2000 in U.S. dollars and were flat in local currencies. In Asia Pacific, sales were \$49.4 million, down 1 percent from 2000 in U.S. dollars and were up 6 percent in local currencies.

Sales for the Industrial/Automotive segment were \$199.5 million, down 12 percent from \$228 million reported in 2000. Sales in the Americas were down 19 percent from 2000. The economic conditions and demand for industrial capital equipment in North America were weak throughout the entire year, which led to broad-based declines across all of this segment's primary markets and product categories. In Europe, 2001 sales were down 7 percent from 2000 in U.S. dollars and down 4 percent in local currencies. An economic slowdown in Europe resulted in lower sales in the primary markets and product categories. In Asia Pacific, sales were up 1 percent in U.S. dollars and up 8 percent in local currencies. Sales gains were made in Japan, Australia/New Zealand, and China while Korea and Southeast Asia were down due to weak economic conditions.

Sales for the Contractor Equipment segment were \$225.1 million, up 2 percent from \$221.5 million reported in 2000. Sales in the Americas were up 2 percent from 2000 due to a favorable U.S. housing market, the acquisition of ASM Company, Inc. and successful new product introductions. Sales gains in the home center channel offset a decline in the paint store channel. In Europe, 2001 sales were up 8 percent from 2000 in U.S. dollars and up 11 percent in local currencies. Sales gains were apparent throughout Europe, except in Germany where the construction market was in decline. In Asia Pacific, sales were down 12 percent from 2000 in U.S. dollars and down 6 percent when measured in local currencies. The contractor market was generally weak throughout the Asia Pacific region, except in Korea due to new construction spending.

Sales for the Lubrication Equipment segment were \$48.2 million, up 7 percent from \$44.9 million reported in 2000, primarily due to new equipment installations at Sears, Wal-Mart and an order for the Australian Army.

The gross profit margin of 49.7 percent for 2001 decreased 1.0 percentage point from the prior year. This reduction resulted from lower sales of Industrial/Automotive products, product mix that included a greater percentage of sales from home center paint sprayers, lower production levels and the negative impact of exchange rates. The reduction was partially offset by a \$1.6 million favorable impact from the liquidation of LIFO inventory quantities carried at lower costs from prior years.

Operating expenses as a percentage of sales for 2001 and 2000 were 28.5 percent and 28.2 percent, respectively. Operating expenses totaled \$134.6 million compared to \$139.6 million in 2000. Lower selling and marketing expenses more than offset increased spending in product development and the general and administrative areas. Operating expenses for 2001 and 2000 include contributions to the Graco Foundation totaling \$1.6 million and \$1.7 million, respectively.

The Company recorded pension income of \$2.6 million in 2001 versus \$3.8 million in 2000. These amounts resulted from recognition of prior years investment gains attributable to pension plan assets. Pension expense/income is recorded in cost of products sold and operating expense based on salaries and wages.

Operating earnings in 2001 decreased \$11.1 million, or 10 percent, from the prior year. This was the result of several factors, including lower sales in the Industrial/Automotive segment, restructuring charges and adverse exchange rates. 2001 operating earnings include restructuring costs totaling approximately \$1.4 million before income taxes. These restructuring costs are related to closing a facility and relocating production to Maasmechelen, Belgium and Minneapolis, Minnesota. The costs are for items such as severance and lease termination fees. By segment, before unallocated corporate expense, operating earnings for the Industrial/Automotive Equipment segment decreased 16 percent, and declined slightly as a percentage of sales due to the fixed nature of some expenses and higher product development spending. Contractor Equipment segment operating earnings decreased 1 percent and declined slightly as a percentage of sales. The decline in profitability was primarily due to product mix, including a greater percentage of sales coming from the home center channel, as well as increased selling, general and administrative spending. Operating earnings for the Lubrication Equipment segment increased 14 percent and increased by 1.5 percentage points as a percent of sales. This improvement was due to higher sales and disciplined spending.

Interest expense decreased \$2.9 million, or 69.8 percent due to lower debt levels throughout the year. Other expense totaled \$1.5 million in 2001 compared to \$1.2 million in 2000.

The Company's net effective income tax rate of 33 percent in 2001 and 34 percent in 2000 was lower than the U.S. federal tax rate of 35 percent due primarily to earnings from sales outside the U.S. being taxed at rates lower than the federal statutory rate.

## Liquidity and Capital Resources

The following table highlights several key measures of asset performance.

(In thousands)	2002	2001
Cash and cash equivalents	\$103,333	\$26,531
Working capital	\$160,310	\$82,244
Current ratio	3.0	2.1
Days receivables outstanding	74	72
Inventory turnover	7.8	7.8

**Financial Condition.** At December 27, 2002, the Company's capital structure included \$13.2 million of current debt, no long-term debt and \$245.4 million of shareholders' equity. The ratio of total debt to total capital was 5 percent at the end of 2002 and 2001. Total debt outstanding increased \$3.1 million for the year as the result of higher short-term borrowings by foreign subsidiaries.

At December 27, 2002, the Company had various lines of credit totaling \$58 million, of which \$49 million was unused. Cash balances of \$103.3 million at December 27, 2002, internally generated funds and unused financing sources provide the Company with the financial flexibility to meet its liquidity needs, including its 2003 capital expenditure plan of approximately \$20 million.

During March 2003, the Company repurchased 2.2 million shares of its common stock for \$54.8 million from David A. Koch, a current Board member, and former Chairman and Chief Executive Officer of the Company, his wife, and a family trust and family foundation. The Company used

available cash balances to fund the repurchase.

Shareholders' equity increased \$71.7 million in 2002 to \$245.4 million. The increase was due to current year earnings of \$75.6 million, common stock issued of \$13.9 million and \$4.3 million of tax benefits related to stock option exercises, offset by \$14.4 million of dividends declared, \$7.1 million of shares repurchased and \$0.6 million of other miscellaneous adjustments.

**Contractual Obligations.** As of December 27, 2002, the Company is obligated to make cash payments in connection with its long-term debt, capital leases, operating leases and purchase obligations in the amounts listed below. The Company has no material off-balance sheet debt or other unrecorded obligations other than the items noted in the following table. In addition to the commitments noted in the following table, the Company could be obligated to perform under standby letters of credit totaling \$3.1 million at December 27, 2002. The Company has also guaranteed the debt of its subsidiaries for up to \$18.5 million. The Company expects no pension funding requirement for 2003.

(In thousands)	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-term debt	\$ --	\$ --	\$ --	\$ --	\$ --
Capital lease obligations	--	--	--	--	--
Operating leases	4,039	1,949	1,721	369	--
Purchase obligations <sup>1</sup>					
<b>Total</b>	<b>\$4,039</b>	<b>\$1,949</b>	<b>\$1,721</b>	<b>\$369</b>	<b>\$ --</b>

<sup>1</sup> The Company is committed to pay suppliers under the terms of open purchase orders issued in the normal course of business. The Company also has commitments with certain suppliers to purchase minimum quantities, and under the terms of certain agreements, the Company is committed for certain portions of the supplier's inventory. The Company does not purchase, or commit to purchase, quantities in excess of normal usage or amounts that cannot be used within one year. The Company estimates that the maximum commitment amount under such agreements does not exceed \$9 million.

**Cash Flows.** During 2002, \$95.7 million was generated from operating activities, compared to \$89.2 million in 2001 and \$82.2 million in 2000. The increase in 2002 was due to a number of factors, including higher net earnings offset somewhat by increased accounts receivable. The increase in accounts receivable was primarily due to higher year-end Contractor Equipment and Industrial/Automotive Equipment sales versus last year.

Cash generated by operations was used to fund \$12.3 million of capital expenditures, \$13.9 million of cash dividends and \$7.1 million of share repurchases. The remaining cash was invested in highly liquid investments with a maturity of three months or less which totaled \$103.3 million at December 27, 2002. Significant uses of cash in 2001 included capital expenditures of \$30.2 million (including two plant expansions totaling \$18 million), the acquisition of the ASM Company, Inc. for \$15.9 million, dividends, share repurchases and the retirement of debt.

**Pension Plans.** The Company has noncontributory defined benefit pension plans covering substantially all U.S. employees, certain directors and some of the employees of the Company's non-U.S. subsidiaries. Pension income approximated \$0.3 million and \$2.6 million for the years ended December 27, 2002, and December 28, 2001, respectively and is calculated based on several actuarial assumptions, including an expected long-term rate of return on Qualified Plan assets of 9 percent and an assumed discount rate of 6.5 percent.

In developing the long-term rate of return assumption, management considers several factors, including the asset allocation, the long-term historical performance of Qualified Plan assets, and the input received by actuaries, including their review of asset class return expectations based on broad equity and bond indices. On a long-term historical basis, actual returns on Qualified Plan assets have exceeded assumed returns. The Company believes that its current assumption of 9 percent is appropriate in light of these factors. Lowering the expected long-term rate of return by 0.5 percent would have increased Qualified Plan pension expense for 2002 by approximately \$0.6 million.

The discount rate that is used to determine future pension obligations is based on a review of long-term bonds that receive one of the two highest ratings given by a recognized rating agency. Due to the decline in these rates over the last 12 months the Company has lowered its discount rate from 7 percent to 6.5 percent. Lowering the discount rate and the salary increase assumptions by 0.5 percent would have increased Qualified Plan pension expense for 2002 by approximately \$0.3 million.

#### Application of Critical Accounting Policies

The Company prepares its consolidated financial statements in conformity with generally accepted accounting principles in the United States of America ("U.S. GAAP"). This requires management to make estimates and judgments that affect reported amounts and related disclosures. Actual amounts will differ from those estimates. The Company considers the following policies to be the most critical in understanding the judgments that are involved in the preparation of the Company's consolidated financial statements.

**Sales Returns.** An allowance is established for possible return of products. The amount of the allowance is an estimate, which is based on historical ratios of returns to sales, the historical average length of time between the sale and the return and other factors. Also, the Company's written agreements with distributors typically limit the amount that may be returned. Though management considers these balances adequate and proper, changes in customers' behavior versus historical experience or changes in the Company's return policies are among the factors that would result in materially different amounts for this item.

**Warranty Claims.** A liability is established for estimated warranty and service claims to be paid in the future that relate to current and prior period sales. The Company estimates warranty costs based on historical warranty claim experience and other factors, including evaluating specific customer warranty issues. The establishment of reserves requires the use of judgment and assumptions regarding the potential for losses relating to warranty issues. Though management considers these balances adequate and proper, changes in the Company's warranty policy or a significant change in product defects versus historical averages are among the factors that would result in materially different amounts for this item.

**Inventory Valuation.** The Company's inventories are valued at the lower of cost or market. Reserves for overstock and obsolescence are estimated. The amount of the reserve is determined based on projected sales information, plans for discontinued products and other factors. Though management considers these balances adequate and proper, changes in sales volumes due to unexpected economic or competitive conditions are among the factors that would result in materially different amounts for this item.

**Product Liability.** The Company is self-insured for most product liability claims. Third party insurance is carried for what is believed to be the major portion of potential exposures that exceed the Company's self-insured retentions. The Company has established a liability for potential uninsured claims. The Company employs an actuary to assist in evaluating its potential ultimate exposure for uninsured claims and then considers factors such as known outstanding claims, historical experience, sales trends and other relevant factors in setting the liability. Though management considers these balances adequate and proper, a substantial change in the number and/or severity of claims would result in materially different amounts for this item.

**Income Taxes.** In the preparation of the Company's consolidated financial statements, management calculates income taxes. This includes estimating current tax liability as well as assessing temporary differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income. A valuation allowance is established to the extent that management believes that recovery is not likely. Reserves are also established for potential and ongoing audits of federal, state and international issues. The Company routinely monitors the potential impact of such situations and believes that it is properly reserved. Valuations related to amounts owed and tax rates could be impacted by changes to tax codes, changes in statutory tax rates, the Company's future taxable income levels and the results of tax audits.

### **New Accounting Standards**

In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," the Company ceased amortization of goodwill in 2002. Results of goodwill impairment testing in 2002 indicated no impairment. Had SFAS No. 142 been effective at the beginning of 2000, the non-amortization provisions would have increased 2001 net earnings by \$400,000 or \$.01 per share and would have had no effect on 2000 net earnings.

SFAS No. 143, "Accounting for Asset Retirement Obligations" was issued in 2001 and had no effect on the Company's 2002 financial position or operating results.

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" was effective for the Company at the beginning of 2002. This standard provides for a single accounting model to be used for long-lived assets to be disposed of, and broadens the presentation of discontinued operations to include more disposal transactions. The adoption of SFAS No. 144 had no effect on the Company's 2002 financial position or operating results.

SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" was issued in 2002 and requires costs associated with exit or disposal activities to be recognized when the costs are incurred, rather than at a date of commitment to an exit or disposal plan. This new standard will be effective for activities initiated in 2003 or later.

The Company accounts for its stock option and purchase plans using the intrinsic value method and has adopted the "disclosure only" provisions of SFAS No. 123, as amended in 2002 by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." No compensation cost has been recognized for the Employee Stock Purchase Plan and stock options granted under the various stock incentive plans. In accordance with SFAS No. 148, pro forma net earnings and earnings per share are disclosed in Note A to the Consolidated Financial Statements, as if the fair value based method had been applied for all periods presented.

### **Quantitative and Qualitative Disclosure About Market Risk**

The Company sells and purchases products and services in currencies other than the U.S. dollar. Consequently, the Company is subject to profitability risk arising from exchange rate movements.

The Company manages foreign currency market risk, from time to time, through the use of a variety of financial and derivative instruments. The Company does not enter into any of these instruments for trading purposes to generate revenue. Rather, the Company's objective in managing these risks is to reduce fluctuations in earnings and cash flows associated with changes in foreign currency exchange rates. The Company uses forward exchange contracts, options and other hedging activities to hedge the U.S. dollar value resulting from anticipated currency transactions and net monetary asset and liability positions. At December 27, 2002, the foreign currencies to which the Company had the most significant balance sheet exchange rate exposure were the European euro, Canadian dollar, Japanese yen, British pound, and Korean won.

It is not possible to determine the true impact of foreign currency translation changes; however, the direct effect on net sales and net earnings can be estimated. When compared to 2001 results, the weaker U.S. dollar versus foreign currencies helped to increase sales and net earnings. For the year ended December 27, 2002 the impact of foreign currency translation resulted in an overall increase in net sales and net earnings of \$3.5 million and \$1.5 million, respectively. When compared to 2000 results, the stronger U.S. dollar versus foreign currencies reduced the Company's sales and net earnings. For the year ended December 28, 2001 the impact of foreign currency translation resulted in an overall decrease in net sales and net earnings of \$6.8 million and \$3.1 million, respectively.

When appropriate, the Company utilizes interest rate swaps to manage its exposure to fluctuations in earnings due to changes in interest rates on its variable rate debt. There was no such debt at December 27, 2002.

### **2003 Outlook**

The Company does not provide analysts or shareholders with specific targets for net sales or net earnings growth in the upcoming year. Rather, management is committed to achieving its stated financial objectives over a long-term time horizon. The Company's financial objectives are:

- Net sales growth exceeding 10 percent annually
- Net earnings growth exceeding 12 percent annually
- Return on sales exceeding 10 percent
- Return on assets exceeding 15 percent
- Return on equity exceeding 20 percent

The Company is expecting higher net sales and net earnings in 2003. It anticipates another year of modest growth for the major industrialized countries, where the vast majority of its business activity is conducted. The Company is, however, concerned about a weakening of this economic outlook and the unknown impact of the war on terrorism and possible military conflict in the Middle East or the Korean Peninsula. In addition to economic growth, the improved sales outlook is dependent upon many factors, including the successful launch of new products, expanding distribution coverage, modest price increases and stable or favorable exchange rates versus 2002. The earnings outlook assumes higher sales,

continued improvements in manufacturing (which minimize normal cost increases), the continued disciplined management of operating expenses and a relatively stable effective income tax rate.

## Forward-Looking Statements

A forward-looking statement is any statement made in this report and other reports that the Company files periodically with the Securities and Exchange Commission, as well as in press or earnings releases, analyst briefings, conference calls and the Company's Annual Report to shareholders which reflects the Company's current thinking on market trends and the Company's future financial performance at the time they are made. All forecasts and projections are forward-looking statements.

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 by making cautionary statements concerning any forward-looking statements made by or on behalf of the Company. The Company cannot give any assurance that the results forecasted in any forward-looking statement will actually be achieved. Future results could differ materially from those expressed, due to the impact of changes in various factors. These risk factors include, but are not limited to: economic conditions in the United States and other major world economies, currency fluctuations, political instability, changes in laws and regulations, and changes in product demand. Please refer to Exhibit 99 to the Company's Annual Report on Form 10-K for fiscal year 2002 for a more comprehensive discussion of these and other risk factors.

Investors should realize that factors other than those identified above and in Exhibit 99 might prove important to the Company's future results. It is not possible for management to identify each and every factor that may have an impact on the Company's operations in the future as new factors can develop from time to time.

## Item 8. Financial Statements and Supplementary Data

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## Responsibility for Financial Reporting

Management is responsible for the accuracy, consistency, and integrity of the information presented in this Annual Report on Form 10-K. The consolidated financial statements and financial statement schedule have been prepared in accordance with generally accepted accounting principles and, where necessary, include estimates based upon management's informed judgment.

In meeting this responsibility, management believes that its comprehensive systems of internal control provide reasonable assurance that the Company's assets are safeguarded and transactions are executed and recorded by qualified personnel in accordance with approved procedures. Internal auditors periodically review these accounting and control systems. Deloitte & Touche LLP, independent certified public accountants, are retained to audit the consolidated financial statements and express an opinion thereon. Their opinion is included below.

The Audit Committee of the Board is responsible for providing independent, objective oversight of the Company's accounting functions and internal controls. In performing its oversight function, the Audit Committee has relied upon advice and information which it has received in its discussions with the Company's management and independent auditors.

## Independent Auditors' Report

Shareholders and Board of Directors  
Graco Inc.  
Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheets of Graco Inc. and Subsidiaries (the Company) as of December 27, 2002 and December 28, 2001 and the related consolidated statements of earnings, shareholders' equity, comprehensive income, and cash flows for each of the three years in the period ended December 27, 2002. Our audits also included the financial statement schedule listed in the Index at Item 17. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Graco Inc. and Subsidiaries as of December 27, 2002 and December 28, 2001 and the results of their operations and cash flows for each of the three years in the period ended December 27, 2002, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Deloitte & Touche LLP  
 Minneapolis, Minnesota  
 January 20, 2003  
 (March 19, 2003 as to Note M)

**CONSOLIDATED STATEMENTS OF EARNINGS**

**Graco Inc. and Subsidiaries**

(In thousands, except per share amounts)	Years Ended		
	December 27, 2002	December 28, 2001	December 29, 2000
<b>Net Sales</b>	\$487,048	\$472,819	\$494,373
Cost of products sold	236,890	238,057	243,521
<b>Gross Profit</b>	250,158	234,762	250,852
Product development	18,172	20,808	19,998
Selling, marketing and distribution	86,409	80,528	86,598
General and administrative	32,731	33,244	33,014
<b>Operating Earnings</b>	112,846	100,182	111,242
Interest expense	614	1,247	4,127
Other expense, net	507	1,469	1,207
<b>Earnings before Income Taxes</b>	111,725	97,466	105,908
Income taxes	36,100	32,200	35,800
<b>Net Earnings</b>	\$ 75,625	\$ 65,266	\$ 70,108
<b>Basic Net Earnings per Common Share</b>	\$ 1.59	\$ 1.41	\$ 1.54
<b>Diluted Net Earnings per Common Share</b>	\$ 1.57	\$ 1.38	\$ 1.51

See Notes to Consolidated Financial Statements.

**CONSOLIDATED BALANCE SHEETS**

**Graco Inc. and Subsidiaries**

(In thousands, except share and per share amounts)	December 27, 2002	December 28, 2001
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 103,333	\$ 26,531
Accounts receivable, less allowances of \$5,600 and \$4,500	93,617	85,440
Inventories	30,311	30,333
Deferred income taxes	12,022	11,710
Other current assets	1,241	1,483
Total current assets	240,524	155,497
<b>Property, Plant and Equipment, net</b>	94,953	98,944
<b>Intangible Assets, net</b>	11,860	14,274
<b>Other Assets</b>	8,513	7,398
<b>Total Assets</b>	\$ 355,850	\$ 276,113

**Liabilities and Shareholders' Equity**

**Current Liabilities**

Notes payable to banks	\$ 13,204	\$ 9,512
Current portion of long-term debt	--	550
Trade accounts payable	13,031	10,676
Salaries, wages and commissions	14,490	10,620
Accrued insurance liabilities	10,251	10,380
Accrued warranty and service liabilities	6,294	6,091
Income taxes payable	5,583	6,014
Dividends payable	3,922	3,422
Other current liabilities	13,439	15,988
<b>Total current liabilities</b>	<b>80,214</b>	<b>73,253</b>
<b>Retirement Benefits and Deferred Compensation</b>	<b>28,578</b>	<b>27,359</b>
<b>Deferred Income Taxes</b>	<b>1,652</b>	<b>1,761</b>
<b>Commitments and Contingencies (Note K)</b>		
<b>Shareholders' Equity</b>		
Common stock, \$1 par value; 67,000,000 shares authorized; 47,532,677 and 31,113,144 shares outstanding in 2002 and 2001	47,533	31,113
Additional paid-in capital	71,277	54,269
Retained earnings	128,125	89,155
Accumulated comprehensive income (loss) and other	(1,529)	(797)
<b>Total shareholders' equity</b>	<b>245,406</b>	<b>173,740</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 355,850</b>	<b>\$ 276,113</b>

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Graco Inc. and Subsidiaries

(In thousands)	Years Ended		
	December 27, 2002	December 28, 2001	December 29, 2000
<b>Cash Flows from Operating Activities</b>			
Net earnings	\$ 75,625	\$ 65,266	\$ 70,108
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	18,080	18,494	15,452
Deferred income taxes	274	762	1,644
Tax benefit related to stock options exercised	4,312	3,365	1,503
(Gain) loss on sale of fixed assets	284	424	(1,561)
Change in:			
Accounts receivable	(5,053)	309	(8,287)
Inventories	452	5,329	4,161
Trade accounts payable	2,215	(2,402)	(516)
Salaries, wages and commissions	3,565	(4,311)	1,921
Retirement benefits and deferred compensation	(566)	(2,624)	(3,999)
Other accrued liabilities	(4,192)	3,062	1,416
Other	677	1,507	367
<b>Net cash provided by operating activities</b>	<b>95,673</b>	<b>89,181</b>	<b>82,209</b>
<b>Cash Flows from Investing Activities</b>			
Property, plant and equipment additions	(12,253)	(30,203)	(14,523)
Proceeds from sale of property, plant and equipment	295	267	4,845
Acquisition of business, net of cash acquired	--	(15,949)	--
<b>Net cash used in investing activities</b>	<b>(11,958)</b>	<b>(45,885)</b>	<b>(9,678)</b>
<b>Cash Flows from Financing Activities</b>			
Borrowings on notes payable and lines of credit	21,198	160,274	188,552
Payments on notes payable and lines of credit	(18,200)	(165,937)	(187,144)
Borrowings on long-term debt	--	21,000	43,665
Payments on long-term debt	(550)	(39,810)	(91,215)
Common stock issued	12,867	11,932	8,127
Common stock retired	(7,088)	(3,761)	(19,182)
Cash dividends paid	(13,887)	(12,339)	(11,361)
<b>Net cash used in financing activities</b>	<b>(5,660)</b>	<b>(28,641)</b>	<b>(68,558)</b>
Effect of exchange rate changes on cash	(1,253)	805	510

Net increase in cash and cash equivalents	76,802	15,460	4,483
Cash and cash equivalents			
Beginning of year	26,531	11,071	6,588
<b>End of year</b>	<b>\$103,333</b>	<b>\$ 26,531</b>	<b>\$ 11,071</b>

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

Graco Inc. and Subsidiaries

(In thousands)	Years Ended		
	December 27, 2002	December 28, 2001	December 29, 2000
<b>Common Stock</b>			
Balance, beginning of year	\$ 31,113	\$ 20,274	\$ 20,416
Stock split	15,875	10,148	--
Shares issued	798	817	475
Shares repurchased	(253)	(126)	(617)
Balance, end of year	47,533	31,113	20,274
<b>Additional Paid-In Capital</b>			
Balance, beginning of year	54,269	39,954	31,755
Shares issued	13,138	11,115	7,652
Tax benefit related to stock options exercised	4,312	3,365	1,503
Shares repurchased	(442)	(165)	(956)
Balance, end of year	71,277	54,269	39,954
<b>Retained Earnings</b>			
Balance, beginning of year	89,155	50,233	9,279
Net income	75,625	65,266	70,108
Dividends declared	(14,387)	(12,721)	(11,545)
Stock split	(15,875)	(10,148)	--
Shares repurchased	(6,393)	(3,470)	(17,609)
Change in accounting period	--	(5)	--
Balance, end of year	128,125	89,155	50,233
<b>Accumulated Other Comprehensive Income (Loss)</b>			
Balance, beginning of year	(720)	394	1,490
Current period change	18	(1,114)	(1,096)
Balance, end of year	(702)	(720)	394
<b>Unearned Compensation</b>			
Balance, beginning of year	(77)	--	--
Restricted stock issued	(1,069)	(93)	--
Charged to operations	319	16	--
Balance, end of year	(827)	(77)	--
<b>Total Shareholders' Equity</b>	<b>\$ 245,406</b>	<b>\$ 173,740</b>	<b>\$ 110,855</b>

See Notes to Consolidated Financial Statements.

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Graco Inc. and Subsidiaries

(In thousands)	Years Ended		
	December 27, 2002	December 28, 2001	December 29, 2000
<b>Net Earnings</b>			
Other comprehensive income, net of tax:	\$ 75,625	\$ 65,266	\$ 70,108
Foreign currency translation adjustments	--	(759)	(1,096)
Minimum pension liability adjustment	18	(355)	16
<b>Comprehensive Income</b>	<b>\$ 75,643</b>	<b>\$ 64,152</b>	<b>\$ 69,028</b>

See Notes to Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Graco Inc. and Subsidiaries

Years Ended December 27, 2002, December 28, 2001 and December 29, 2000

#### A. Summary of Significant Accounting Policies

**Fiscal Year.** The fiscal year of Graco Inc. and Subsidiaries (the Company) is 52 or 53 weeks, ending on the last Friday in December. All years presented were 52-week years.

**Basis of Statement Presentation.** The consolidated financial statements include the accounts of the parent company and its subsidiaries after elimination of all significant intercompany balances and transactions. As of December 27, 2002, all subsidiaries are 100 percent owned. In 2000, subsidiaries in Japan and Korea were included on the basis of fiscal years ended November 30. In 2001, the one-month reporting lag in Japan and Korea was eliminated and net earnings for December 2000 were recorded as adjustments to equity. Certain prior year amounts have been reclassified to conform with 2002 presentation, but had no effect on previously reported net earnings or shareholders' equity.

**Foreign Currency Translation.** The U.S. dollar is the functional currency for all foreign subsidiaries. Accordingly, gains and losses from the translation of foreign currency balances and transactions of foreign subsidiaries are included in other expense (income). Prior to 2002 the functional currency of the Company's German subsidiary, Graco Verfahrenstechnik (GV), was the euro; and adjustments resulting from the translation of GV's financial statements into U.S. dollars were charged or credited to a separate component of shareholders' equity. As a result of relocating GV manufacturing, the functional currency of GV changed from the euro to the U.S. dollar. Consequently, effective at the beginning of 2002, GV translation adjustments are included in other expense (income).

**Accounting Estimates.** The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Such estimates and assumptions also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Cash Equivalents.** All highly liquid investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents.

**Inventory Valuation.** Inventories are stated at the lower of cost or market. The last-in, first-out (LIFO) cost method is used for valuing U.S. inventories. Inventories of foreign subsidiaries are valued using the first-in, first-out (FIFO) cost method.

**Property, Plant and Equipment.** For financial reporting purposes, plant and equipment are depreciated over their estimated useful lives, primarily by using the straight-line method as follows:

Buildings and improvements	10 to 30 years
Leasehold improvements	5 to 10 years
Manufacturing equipment	5 to 10 years
Office, warehouse and automotive equipment	3 to 10 years

**Intangible Assets.** In accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," the Company ceased amortization of goodwill in 2002. Results of goodwill impairment testing in 2002 indicated no impairment. Had SFAS No. 142 been effective at the beginning of 2000, the non-amortization provisions would have increased 2001 net earnings by \$400,000 or \$.01 per share and would have had no effect on 2000 net earnings.

Components of intangible assets were:

(In thousands)	2002	2001
Goodwill, Contractor segment	\$ 7,939	\$ 7,939
Other identifiable intangibles, net of accumulated amortization of \$6,100 and \$6,400	3,921	6,335
Total intangible assets, net	\$11,860	\$14,274

Other identifiable intangibles includes values assigned to patents, trademarks, trade names, customer lists and noncompete agreements, which are being amortized on a straight-line basis over useful lives ranging from 5 to 10 years. Amortization of intangibles was \$2,400,000 in 2002. Estimated annual amortization is as follows: \$1,600,000 in 2003, \$900,000 in 2004, \$400,000 in 2005, \$300,000 in 2006 and \$200,000 in 2007.

**Impairment of Long-Lived Assets.** Long-lived assets are reviewed for impairment whenever events or changes in business circumstances indicate the carrying value of the assets may not be recoverable. There have been no write-downs of any long-lived assets in the periods presented.

**Restructuring.** During the third quarter of 2001 the Company announced plans to relocate the operations of its German subsidiary, Graco Verfahrenstechnik, to other Company facilities in Belgium and the U.S. This included termination of approximately 50 employees, termination of leases and consolidation of product lines. General and administrative expense in 2001 included a \$1.4 million charge to establish a restructuring accrual for costs associated with termination of employees and lease termination. There were no significant payments charged against the accrual in 2001. All amounts accrued were paid in 2002. There were no significant differences between estimated amounts and actual amounts paid.

**Self-Insurance.** The Company is self-insured for certain losses relating to product liability, workers' compensation and employee medical benefits claims. The Company has purchased stop-loss coverage in order to limit its exposure to significant claims. Accrued insurance liabilities are based

on claims filed and estimates of claims incurred but not reported.

**Product Warranties.** 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 customer warranty issues. Following is a summary of 2002 activity in accrued warranty and service liabilities:

(In thousands)	2002
Balance, beginning of year	\$6,091
Additions charged to cost and expense	8,552
Reductions for claims settled	(8,349)
Balance, end of year	\$6,294

**Revenue Recognition.** The Company recognizes revenue when title passes, which is usually upon shipment. The Company records provisions for anticipated returns and warranty claims at the time revenue is recognized. Historically, sales returns have been between 2 and 3 percent of sales. Provisions for sales returns are recorded as a reduction of net sales, and provisions for warranty claims are recorded in selling, marketing and distribution expenses.

**Earnings Per Common Share.** Basic net earnings per share is computed by dividing earnings available to common shareholders by the weighted average number of shares outstanding during the year. Diluted net earnings per share is computed after giving effect to the exercise of all dilutive outstanding option grants.

**Comprehensive Income.** Comprehensive income is a measure of all changes in shareholders' equity except those resulting from investments by and distributions to owners, and includes such items as net earnings, certain foreign currency translation items, minimum pension liability adjustments and changes in the value of available-for-sale securities.

**Stock-Based Compensation.** The Company accounts for its stock option and purchase plans using the intrinsic value method and has adopted the "disclosure only" provisions of SFAS No. 123, as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." No compensation cost has been recognized for the Employee Stock Purchase Plan and stock options granted under the various stock incentive plans.

Had compensation cost for the stock option plans been determined based upon fair value at the grant date for awards under these plans, the Company's net earnings and earnings per share would have been reduced as follows:

(In thousands, except per share amounts)	2002	2001	2000
Net earnings			
As reported	\$75,625	\$65,266	\$70,108
Stock-based compensation, net of related tax effects	(4,233)	(4,268)	(3,526)
Pro forma	\$71,392	\$60,998	\$66,582
Net earnings per common share			
Basic as reported	\$ 1.59	\$ 1.41	\$ 1.54
Diluted as reported	1.57	1.38	1.51
Pro forma basic	1.51	1.32	1.46
Pro forma diluted	1.48	1.29	1.44

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:

	2002	2001	2000
Expected life in years	6.5	5.1	6.1
Interest rate	5.0%	5.1%	6.4%
Volatility	31.3%	37.4%	44.5%
Dividend yield	1.1%	1.4%	1.8%
Discount for non-transferability	10.0%	10.0%	10.0%
Weighted average fair value per share of options granted	\$9.27	\$5.97	\$5.45

The fair value of the employees' purchase rights under the Employee Stock Purchase Plan was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions and results:

	2002	2001	2000
Expected life in years	1.0	1.0	1.0
Interest rate	4.9%	5.1%	6.4%
Volatility	32.1%	37.4%	45.2%
Dividend yield	1.1%	1.5%	1.9%
Discount for non-transferability	10.0%	10.0%	10.0%
Weighted average fair value per share of purchase rights	\$6.96	\$4.76	\$3.97

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 Black-Scholes.

**Derivative Instruments and Hedging Activities.** At the beginning of fiscal 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, "Accounting for Certain Derivative Instruments and Certain Hedging Activities." SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that all derivatives, including those embedded in other contracts, be recognized as either assets or liabilities and that those financial instruments be measured at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation. The adoption of SFAS No. 133 resulted in no transition adjustment.

As part of its risk management program, the Company uses currency hedges and interest rate swaps to hedge known market exposures. Terms of derivative instruments are structured to match the terms of the risk being hedged and are generally held to maturity. The Company does not hold or issue derivative financial instruments for trading purposes. All other contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales. The Company's policy is to not enter into contracts with terms that cannot be designated as normal purchases or sales.

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

The Company may periodically hedge anticipated transactions, generally with forward exchange contracts, which are designated as cash flow hedges. Gains and losses representing effective hedges are initially recorded as a component of other comprehensive income and are subsequently reclassified into earnings when the hedged exposure affects earnings. Gains and losses on such transactions were not significant in 2002 and 2001, and there were no such transactions outstanding as of December 27, 2002 and December 28, 2001.

**Other Recent Accounting Pronouncements.** SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" was effective for the Company at the beginning of 2002. This standard provides for a single accounting model to be used for long-lived assets to be disposed of, and broadens the presentation of discontinued operations to include more disposal transactions. The adoption of SFAS No. 144 had no effect on the Company's 2002 financial position or operating results.

## B. Segment Information

The Company has three reportable segments: Industrial/Automotive, Contractor and Lubrication. The Industrial/Automotive segment markets equipment and pre-engineered packages for moving and applying paints, coatings, sealants, adhesives and other fluids. Markets served include automotive and truck assembly and components plants, wood products, rail, marine, aerospace, farm, construction, bus, recreational vehicles, and various other industries. The Contractor segment markets sprayers for architectural coatings for painting, roofing, texture, corrosion control and line striping and also high-pressure washers. The Lubrication segment markets products to move and dispense lubricants for fast oil change facilities, service garages, fleet service centers, automobile dealerships, the mining industry and industrial lubrication. All segments market parts and accessories for their products.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The cost of manufacturing for each segment is based on product cost, and expenses are based on actual costs incurred along with cost allocations of shared and centralized functions. Certain products are sold across segments, in which case the segment marketing the product is credited with the sale. Assets of the Company are not tracked along reportable segment lines.

Reportable segments are defined by product and type of customer. Segments are responsible for the sales, marketing and development of their products and market channel. This allows for focused marketing and efficient product development. The segments share common purchasing, manufacturing, distribution and administration functions.

(In thousands)

Reportable Segments	2002	2001	2000
Sales			
Industrial / Automotive	\$ 204,206	\$ 199,508	\$ 227,963
Contractor	238,027	225,110	221,538
Lubrication	44,815	48,201	44,872
Total	\$ 487,048	\$ 472,819	\$ 494,373
Segment operating earnings			
Industrial / Automotive	\$ 54,247	\$ 48,820	\$ 57,798
Contractor	53,756	47,297	47,935
Lubrication	9,587	12,119	10,600
Unallocated corporate expenses	(4,744)	(8,054)	(5,091)
Total	\$ 112,846	\$ 100,182	\$ 111,242

(In thousands)

Geographic Information	2002	2001	2000
Sales (based on customer location)			
United States	\$319,546	\$308,535	\$322,792
Other countries	167,502	164,284	171,581
Total	\$487,048	\$472,819	\$494,373

Long-lived assets			
United States	\$106,382	\$109,819	\$ 80,811
Belgium	7,496	8,954	10,437
Other countries	1,448	1,843	3,554
Total	\$115,326	\$120,616	\$ 94,802

### Sales to Major Customers

In 2002, sales to two customers in the Contractor segment individually represented 10 percent or more of consolidated sales. Sales to a home center retailer totaled 11 percent of consolidated sales and sales to a paint manufacturer and retailer totaled 10 percent of consolidated sales. In 2001, sales to a home center retailer in the Contractor segment totaled 11 percent of consolidated sales. No customer represented 10 percent or more of consolidated sales in 2000.

### C. Inventories

Major components of inventories were as follows:

(In thousands)	2002	2001
Finished products and components	\$ 26,199	\$ 23,863
Products and components in various stages of completion	17,219	18,827
Raw materials and purchased components	18,021	18,899
	61,439	61,589
Reduction to LIFO cost	( 31,128)	( 31,256)
Total	\$ 30,311	\$ 30,333

Inventories valued under the LIFO method were \$18,254,000 for 2002 and \$18,249,000 for 2001. All other inventory was valued on the FIFO method.

In 2002 and 2001, certain inventory quantities were reduced, resulting in liquidation of LIFO inventory quantities carried at lower costs from prior years. In 2002, the effect on net earnings was not significant. The effect in 2001 was to increase net earnings by approximately \$1,000,000.

### D. Property, Plant and Equipment

Property, plant and equipment were as follows:

(In thousands)	2002	2001
Land	\$ 5,818	\$ 5,815
Buildings and improvements	66,233	65,648
Manufacturing equipment	119,861	114,605
Office, warehouse and automotive equipment	24,185	23,998
Construction in progress	3,330	1,457
Total property, plant and equipment	219,427	211,523
Accumulated depreciation	(124,474)	(112,579)
Net property, plant and equipment	\$ 94,953	\$ 98,944

### E. Income Taxes

Earnings before income tax expense consist of:

(In thousands)	2002	2001	2000
Domestic	\$ 94,214	\$81,731	\$ 95,440
Foreign	17,511	15,735	10,468
Total	\$111,725	\$97,466	\$105,908

Income tax expense consists of:

(In thousands)	2002	2001	2000
Current:			
Domestic:			
Federal	\$ 29,571	\$ 23,725	\$ 28,532

State and local	2,600	2,105	2,164
Foreign	4,350	5,349	3,018
	36,521	31,179	33,714
Deferred:			
Domestic	(1,025)	555	2,414
Foreign	604	466	(328)
	(421)	1,021	2,086
Total	\$ 36,100	\$ 32,200	\$ 35,800

Income taxes paid were \$32,640,000, \$25,888,000 and \$30,919,000 in 2002, 2001 and 2000.

A reconciliation between the U.S. federal statutory tax rate and the effective tax rate is as follows:

	2002	2001	2000
Statutory tax rate	35%	35%	35%
Earnings from non-U.S. sales at lower tax rates	(3)	(2)	(1)
State taxes, net of federal effect	2	1	1
U.S. general business tax credits	(2)	(1)	(1)
Effective tax rate	32%	33%	34%

Deferred income taxes are provided for all temporary differences between the financial reporting and the tax basis of assets and liabilities. The deferred tax assets (liabilities) resulting from these differences are as follows:

(In thousands)	2002	2001
Inventory valuations	\$ 2,923	\$ 2,126
Insurance accruals	3,073	2,842
Warranty reserve	2,110	2,030
Vacation accruals	1,056	1,331
Bad debt reserves	1,549	1,329
Net operating loss carryforward	--	509
Other	1,311	1,543
Current	12,022	11,710
Unremitted earnings of consolidated foreign subsidiaries	(1,767)	(1,950)
Excess of tax over book depreciation	(7,364)	(7,094)
Postretirement benefits	5,804	5,739
Pension and deferred compensation	527	741
Other	1,148	803
Non-current	(1,652)	(1,761)
Net deferred tax assets	\$10,370	\$ 9,949

Total deferred tax assets were \$20,105,000 and \$19,141,000 and total deferred tax liabilities were \$9,735,000 and \$9,192,000 on December 27, 2002, and December 28, 2001.

## F. Debt

Interest paid on debt during 2002, 2001 and 2000 was \$677,000, \$1,288,000 and \$4,171,000.

In July 1998, the Company entered into a five-year \$190 million reducing revolving credit facility (the Revolver) with a syndicate of ten banks including the lead bank, U.S. Bank National Association. Available credit under the Revolver was reduced to \$50 million by December 28, 2001 and the Revolver was terminated in September 2002.

On December 27, 2002, the Company entered into a 364-day credit agreement with U.S. Bank National Association providing credit up to \$30 million. Outstanding balances bear interest at the London Interbank Offered Rate plus a spread of up to 1.125 percent. This spread changes as the ratio of total debt to earnings before interest, taxes and depreciation and amortization declines. The agreement requires the Company to maintain certain financial ratios as to net worth, cash flow leverage and fixed charge coverage.

On December 27, 2002, the Company had lines of credit with U.S. and foreign banks of \$58 million, including the \$30 million U.S. Bank credit facility. The unused portion of these credit lines was \$49 million at December 27, 2002. Borrowing rates under these credit lines vary with the prime rate, rates on domestic certificates of deposit and the London Interbank market. The weighted average short-term borrowing rates were 1.8 percent, 5.2 percent, and 6.2 percent for the years ended December 27, 2002, December 28, 2001, and December 29, 2000. The Company pays commitment fees of up to 0.2 percent per annum on the daily average unused amounts on certain of these lines. No compensating balances are required.

The Company is in compliance with the financial covenants of its debt agreements.

## G. Shareholders' Equity

Three-for-two stock splits were distributed in June 2002 and in February 2001. All stock option, share and per share data reflect these splits.

At December 27, 2002, the Company had 22,549 authorized, but not issued, cumulative preferred shares, \$100 par value. The Company also has authorized, but not issued, a separate class of 3 million shares of preferred stock, \$1 par value.

The Company maintains a plan in which one preferred share purchase right (Right) exists for each common share of the Company. Each Right will entitle its holder to purchase one four-hundredth of a share of a new series of junior participating preferred stock at an exercise price of \$180, subject to adjustment. The Rights are exercisable only if a person or group acquires beneficial ownership of 15 percent or more of the Company's outstanding common stock. The Rights expire in March 2010 and may be redeemed earlier by the Board of Directors for \$.001 per Right.

## H. Stock Option and Purchase Plans

**Stock Option and Award Plans.** The Company has various stock incentive plans under which it grants stock options and restricted share awards to officers and other employees. Option price is the market price on the date of grant. Options become exercisable at such time and in such installments as set by the Company, and expire ten years from the date of grant. Restricted share awards of 2,210,057 common shares have been made to certain key employees under the plans, of which 39,000 shares remain restricted as of December 27, 2002. Compensation cost charged to operations for the restricted share awards was \$319,000 in 2002, \$16,000 in 2001 and zero in 2000.

Options on common shares granted and outstanding, as well as the weighted average exercise price, are shown below:

	Options	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 31, 1999	2,998,718	\$ 8.46	1,676,309	\$ 6.67
Granted	657,000	13.73		
Exercised	(581,396)	7.12		
Canceled	(130,887)	10.26		
Outstanding, December 29, 2000	2,943,435	\$ 9.83	1,414,726	\$ 7.64
Granted	986,834	18.36		
Exercised	(857,483)	8.63		
Canceled	(87,835)	13.39		
Outstanding, December 28, 2001	2,984,951	\$12.87	903,401	\$ 8.59
Granted	569,250	27.64		
Exercised	(797,889)	10.50		
Canceled	(100,657)	16.99		
Outstanding, December 27, 2002	2,655,655	\$16.59	1,022,457	\$10.81

The following table summarizes information for options outstanding and exercisable at December 27, 2002:

Range of Prices	Options Outstanding	Options Outstanding Weighted Avg. Remaining Life	Options Outstanding Weighted Avg. Exercise Price	Options Exercisable	Options Outstanding Weighted Avg. Exercise Price
\$ 3-10	573,960	4	\$ 7.37	509,842	\$ 7.10
11-16	781,512	6	13.63	434,272	13.65
17-21	750,433	8	18.62	74,593	18.69
26-29	549,750	9	27.64	3,750	28.70
\$ 3-29	2,655,655	7	\$16.59	1,022,457	\$10.81

**Stock Purchase Plans.** Under the Company's Employee Stock Purchase Plan, the purchase price of the shares is the lesser of 85 percent of the fair market value on the first day or the last day of the plan year.

The Nonemployee Director Stock Plan enables individual nonemployee directors of the Company to elect to receive or defer all or part of a director's annual retainer, and/or payment for attendance at Board or Committee meetings, in the form of shares of the Company's common stock instead of cash. The Company issued 9,681, 9,009 and 10,391 shares under this Plan during 2002, 2001 and 2000. The expense related to this Plan is not significant.

**Authorized Shares.** Shares authorized for issuance under the various stock option and purchase plans are shown below:

	Total Shares Authorized	Available for Future Issuance as of December 27, 2002
Long-term Stock Incentive Plan	11,728,125	--
Employee Stock Incentive Plan	2,250,000	1,285,969
Stock Incentive Plan	2,250,000	1,584,000
Nonemployee Director Stock Option Plan	675,000	--
Employee Stock Purchase Plan	13,162,500	1,094,541

Nonemployee Director Stock Plan	506,250	446,815
Total	30,571,875	4,411,325

Amounts available for future issuance exclude the number of shares to be issued upon exercise of outstanding options. The Long-term Stock Incentive Plan and the Nonemployee Director Stock Option Plan were replaced by the Stock Incentive Plan in 2001, consequently no shares are available for future grants under those two plans.

### I. Earnings per Share

The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per share amounts)	2002	2001	2000
<b>Numerator</b>			
Net earnings available to common shareholders	\$75,625	\$65,266	\$70,108
<b>Denominators</b>			
Weighted average shares outstanding for basic earnings per share	47,424	46,355	45,610
Dilutive effect of stock options computed based on the treasury stock method using the average market price	781	867	747
Denominator for diluted earnings per share	48,205	47,222	46,357
Basic earnings per share	\$ 1.59	\$ 1.41	\$ 1.54
Diluted earnings per share	\$ 1.57	\$ 1.38	\$ 1.51

Stock options to purchase 524,000 common shares were not included in the 2002 calculation of diluted earnings per share because they would have been anti-dilutive.

### J. Retirement Benefits

The Company has a defined contribution plan, under Section 401(k) of the Internal Revenue Code, which provides additional retirement benefits to all U.S. employees who elect to participate. The Company matches employee contributions at a 100 percent rate, up to 3 percent of the employee's compensation. Employer contributions were \$2,158,000, \$2,187,000 and \$2,162,000 in 2002, 2001 and 2000.

The Company's postretirement medical plan provides certain medical benefits for retired employees. U.S. employees are eligible for these benefits upon retirement and fulfillment of other eligibility requirements as specified by the plan.

The Company has noncontributory defined benefit pension plans covering substantially all U.S. employees, certain directors and some of the employees of the Company's non-U.S. subsidiaries. For the U.S. plans, the benefits are based on years of service and the highest five consecutive years' earnings in the ten years preceding retirement. The Company funds these plans annually in amounts consistent with minimum funding requirements and maximum tax deduction limits and invests primarily in common stocks and bonds, including the Company's common stock. The market value of the plans' investment in the common stock of the Company was \$6,700,000 and \$19,500,000 at December 27, 2002 and December 28, 2001.

The following tables provide a reconciliation of the changes in the plans' benefit obligations and fair value of assets over the periods ending December 27, 2002 and December 28, 2001 and a statement of the funded status as of the same dates.

(In thousands)	Pension Benefits		Postretirement Medical Benefits	
	2002	2001	2002	2001
<b>Reconciliation of benefit obligation</b>				
Obligation, beginning of year	\$ 116,892	\$ 109,582	\$ 20,301	\$ 16,298
Service cost	3,450	3,825	594	493
Interest cost	7,961	7,452	1,378	1,126
Assumption changes	5,801	--	2,147	3,058
Actuarial loss	981	10	242	707
Benefit payments	(4,705)	(3,977)	(1,439)	(1,381)
Obligation, end of year	\$ 130,380	\$ 116,892	\$ 23,223	\$ 20,301
<b>Reconciliation of fair value of plan assets</b>				
Fair value, beginning of year	\$ 129,464	\$ 136,816	\$ --	\$ --
Actual return on assets	(15,899)	(3,813)	--	--
Employer contribution	598	438	1,439	1,381
Benefit payments	(4,705)	(3,977)	(1,439)	(1,381)
Fair value, end of year	\$ 109,458	\$ 129,464	\$ --	\$ --

**Funded status**

Funded status over (under), end of year	\$ (20,921)	\$ 12,572	\$ (23,223)	\$ (20,301)
Unrecognized transition obligation (asset)	(40)	(55)	--	--
Unrecognized prior service cost	1,416	1,559	--	--
Unrecognized loss (gain)	16,429	(17,516)	6,639	4,410
Net	\$ (3,116)	\$ (3,440)	\$ (16,584)	\$ (15,891)

The following table provides the amounts included in the consolidated balance sheets as of December 27, 2002 and December 28, 2001.

(In thousands)	Pension Benefits		Postretirement Medical Benefits	
	2002	2001	2002	2001
Accrued benefit liability	\$ (9,981)	\$ (9,282)	\$ (16,584)	\$ (15,891)
Other assets	6,865	5,842	--	--
Net	\$ (3,116)	\$ (3,440)	\$ (16,584)	\$ (15,891)

The components of net periodic benefit cost for the plans for 2002, 2001 and 2000 were as follows:

(In thousands)	Pension Benefits			Postretirement Medical Benefits		
	2002	2001	2000	2002	2001	2000
Service cost - benefits earned during the period	\$ 3,450	\$ 3,825	\$ 3,733	\$ 594	\$ 493	\$ 459
Interest cost on projected benefit obligation	7,961	7,452	6,961	1,378	1,126	1,063
Expected return on assets	(11,445)	(12,139)	(12,086)	--	--	--
Amortization of transition obligation (asset)	(15)	(10)	(3)	--	--	--
Amortization of prior service cost	149	174	220	--	--	--
Amortization of net loss (gain)	(565)	(2,041)	(2,707)	160	--	--
Cost of pension plans which are not significant and have not adopted SFAS No. 87	218	163	130	N/A	N/A	N/A
Net periodic benefit cost (credit)	\$ (247)	\$ (2,576)	\$ (3,752)	\$ 2,132	\$ 1,619	\$ 1,522

The Company's retirement medical plan limits the annual cost increase that will be paid by the Company. In measuring the accumulated postretirement benefit obligation (APBO), the annual trend rate for health care costs was assumed to be 11 percent for 2003, decreasing by one percentage point each year to a constant rate of 5 percent in 2009 and thereafter, subject to the plan's 6 percent annual increase limitation.

Other assumptions used in the measurement of the Company's benefit obligation are shown below:

Weighted average assumptions	Pension Benefits			Postretirement Medical Benefits		
	2002	2001	2000	2002	2001	2000
Discount rate	6.5%	7.0%	7.0%	6.5%	7.0%	7.0%
Expected return on assets	9.0%	9.0%	9.0%	N/A	N/A	N/A
Rate of compensation increase	3.3%	3.8%	3.6%	N/A	N/A	N/A

At December 27, 2002, a one percent change in assumed health care cost trend rates would have the following effects:

(In thousands)	1% Increase	1% Decrease
Effect on total of service and interest cost components of net periodic postretirement health care benefit cost	\$ 28	\$ (174)
Effect on the health care component of the accumulated postretirement benefit obligation	212	(1,567)

**K. Commitments and Contingencies**

**Lease Commitments.** Aggregate annual rental commitments under operating leases with noncancelable terms of more than one year were \$4,039,000 at December 27, 2002, payable as follows:

(In thousands)	Buildings	Vehicles & Equipment	Total
2003	\$ 776	\$1,173	\$1,949
2004	694	652	1,346
2005	141	234	375
2006	140	105	245
2007	105	19	124

Thereafter	--	--	--
Total	\$1,856	\$2,183	\$4,039

Total rental expense was \$1,774,000 for 2002, \$2,416,000 for 2001 and \$2,499,000 for 2000.

**Other Commitments.** The Company is committed to pay suppliers under the terms of open purchase orders issued in the normal course of business. The Company also has commitments with certain suppliers to purchase minimum quantities, and under the terms of certain agreements, the Company is committed for certain portions of the supplier's inventory. The Company does not purchase, or commit to purchase quantities in excess of normal usage or amounts that cannot be used within one year. The Company estimates that the maximum commitment amount under such agreements does not exceed \$9,000,000. In addition, the Company could be obligated to perform under standby letters of credit totaling \$3,100,000 at December 27, 2002. The Company has also guaranteed the debt of its subsidiaries for up to \$18,500,000.

**Contingencies.** The Company is party to various legal proceedings arising in the normal course of business activities, none of which, in management's opinion, is expected to have a material adverse impact on the Company's consolidated results of operations or its financial position.

#### L. Acquisition

On March 19, 2001, the Company purchased ASM Company, Inc. (ASM) for \$16 million cash. ASM manufactures and markets spray tips, guns, poles and other accessories for the professional painter, and had sales of approximately \$11 million in 2000.

The Company used the purchase method to account for the acquisition. Based on the results of an independent appraisal, the purchase price was allocated to net tangible assets of \$4 million (net of assumed liabilities totaling \$2 million), identifiable intangible assets of \$3 million and goodwill of \$9 million. Identifiable intangible assets include patents, proprietary technologies, trade names, trademarks, customer list and a noncompete agreement. Identifiable intangibles have been amortized on a straight-line basis, with useful lives ranging from 2 to 10 years.

#### M. Subsequent Event – Repurchase of Common Stock

During March 2003, the Company repurchased 2.2 million shares of its common stock for \$54.8 million from David A. Koch, a current Board member, and former Chairman and Chief Executive Officer of the Company, his wife, and a family trust and family foundation. The Company used available cash balances to fund the repurchase.

#### Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

### PART III

#### Item 10. Directors and Executive Officers of the Company

The information under the heading "Executive Officers of the Company" in Part I of this 2002 Annual Report on Form 10-K and the information under the headings "Election of Directors, Nominees and Other Directors" on pages 2 through 4 and under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" on page 16, of the Company's Proxy Statement for its 2003 Annual Meeting of Shareholders, to be held on May 6, 2003, (the "Proxy Statement"), are incorporated herein by reference.

#### Item 11. Executive Compensation

The information contained under the heading "Executive Compensation" on pages 6 through 8 of the Proxy Statement is incorporated herein by reference, other than the subsection thereunder entitled "Report of the Management Organization and Compensation Committee" and "Comparative Stock Performance Graph."

#### Item 12. Security Ownership of Certain Beneficial Owners and Management

The information contained under the heading "Beneficial Ownership of Shares" on page 15 and under the heading "Equity Compensation Plan Information" on page 12 of the Proxy Statement is incorporated herein by reference.

#### Item 13. Certain Relationships and Related Transactions

The information under the heading "Certain Business Relationships" on page 14 of the Proxy Statement is incorporated herein by reference.

#### Item 14. Controls and Procedures

##### Evaluation of disclosure controls and procedures

Within the 90 days prior to the filing date of this report, the Company carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. This evaluation was done under the supervision and with the participation of the Company's President and Chief Executive Officer, Vice President and Controller, Vice President and Treasurer, and Vice President, General Counsel and Secretary. Based upon that evaluation, they concluded that the Company's disclosure controls and procedures are effective in gathering, analyzing and disclosing information needed to satisfy the Company's disclosure obligations under the Exchange Act.

##### Changes in internal controls

There were no significant changes in the Company's internal controls or in other factors that could significantly affect those controls since the most recent evaluation of such controls.

## PART IV

### Item 15. Exhibits, Financial Statement Schedule, and Reports on Form 8-K

(a) The following documents are filed as part of this report:

- |     |   |            |
|-----|---|------------|
| (1) | Financial Statements<br>See Part II   | Page<br>37 |
| (2) | Financial Statement Schedule<br>• Schedule II - Valuation and Qualifying Accounts | 37         |

All other schedules are omitted because they are not applicable, or not required, or because the required information is included in the Consolidated Financial Statements or Notes thereto.

- |     |   |    |
|-----|---|----|
| (3) | Management Contract, Compensatory Plan or Arrangement. (See Exhibit Index)<br>Those entries marked by an asterisk are Management Contracts, Compensatory Plans or Arrangements. | 42 |
|-----|---|----|

(b) Reports on Form 8-K  
There were no reports on Form 8-K for the thirteen weeks ended December 27, 2002.

(c) Exhibit Index 42

### Schedule II — Valuation and Qualifying Accounts

Graco Inc. and Subsidiaries

Description	Balance at beginning of year	Additions charged to costs and expenses	Deductions From Reserves	Change <sup>3</sup> Add (Deduct)	Balance at end of year
Year ended December 27, 2002					
Allowance for doubtful accounts	\$ 2,000	\$ 700	\$ 400 <sup>1</sup>		\$ 2,300
Allowance for returns and credits	2,500	7,000	6,200 <sup>2</sup>		3,300
	\$ 4,500	\$ 7,700	\$ 6,600		\$ 5,600
Year ended December 28, 2001					
Allowance for doubtful accounts	\$ 2,300	\$ 100	\$ 500 <sup>1</sup>	\$ 100	\$ 2,000
Allowance for returns and credits	2,400	7,000	7,000 <sup>2</sup>	100	2,500
	\$ 4,700	\$ 7,100	\$ 7,500	\$ 200	\$ 4,500
Year ended December 29, 2000					
Allowance for doubtful accounts	\$ 2,500	\$ 100	\$ 300 <sup>1</sup>		\$ 2,300
Allowance for returns and credits	2,000	8,100	7,700 <sup>2</sup>		2,400
	\$ 4,500	\$ 8,200	\$ 8,000		\$ 4,700

<sup>1</sup> Accounts determined to be uncollectible and charged against reserve, net of collections on accounts previously charged against reserves.

<sup>2</sup> Credits issued and returns processed.

<sup>3</sup> Assumed or established in connection with acquisition

### Signatures

Pursuant to the requirements of Section 13 or 15(d) 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.

DAVID A. ROBERTS

March 20, 2003

David A. Roberts  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

DAVID A. ROBERTS

March 20, 2003

David A. Roberts  
President and Chief Executive Officer  
(Principal Executive Officer)

MARK W. SHEAHAN

March 20, 2003

Mark W. Sheahan  
Vice President and Treasurer  
(Principal Financial Officer)

JAMES A. GRANER

March 20, 2003

James A. Graner  
Vice President and Controller  
(Principal Accounting Officer)

L. R. Mitau	Director, Chairman of the Board
D. A. Koch	Chairman Emeritus
R. O. Baukol	Director
R. G. Bohn	Director
W. J. Carroll	Director
J. K. Gilligan	Director
J. H. Moar	Director
M. A.M. Morfitt	Director
M. H. Rauenhorst	Director
D. A. Roberts	Director
W. G. Van Dyke	Director

David A. Roberts, by signing his name hereto, does hereby sign this document on behalf of himself and each of the above named directors of the Registrant pursuant to powers of attorney duly executed by such persons.

DAVID A. ROBERTS

March 20, 2003

David A. Roberts  
President and Chief Executive Officer  
(For himself as attorney-in-fact)

## Certifications

I, David A. Roberts, certify that:

1. I have reviewed this annual report on Form 10-K of Graco Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 18, 2003

DAVID A. ROBERTS  
David A. Roberts  
President and Chief Executive Officer

## Certifications

I, James A. Graner, certify that:

1. I have reviewed this annual report on Form 10-K of Graco Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 18, 2003

JAMES A. GRANER  
James A. Graner  
Vice President and Controller

## Certifications

I, Mark W. Sheahan, certify that:

1. I have reviewed this annual report on Form 10-K of Graco Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

- a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 18, 2003

MARK W. SHEAHAN  
 Mark W. Sheahan  
 Vice President and Treasurer

## Exhibit Index

<u>Exhibit Number</u>	<u>Description</u>
3.1	Restated Articles of Incorporation as amended May 7, 2002.
3.2	Restated Bylaws as amended June 13, 2002. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)
4.1	Rights Agreement dated as of February 25, 2000, between the Company and Wells Fargo, formerly known as Norwest Bank Minnesota, National Association, as Rights Agent, including as Exhibit A the form of the Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Shares. (Incorporated by reference to Exhibit 4 to the Company's Report on Form 8-K dated February 25, 2000.)
*10.1	2002 Corporate and Business Unit Annual Bonus Plan. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 2002.)
*10.2	Executive Officer Annual Incentive Bonus Plan. (Incorporated by reference to Exhibit 10.35 to the Company's 1999 Annual Report on Form 10-K.)
*10.3	Nonemployee Director Stock Option Plan, as amended and restated February 23, 2001. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended March 30, 2001.)
*10.4	Nonemployee Director Stock Plan, as amended and restated June 18, 1999. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the twenty-six weeks ended June 25, 1999.)
*10.5	Long Term Stock Incentive Plan, as amended and restated December 10, 1999. (Incorporated by reference to Exhibit 10.5 to the Company's 1999 Annual Report on Form 10-K.)
*10.6	Graco Inc. Stock Incentive Plan, dated May 1, 2001. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2001.)
*10.7	Deferred Compensation Plan Restated, effective December 1, 1992. (Incorporated by reference to Exhibit 2 to the Company's Report on Form 8-K dated March 11, 1993.) Amendment 1 dated September 1, 1996. (Incorporated by reference to the Company's Report on Form 10-Q for the twenty-six weeks ended June 27, 1997.)
*10.8	Chairman's Award Plan. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 7, 1988.)
*10.9	Retirement Plan for Nonemployee Directors. (Incorporated by reference to Attachment C to Item 5 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 1991.)
*10.10	Restoration Plan 1998 Restatement. (Incorporated by reference to Exhibit 10.8 to the Company's 1997 Annual Report on Form 10-K.)
*10.11	Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Nonemployee Director Stock Option Plan with schedule of awards current as of December 28, 2001. (Incorporated by reference

to Exhibit 10.11 to the Company's 2001 Annual Report on Form 10-K.)

- \*10.12 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Long Term Stock Incentive Plan with schedule of awards current as of December 28, 2001. (Incorporated by reference to Exhibit 10.12 to the Company's 2001 Annual Report on Form 10-K.)
- \*10.13 Stock Option Agreement. Form of agreement used for award of non-incentive stock options to executive officers under the Graco Inc. Stock Incentive Plan with schedule of awards current as of March 29, 2002. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirteen weeks ended March 29, 2002.)
- \*10.14 Executive Deferred Compensation Agreement. Form of supplementary agreement entered into by the Company which provides a retirement benefit to selected executive officers, as amended by Amendment 1, effective September 1, 1990. (Incorporated by reference to Exhibit 3 to the Company's Report on Form 8-K dated March 11, 1993.)
- \*10.15 Key Employee Agreement. Form of agreement with officers and other key employees relating to change of control. (Incorporated by reference to Exhibit 10.15 to the Company's 2001 Annual Report on Form 10-K.)
- \*10.16 Executive Long Term Incentive Agreement. Form of agreement used for award of restricted stock to executive officers under the Graco Inc. Stock Incentive Plan with schedule of awards current as of June 28, 2002. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)
- \*10.17 Trust Agreement dated September 30, 1997, between the Company and Wells Fargo, formerly known as Norwest Bank Minnesota, N.A. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirty-nine weeks ended September 26, 1997.)
- \*10.18 Letter Agreement with President and Chief Executive Officer, dated June 5, 2001. (Incorporated by reference to Exhibit 10.2 to the Company's Report on Form 10-Q for the thirteen weeks ended June 29, 2001.)
- \*10.19 Form of salary protection arrangement between the Company and executive officers. (Incorporated by reference to Exhibit 10.21 to the Company's 1995 Annual Report on Form 10-K.)
- \*10.20 Executive Group Long-Term Disability Policy. (Incorporated by reference to Exhibit 10.1 to the Company's Report on Form 10-Q for the thirteen weeks ended June 28, 2002.)
- \*10.21 Separation and Release Agreement between Stephen L. Bauman and the Company dated July 25, 2002. (Incorporated by reference to Exhibit 10 to the Company's Report on Form 10-Q for the thirteen weeks ended September 27, 2002.)
- \*10.22 Stock Option Agreement. Form of agreement used for award of nonstatutory stock options to nonemployee directors under the Graco Inc. Stock Incentive Plan with schedule of awards current as of June 28, 2002.
- \*10.23 Employee Stock Incentive Plan as adopted by the Board of Directors in February 1999.
  - 11 Statement of Computation of Earnings per share included in Note I on page 31.
  - 21 Subsidiaries of the Registrant included herein on page 44.
  - 23 Independent Auditors' Consent included herein on page 45.
  - 24 Power of Attorney included herein on page 46.
  - 99 Cautionary Statement Regarding Forward-Looking Statements included herein on page 47.
  - 99.1 Certification of President and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 included herein on page 49.
  - 99.2 Certification of Vice President and Controller pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 included herein on page 50.
  - 99.3 Certification of Vice President and Treasurer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 included herein on page 51.

\*Management Contracts, Compensatory Plans or Arrangements.

Pursuant to Item 601(b)(4)(iii) of Regulation S-K, copies of certain instruments defining the rights of holders of certain long-term debt of the Company and its subsidiaries are not filed as exhibits because the amount of debt authorized under any such instrument does not exceed 10 percent of the total assets of the Company and its subsidiaries. The Company agrees to furnish copies thereof to the Securities and Exchange Commission upon request.

## Exhibit 21

### Subsidiaries of Graco Inc.

The following are subsidiaries of the Company:

Subsidiary	Jurisdiction of Organization	Percentage of Voting Securities Owned by The Company
Equipos Graco Argentina S.A	Argentina	100%*
Graco Barbados FSC Limited	Barbados	100%
Graco Canada Inc.	Canada	100%
Graco do Brasil Limitada	Brazil	100%*
Graco Europe N.V	Belgium	100%*
Graco Fluid Equipment (Shanghai) Co., Ltd.	China (PRC)	100%
Graco GmbH	Germany	100%
Graco Hong Kong Limited	Hong Kong	100%*
Graco K.K	Japan	100%
Graco Korea Inc.	Korea	100%
Graco Limited	England	100%*
Graco Minnesota Inc.	United States	100%
Graco N.V	Belgium	100%*
Graco S.A.S	France	100%
Graco South Dakota Inc.	United States	100%**

\* Includes shares held by selected directors and/or executive officers of the Company or the relevant subsidiary to satisfy the requirements of local law.

\*\* Shares 100% held by Graco Minnesota Inc.

## Exhibit 23

### INDEPENDENT AUDITORS' CONSENT

We consent to the incorporation by reference in Registration Statements No. 333-17691, No. 333-17787, No. 33-54205, No. 333-03459, No. 333-75307, and No. 333-63128 on Form S-8 of our report dated January 20, 2003 (March 19, 2003 as to Note M), appearing in this Annual Report on Form 10-K of Graco Inc. for the year ended December 27, 2002.

Deloitte & Touche LLP  
 Minneapolis, Minnesota  
 March 19, 2003

## Exhibit 24

### Power of Attorney

Know all by these presents, that each person whose signature appears below hereby constitutes and appoints David A. Roberts or Mark W. Sheahan, that person's true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution for that person and in that person's name, place and stead, in any and all capacities, to sign the Report on Form 10-K for the year ended December 27, 2002, of Graco Inc. (and any and all amendments thereto) and to file the same with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as that person might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitutes, may lawfully do or cause to be done by virtue hereof.

In witness whereof, this Power of Attorney has been signed by the following persons on the date indicated.

	Date
\R. O. Baukol _____	February 21, 2003 _____
R. O. Baukol	
\R. G. Bohn _____	February 21, 2003 _____
R. G. Bohn	
\W. J. Carroll _____	February 21, 2003 _____
W. J. Carroll	
\J. K. Gilligan _____	February 21, 2003 _____
J. K. Gilligan	
\D. A. Koch _____	February 21, 2003 _____
D. A. Koch	
\L. R. Mitau _____	February 21, 2003 _____
L. R. Mitau	

<u>\J. H. Moar</u>	<u>February 21, 2003</u>
J. H. Moar	
<u>\M. A.M. Morfitt</u>	<u>February 21, 2003</u>
M. A.M. Morfitt	
<u>\M. H. Rauenhorst</u>	<u>February 21, 2003</u>
M. H. Rauenhorst	
<u>\D. A. Roberts</u>	<u>February 21, 2003</u>
D. A. Roberts	
<u>\W. G. Van Dyke</u>	<u>February 21, 2003</u>
W. G. Van Dyke	

Exhibit 99

### CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

Graco Inc. (the "Company") wishes 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 the Company with the Securities and Exchange Commission, including the Company's Form 10-K, Form 10-Q and Form 8-K, its Annual Report to Shareholders, and other written documents or oral statements released by the 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 the Company's expectations concerning the future. Such statements are based upon currently available information, but various risks and uncertainties may cause the Company's actual results to differ materially from those expressed in these statements. Among the factors which management believes could affect the Company's operating results are the following:

- With respect to the Company's business as a whole, the Company's prospects and operating results may be affected by:
  - changing economic conditions in the United States and other major world economies, including economic expansions, downturns or recessions; fluctuations in capital goods investment activity, interest rates, and foreign currency exchange rates, specifically the current economic turmoil, political instability and currency devaluations in Latin America and the weak economic conditions in Japan and Germany;
  - international trade factors, including changes in international trade policy, such as export controls, trade sanctions (including specifically the tax dispute related to foreign sales corporations currently pending between the United States and European Community); increased tariff barriers and other restrictions; weaker protection of the Company's proprietary technology in certain foreign countries; the burden of complying with foreign laws and standards; and potentially burdensome taxes;
  - the ability of the Company to develop new products and technologies; maintain and enhance its market position relative to its competitors; maintain and enhance its distribution channels; identify and enter into new markets; successfully conclude and integrate acquisitions; realize productivity and product quality improvements; and continue to control expenses;
  - disruption in operations, transportation, communication, customer operations, distribution, payment or sources of supply, including the cost and availability of skilled labor, raw materials and energy, caused by political or economic instability, acts of God, labor disputes, war, embargo, fire or other cause beyond its reasonable control, including military conflict in the Middle East or on the Korean peninsula and terrorist activity throughout the world;
  - worldwide competition from low-cost non-U.S. manufacturers, including those that copy the Company's products;
  - breakdown or interruption in the Company's information processing software, hardware or networks;
  - changes in the markets in which the Company participates, including consolidation of competitors and major customers, price competition, and mix of products demanded.;
  - changes in accounting standards or in the application by the Company of critical accounting policies;
  - growth in either the severity or magnitude of the products liability claims against the Company; and
  - changes in the return on investments in the Company's retirement plan.
- The prospects and operating results of the Company's Contractor Equipment Division may be affected by: variations in the level of residential, commercial and institutional building and remodeling activity; the loss or significant reduction in sales to a large customer; the availability and cost of construction financing; changes in the environmental regulation of coatings; consolidation in the paint equipment manufacturing industry and paint manufacturing industry; changes in the technology of paint and coating applications; changes in the buying and channel preferences of the end user; the Company's success in converting painters outside North America from brush and roller to spray equipment; changes in the business practices (including inventory management) of the major distributors of contractor equipment; changes in construction materials and techniques; changes in the cost of labor in foreign

markets; the regional market strength of certain competitors; the level of government spending on infrastructure development and road construction, maintenance and repair; and the nature and extent of highway safety regulation.

- The prospects and operating results of the Company's Industrial/Automotive Equipment Division may be affected by: the capital equipment spending levels of industrial customers; the availability and cost of customer financing; changes in the environmental regulation of coatings; changes in the technical and performance characteristics of materials, including powder; changes in application technology; the ability of the Company to meet changing customer requirements; consolidation or other change in the channels of distribution; the pricing strategies of competitors; consolidation in the fluid handling equipment manufacturing industry; the equipment purchase plans of major automobile manufacturers worldwide (which are in turn impacted by the level of automotive sales worldwide); changes in the worldwide procurement practices of the major automobile manufacturers; changes in automotive manufacturing processes; and consolidation in the automobile manufacturing industry worldwide.
- The prospects and operating results of the Company's Lubrication Equipment Division may be affected by: consolidation in the oil production industry; the development of extended life lubricants for vehicles; the reduction in the need for changing vehicle lubricants; consumer trends in "do-it-yourself" vs. "do-it-for-me" oil changes; the successful development of vehicles that use power sources other than the internal combustion engine; consolidation of automotive dealerships; trends in spending by state and local governments; and variations in the equipment spending levels of the major oil companies.

Exhibit 99.1

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Graco Inc. (the "Company") on Form 10-K for the period ending December 27, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, David A. Roberts, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

DAVID A. ROBERTS  
David A. Roberts  
President and Chief Executive Officer  
March 18, 2003

Exhibit 99.2

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Graco Inc. (the "Company") on Form 10-K for the period ending December 27, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, James A. Graner, Vice President and Controller of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

JAMES A. GRANER  
James A. Graner  
Vice President and Controller  
March 18, 2003

Exhibit 99.3

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Graco Inc. (the "Company") on Form 10-K for the period ending December 27, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mark W. Sheahan, Vice President and Treasurer of the Company, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

MARK W. SHEAHAN

Mark W. Sheahan  
Vice President and Treasurer  
March 18, 2003

**ARTICLES OF AMENDMENT  
RESTATING  
ARTICLE OF INCORPORATION OF  
GRACO INC.**

**INCIDENT TO A STOCK SPLIT BY  
BOARD OF DIRECTORS**

The undersigned, Robert M. Mattison, Secretary of Graco Inc., a Minnesota corporation, (the "Company"), hereby certifies:

- (i) that Article 4.1(a) of the Company's Articles of Incorporation has been amended to read in its entirety as follows:

4.1(a) The total number of shares which this corporation shall be authorized to issue is Seventy Million Twenty-two Thousand Five Hundred Forty-nine (70,022,549) shares of which Sixty-seven Million (67,000,000) shares of the par value of \$1.00 per share shall be Common Shares, Three Million (3,000,000) shares of the par value of \$1.00 per share shall be Preferred Shares and Twenty-two Thousand Five Hundred Forty-nine (22,549) shares of the par value of \$100.00 per share shall be Cumulative Preferred Shares.

- (ii) That such amendment has been adopted in accordance with the requirements of, and pursuant to, Chapter 302A of the Minnesota Statutes;
- (iii) That such amendment was adopted pursuant to Section 302A.402 of the Minnesota Statutes in connection with a division of the Company's Common Stock; and
- (iv) That such amendment will not adversely affect the rights or preferences of the holders of the outstanding shares of any class or series of the Company and will not result in the percentage of authorized shares of any class or series that remains unissued after such division exceeding the percentage of authorized shares of the same class or series remaining unissued before the division.

The division giving rise to the amendment set forth above concerns a three for two split of the Common Stock of the Company. Such division is being effected as follows:

- (i) on June 6, 2002, (the "Effective Date") each share of Common Stock outstanding on May 21, 2002 (the "Record Date") will be split and converted into one and one-half (1-1/2) shares of Common Stock of the Company; and
- (ii) on or before the Effective Date, the Company's transfer agent and registrar will sign and register a certificate or certificates representing one share of the authorized but unissued Common Stock of the Company for every two shares of Common Stock held of record by each common shareholder of record on the Record Date, and will deliver or mail such certificates to each holder; and
- (iii) in settlement of fractional interests which may arise as a result of common shareholders of record on the Record Date holding a number shares not divisible by two, such common shareholders of record will be entitled to cash in an amount equal to the product of (a) the fraction one-half (1/2) multiplied by (b) 66-2/3% of the closing sale price of the Company's Common Stock as reported by the New York Stock Exchange on the Record Date.

The document entitled "Restated Articles of Incorporation of Graco Inc." marked as Exhibit A and attached hereto contains the full text of the Articles of Incorporation of Graco Inc., incorporating in its entirety the amendment of Article 4.1(a) adopted by the Board of Directors on May 7, 2002.

The document entitled "Restated Articles of Incorporation of Graco Inc.", attached hereto as Exhibit A, correctly sets forth, without change, the corresponding provisions of the existing articles as previously amended and merely restates the existing articles, plus the instant amendment to Article 4.1(a), in their entirety.

The "Restated Articles of Incorporation of Graco Inc.", attached hereto as Exhibit A, supersede the prior restated Articles of Incorporation and all amendments thereto.

IN WITNESS WHEREOF, the undersigned, the Secretary of Graco Inc., being duly authorized on behalf of Graco Inc., has executed this document this 14<sup>th</sup> day of May, 2002.

\Robert M. Mattison

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Robert M. Mattison  
Secretary

The foregoing instrument was acknowledged before me on May 14, 2002, by Robert M. Mattison, as Secretary of Graco Inc., on behalf of such corporation.

\Brenda L. Colsch

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Brenda L. Colsch  
Notary Public

**RESTATED ARTICLES OF INCORPORATION  
OF  
GRACO INC.**

(Approved by the Board of Directors on May 7, 2002)

**ARTICLE I**

1. The name of this corporation shall be Graco Inc.

**ARTICLE 2**

2. Corporation Service Company, is this corporation's registered agent in the State of Minnesota, and Multifoods Tower, 33 South Sixth Street, Minneapolis, Minnesota 55402, the business office address of Corporation Service Company, is the registered office of this corporation.

**ARTICLE 3**

3. Any action required or permitted to be taken at a meeting of the Board of Directors of this corporation not needing approval by the shareholders under Minnesota Statutes, Chapter 302A, may be taken by written action signed by the number of directors that would be required to take such action at a meeting of the Board of Directors at which all directors are present.

**ARTICLE 4**

4.1(a) The total number of shares which this corporation shall be authorized to issue is Seventy Million Twenty-two Thousand Five Hundred Forty-nine (70,022,549) shares of which Sixty-seven Million (67,000,000) shares of the par value of \$1.00 per share shall be Common Shares, Three Million (3,000,000) shares of the par value of \$1.00 per share shall be Preferred Shares and Twenty-two Thousand Five Hundred Forty-nine (22,549) shares of the par value of \$100.00 per share shall be Cumulative Preferred Shares.

(b) Preferred Shares may be issued from time to time in one or more series as the Board of Directors may determine, as hereinafter provided. The Board of Directors is hereby authorized by resolution or resolutions, to provide from time to time for series of Preferred Shares out of the unissued Preferred Shares not then allocated to any series of Preferred Shares. Before any shares of any such series are issued, the Board of Directors shall fix and determine, and is hereby expressly empowered to fix and determine, by resolution or resolutions, the designations and the relative rights and preferences thereof, of the shares of such series. Preferred Shares will be senior to the Cumulative Preferred Shares in terms of dividend and liquidation rights unless the Board of Directors specifically provides otherwise in the resolution or resolutions establishing a series of Preferred Shares.

The Board of Directors is expressly authorized to vary the provisions relating to the foregoing matters among the various series of Preferred Shares.

Preferred Shares of any series that shall be issued and thereafter acquired by the corporation through purchase, redemption (whether through the operation of a sinking fund or otherwise), conversion, exchange or otherwise, shall, upon appropriate filing and recording to the extent required by law, have the status of authorized and unissued Preferred Shares and may be reissued as part of such series or as part of any other series of Preferred Shares. Unless otherwise provided in the resolution or resolutions of the Board of Directors providing for the issue thereof, the number of authorized shares of any series of Preferred Shares may be increased or decreased (but not below the number of shares thereof then outstanding) by resolution or resolutions of the Board of Directors and appropriate filing and recording to the extent required by law. In case the number of shares of any such series of Preferred Shares shall be decreased, the shares representing such decrease shall, unless otherwise provided in the resolution or resolutions of the Board of Directors providing for the issuance thereof, resume the status of authorized but unissued Preferred Shares, undesignated as to series.

4.2 The designations, relative rights, voting powers, preferences and restrictions granted to or imposed upon the Common Shares and Cumulative Preferred Shares, which shall be subject to the rights granted to any series of Preferred Shares in the resolutions authorizing the series, are as follows:

(a) *Voting.* Except as expressly set forth in sub-division (f) below and except as otherwise provided in the resolutions authorizing any series of Preferred Shares or by law, the holders of Common Shares shall have the sole voting rights of shareholders of the corporation and shall be entitled to one vote for each share held. The shareholders of the corporation shall have no right to cumulate votes for the election of directors.

(b) *No Pre-emptive Rights.* Except as provided in the resolutions authorizing any series of Preferred Shares, no holders of any

share of stock of any class of this corporation shall have any pre-emptive right to subscribe to any issue of shares of any class of this corporation now or hereafter authorized or any security hereafter issued by this corporation convertible into shares of this corporation.

(c) *Dividends.* The holders of Cumulative Preferred Shares shall be entitled to receive out of any assets legally available therefor, when and as declared by the Board of Directors, fixed cumulative dividends at the rate of five percent (5%) per annum upon the par value thereof, and no more, payable semiannually on January 1 and July 1 of each year. Such dividends shall be cumulative from January 1, 1969.

In no event shall any dividend be paid or declared (other than dividends payable in Common Shares of any class), nor shall any distribution be made on the Common Shares of any class of the corporation, nor shall any Common Shares of any class be purchased, redeemed or otherwise acquired by the corporation for value unless all dividends on the Cumulative Preferred Shares for all past semiannual dividend periods and for the then current semiannual dividend period shall have been paid, or declared and a sum sufficient for the payment thereof set apart for payment.

Subject to the provisions of this Article 5 and not otherwise, dividends may be declared by the Board of Directors and paid from time to time, out of any funds legally available therefor, upon the Common Shares, and the holders of Cumulative Preferred Shares shall not be entitled to participate in any such dividends.

(d) *Redemption.* The Cumulative Preferred Shares of the corporation may be redeemed as a whole at any time or in part from time to time at the option of the corporation by resolution of the Board of Directors at the redemption price of \$105 per share together with an amount equal to all accrued and unpaid cumulative dividends thereon from the date on which dividends thereon became cumulative to the redemption date. If less than all of the outstanding Cumulative Preferred Shares are to be redeemed, the shares to be redeemed shall be selected by the Board of Directors or by a person appointed for such purpose by the Board of Directors.

Notice of every redemption of Cumulative Preferred Shares shall be mailed addressed to the holders of record of the shares to be redeemed at their respective addresses as they appear on the stock books of the corporation not less than thirty (30) and not more than sixty (60) days prior to the date fixed for redemption.

If notice of redemption shall have been duly given as aforesaid and if on or before the redemption date specified in the notice, all funds necessary for the redemption shall have been deposited in trust with a bank or trust company in good standing and doing business at any place within the United States, and designated in the notice of redemption, for the pro rata benefit of the shares so called for redemption, so as to be and continue to be available therefor, then, from and after the date of such deposit, notwithstanding that any certificate for Cumulative Preferred Shares so called for redemption shall not have been surrendered for cancellation, the shares represented thereby shall no longer be deemed outstanding, and the dividends thereon shall cease to accumulate from and after the date fixed for redemption, and all rights with respect to the Cumulative Preferred Shares so called for redemption shall forthwith, on the date of such deposit, cease and terminate except only the right of the holders thereof to receive the redemption price of the shares so redeemed, including accrued cumulative dividends to the redemption date, but without interest. Any funds deposited by the corporation pursuant to this paragraph and unclaimed at the end of six (6) years after the date fixed for redemption shall be repaid to the corporation upon its request expressed in a resolution of its Board of Directors, after which repayment the holders of the shares so called for redemption shall look only to the corporation for the payment thereof.

(e) *Dissolution, Liquidation, etc.* In the event of any dissolution, liquidation or winding up of the affairs of the corporation, before any distribution or payment shall be made to the holders of Common Shares, the holders of the Cumulative Preferred Shares shall be entitled to be paid in full the par value thereof if such liquidation, dissolution or winding up shall be involuntary, and the sum of \$105 per share if such liquidation, dissolution or winding up shall be voluntary, together, in either event, with a sum, in the case of each share, equal to the cumulative accrued and unpaid dividends thereon to the date fixed for such distribution or payment. If such distribution or payment shall have been made to the holders of the Cumulative Preferred Shares or moneys made available for such payment in full, the remaining assets and funds of the corporation shall be distributed ratably to the holders of the Common Shares. If there shall be insufficient assets to make full payment to the holders of Cumulative Preferred Shares as above provided, the assets of the corporation shall be distributed among the holders of Cumulative Preferred Shares ratably. Except as herein otherwise expressly provided, the Cumulative Preferred Shares shall not be entitled to participate in any of the profits, surplus or assets of the corporation. The consolidation or merger of the corporation into or with any other corporation or corporations pursuant to the statutes of the State of Minnesota shall not be deemed a liquidation, dissolution or winding up of the affairs of the corporation within the meaning of any of the provisions of this paragraph.

(f) *Special Voting Rights.* The holders of Cumulative Preferred Shares shall not be entitled as such to vote at any meeting of the shareholders of the corporation except as required by law or as hereinafter otherwise provided.

(i) If an amendment to the Articles of Incorporation of the corporation would adversely affect the rights of the holders of Cumulative Preferred Shares, then in addition to the vote thereon by the holders of the Common Shares, the holders of Cumulative Preferred Shares shall be entitled to vote separately as a class thereon, and such amendment shall be adopted only if it receives the affirmative vote of the holders of a majority of the Cumulative Preferred Shares.

(ii) After an amount equivalent to three (3) full semi-annual dividend installments of the Cumulative Preferred Shares shall be in default, the holders of Cumulative Preferred Shares at the time outstanding, voting separately as a class shall, at any annual meeting of the shareholders or any special meeting of the shareholders called as herein provided occurring during such period, elect two (2) members of the Board of Directors, and the holders of the Common Shares, voting separately as a class, shall elect the remaining directors of the corporation.

(iii) After an amount equivalent to six (6) full semi-annual dividend installments of the Cumulative Preferred Shares shall be in default, the holders of Cumulative Preferred Shares, voting separately as a class, shall, at any annual meeting of the shareholders or any special meeting of the shareholders called as herein provided occurring during such period, elect the smallest number of directors necessary to constitute a majority of the full Board of Directors, and the holders of the Common Shares, voting separately as a class, shall elect the remaining directors of the corporation.

At any annual meeting or special meeting of shareholders for the election of directors occurring after all cumulative dividends then in default on the Cumulative Preferred Shares then outstanding, including the dividend for the then current semi-annual period, shall have been paid, or declared and set apart for payment, the Cumulative Preferred Shares shall thereupon be divested of any rights with respect to the election of directors as above provided, but always subject to the same provisions for the revesting of such voting power in the Cumulative Preferred Shares in the case of a future like default or defaults in dividends on Preferred Shares.

Voting power for the election of directors vested in the holders of the Cumulative Preferred Shares as above provided may be exercised at any annual meeting of shareholders or at a special meeting of shareholders held for such purpose, which special meeting of shareholders shall be called by the proper officers of the corporation at any time when such voting power shall be vested within twenty (20) days after written request therefor signed by the holder or holders of not less than ten percent (10%) of the Cumulative Preferred Shares then outstanding, the date of such special meeting to be not more than twenty (20) days from the date of giving notice thereof, and such notice shall be given to all holders of Cumulative Preferred Shares and Common Shares not less than ten (10) days prior to said meeting. In each such case such notice shall direct attention to the voting rights of the holders of Cumulative Preferred Shares. At any such meeting the presence in person or by proxy of the holders of a majority of the Cumulative Preferred Shares outstanding shall be required to constitute a quorum for the election of directors whom the holders of Cumulative Preferred Shares are entitled to elect and, likewise, the presence in person or by proxy of the holders of a majority of the Common Shares outstanding shall be required to constitute a quorum for the election of directors whom the holder of Common Shares are entitled to elect; provided that either the Cumulative Preferred shareholders or the Common shareholders who are present in person or by proxy at such a meeting shall have power to adjourn such meeting for the election of directors to be elected by them from time to time, without notice other than announcement at the meeting and, provided further, that the adjournment of the meeting for lack of a quorum of the Common shareholders shall not prevent the election at that meeting of the directors whom the Cumulative Preferred shareholders are entitled to elect if there is a quorum of the Cumulative preferred shareholders.

If at any time the holders of Cumulative Preferred Shares shall become entitled to elect two (2) directors or a majority of the Board of Directors as aforesaid, the terms of all incumbent directors shall expire whenever such two (2) directors or such majority have been duly elected and qualified.

Whenever the Cumulative Preferred Shares shall be divested of voting power with respect to the election of directors the terms of all then incumbent directors shall expire upon the election of a new board by the holders of Common Shares at the next annual or special meeting for the election of directors.

If a vacancy or vacancies in the Board of Directors shall exist with respect to a director or directors elected by the Cumulative Preferred shareholders, the remaining director or directors elected by the Cumulative Preferred shareholders may, by the vote of such remaining director if there be but one, or by the vote of a majority of such remaining directors if there be more than one, elect a successor or successors to hold office for the unexpired term. Likewise, a vacancy or vacancies existing with respect to directors elected by the Common shareholders may be filled by the remaining director or directors elected by the Common shareholders.

## ARTICLE 5

5.1 Whether or not a vote of shareholders is otherwise required, the affirmative vote of the holders of not less than two-thirds of the outstanding shares of "Voting Stock" (as hereafter defined) of the corporation shall be required for the approval or authorization of any "Business Combination" (as hereafter defined) with any Related Person (as hereafter defined) involving the corporation or the approval or authorization by the corporation in its capacity as a shareholder of any Business Combination involving a "Subsidiary" (as hereafter defined) which requires the approval or authorization of the shareholders of the Subsidiary; provided, however, that the two-thirds voting requirement shall not be applicable if:

(a) The "Continuing Directors" (as hereafter defined) by a majority vote have expressly approved the Business Combination; or

(b) The Business Combination is a merger, consolidation, exchange of shares or sale of all or substantially all of the assets of the corporation and the cash or fair market value (determined as of the effective date of such Business Combination or, in the case of a sale of assets as of the date of the distribution of the proceeds of the sale to the shareholders of the corporation) of the property, securities or other consideration to be received per share by holders of common stock of the corporation other than the Related Person is not less than the highest per share price (with appropriate adjustments for recapitalizations, stock splits, stock dividends and like distributions), paid by the Related Person in acquiring any of its holdings of the corporation's common stock during the two-year period prior to the effective date of the Business Combination or the distribution of the proceeds of a sale of assets.

5.2 For the purposes of this Article 6:

(a) The term "Business Combination" shall mean

(i) any merger or consolidation of the corporation or a Subsidiary with or into a Related Person,

(ii) any exchange of shares of the corporation or a Subsidiary for shares of a Related Person which, in the absence of this Article, would have required the affirmative vote of at least a majority of the voting power of the outstanding shares of the corporation entitled to vote or the affirmative vote of the corporation, in its capacity as a shareholder of the Subsidiary,

(iii) any sale, lease, exchange, transfer or other disposition (in one transaction or a series of transactions), including, without limitation, a mortgage or any other security device, of all or any "Substantial Part" (as hereinafter defined) of the assets either of the corporation (including, without limitation, any voting securities of a Subsidiary) or of a Subsidiary, to or with a Related Person,

(iv) any sale, lease, exchange, transfer or other disposition (in one transaction or a series of transactions) of all or any Substantial Part of the assets of a Related Person to or with the corporation or a Subsidiary,

(v) the issuance of any securities to a Related Person (except pursuant to stock dividends, stock splits or similar transactions which would not have the effect of increasing the proportionate voting power of a Related Person) of the corporation, or of a Subsidiary (except pursuant to a pro rata distribution to all holders of common stock of the corporation),

(vi) any recapitalization or reclassification that would have the effect of increasing the voting power of a Related Person, and

(vii) any agreement, contract or other arrangement providing for any of the transactions described in this definition of Business Combination.

(b) The term "Related Person" shall mean and include any individual, corporation, partnership or other person or entity which, together with its "Affiliates" and "Associates" (as defined on February 24, 1984 by Rule 12b-2 under the Securities Exchange Act of 1934), "Beneficially Owns" (as defined on February 24, 1984 by Rule 13d-3 under the Securities Exchange Act of 1934) in the aggregate 15 percent or more of the outstanding Voting Stock of the corporation, and any Affiliate or Associate (other than the corporation or a wholly-owned subsidiary of the corporation) of any such individual, corporation, partnership or other person or entity.

(c) The term "Substantial Part" shall mean more than 30 percent of the fair market value of the total assets of the corporation in question, as of the end of its most recent fiscal year ending prior to the time the determination is being made.

(d) Without limitation, any shares of common stock of the corporation that any Related Person has the right to acquire pursuant to any agreement, or upon exercise of conversion rights, warrants or options, or otherwise, shall be deemed beneficially owned by the Related Person.

(e) The term "Subsidiary" shall mean any corporation, a majority of the equity securities of any class of which are owned by the corporation, by another Subsidiary, or in the aggregate by the corporation and one or more of its Subsidiaries.

(f) The term "Voting Stock" shall mean all outstanding shares of capital stock of the corporation entitled to vote generally in the election of directors and each reference to a proportion of shares of Voting Stock shall refer to such proportion of the votes entitled to be cast by such shares.

(g) The term "Continuing Director" shall mean (i) a director who was a member of the Board of Directors of the corporation either on February 24, 1984 or immediately prior to the time that any Related Person involved in the Business Combination in question became a Related Person and (ii) any person becoming a director whose election, or nomination for election by the corporation's shareholders, was approved by a vote of a majority of the Continuing Directors; provided, however, that in no event shall a Related Person involved in the Business Combination in question be deemed to be a Continuing Director.

5.3 For the purposes of this Article 6 the Continuing Directors by a majority vote shall have the power to make a good faith determination, on the basis of information known to them, of: (i) the number of shares of Voting Stock of the corporation that any person or entity Beneficially Owns, (ii) whether a person or entity is an Affiliate or Associate of another, (iii) whether the assets subject to any Business Combination constitute a Substantial Part, (iv) whether any business transaction is one in which a Related Person has an interest, (v) whether the cash or fair market value of the property, securities or other consideration to be received per share by holders of capital stock of the corporation other than the Related Person in a Business Combination is an amount at least equal to the highest per share price paid by the Related Person and (vi) such other matters with respect to which a determination is required under this Article 6.

5.4 The provisions set forth in this Article 6 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of Voting Stock of the corporation.

## ARTICLE 6

6.1 The number of directors shall initially be ten and, thereafter, shall be fixed from time to time by the Board of Directors or by the affirmative vote of the holders of two-thirds of the voting power of the outstanding capital stock of the corporation, voting together as a single class. The directors shall be divided into three classes, as nearly equal in number as reasonably possible, with the term of office of the first class to expire at the 1988 annual meeting of shareholders, the term of office of the second class to expire at the 1989 annual meeting of shareholders and the term of office of the third class to expire at the 1990 annual meeting of shareholders. At each annual meeting of shareholders following such initial classification and election, directors elected to succeed those directors whose terms expire shall be elected for a term of office to expire at the third succeeding annual meeting of shareholders after their election.

6.2 Subject to the rights of the holders of any series of Preferred Stock then outstanding, newly created directorships resulting from any increase in the authorized number of directors or any vacancies in the Board of Directors resulting from death, resignation, retirement, disqualification, removal from office or other cause may be filled by a majority vote of the directors then in office though less than a quorum, and directors so chosen shall hold office for a term expiring at the next annual meeting of shareholders. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

6.3 Any directors, or the entire Board of Directors, may be removed from office at any time, but only for cause and only by the affirmative vote of the holders of the proportion or number of the voting power of the shares of the classes or series the director represents sufficient to elect them.

6.4 The provisions of this Article 7 may not be repealed or amended in any respect, unless such action is approved by the affirmative vote of the holders of not less than two-thirds of the outstanding shares of the capital stock of the corporation entitled to vote generally in the election of directors, voting together as a single class.

## ARTICLE 7

7. No director of the corporation shall be personally liable to the corporation or its shareholders for monetary damages for breach of fiduciary duty by such director as a director; provided, however, that this Article 8 shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under Section 302A.559 of the Minnesota Business Corporation Act or Section 80A.23 of the Minnesota Securities Law, or (iv) for any transaction from which the director derived an improper personal benefit. No amendment to or repeal of this Article 8 shall apply to or have any effect on the liability or alleged liability of any director of the corporation for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

## ARTICLE 8

8. The Board of Directors of the corporation (the "Board"), when evaluating any offer of another party, (a) to make a tender or exchange offer for any Voting Stock (as defined in Article 6) of the corporation or (b) to effect a Business Combination (as defined in Article 6), shall, in connection with the exercise of its judgment in determining what is in the best interests of the corporation as a whole, be authorized to give due consideration to such factors as the Board determines to be relevant, including, without limitation:

- (i) the interests of the corporation's shareholders;
- (ii) the social, legal and economic effects upon employees, suppliers, customers and others having similar relationships with the corporation, and the communities in which the corporation conducts its business;
- (iii) whether the proposed transaction might violate federal or state laws; and
- (iv) not only the consideration being offered in the proposed transaction, in relation to the then current market price for the outstanding capital stock of the corporation, but also the market price for the capital stock of the corporation over a period of years, the estimated price that might be achieved in a negotiated sale of the corporation as a whole or in part of through orderly liquidation, the premiums over market price for the securities of other corporations in similar transactions, current political, economic or other factors bearing on securities prices and the corporation's financial condition and future prospects.

In connection with any such evaluation, the Board is authorized to conduct such investigations and to engage in such legal proceedings as the Board may determine.

NONEMPLOYEE DIRECTOR  
NONSTATUTORY STOCK OPTION AGREEMENT  
(NSO)

**THIS AGREEMENT**, made this 7<sup>th</sup> day of May, 2002 by and between Graco Inc., a Minnesota corporation (the "Company") and «NAME» (the "Nonemployee Director").

**WITNESSETH THAT:**

**WHEREAS**, the Company pursuant to its Stock Incentive Plan wishes to grant this stock option to Nonemployee Director.

**NOW THEREFORE**, in consideration of the premises and of the mutual covenants herein contained, the parties hereto hereby agree as follows:

**1. Grant of Option**

The Company hereby grants to Nonemployee Director, the right and option (the "Option") to purchase all or any part of an aggregate of «Shares» common shares, par value \$1.00 per share, at the price of «Price» per share on the terms and conditions set forth herein. This is a nonstatutory stock Option which does not qualify for special tax treatment under Sections 421 or 422 of the Internal Revenue Code.

**2. Duration and Exercisability**

- a. This Option may not be exercised by the Nonemployee Director until the expiration of one (1) year from the date of grant, and this Option shall in all events terminate ten (10) years after the date of Grant. During the first year from the date of grant of this Option, no portion of this Option may be exercised. Thereafter this Option shall become exercisable in four cumulative installments of 25% as follows:

<u>Date</u>	<u>Total Portion of Option Which is Exercisable</u>
One Year after Date of Grant	25%
Two Years after Date of Grant	50%
Three Years after Date of Grant	75%
Four Years after Date of Grant	100%

In the event that Nonemployee Director does not purchase in any one year the full number of shares of common stock of the Company to which he/she is entitled under this Option, he/she may, subject to the terms and conditions of Section 3 hereof, purchase such shares of common stock in any subsequent year during the term of this Option.

- b. During the lifetime of the Nonemployee Director, the Option shall be exercisable only by him/her and shall not be assignable or transferable by him/her otherwise than by will or the laws of descent and distribution.

**3. Effect of Termination of Membership on the Board**

- a. In the event a Nonemployee Director ceases being a director of the Company for any reason other than the reasons identified in section 3b below, the Nonemployee Director shall have the right to exercise the Option as follows, subject to the condition that no Option shall be exercisable after the expiration of the term of the Option:

- (1) If the Nonemployee Director was a member of the Board of Directors of the Company for five (5) or more years, the option becomes immediately exercisable upon the date the Nonemployee Director ceases being a director. The Nonemployee Director may exercise the Option for a period of thirty six (36) months from the date the Nonemployee Director ceased being a director, provided that if the Nonemployee Director dies before the thirty-six (36) month period has expired, the Option may be exercised by the Nonemployee Director's legal representative or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death for a period of twelve (12) months from the date of the Nonemployee Director's death.
- (2) If the Nonemployee Director was a member of the Board of Directors of the Company for less than five (5) years, the Nonemployee Director may exercise the Option, to the extent the Option was exercisable at the date the Nonemployee Director ceases being a member of the Board, for a period of thirty (30) days following the date the Nonemployee Director ceased being a director, provided that, if the Nonemployee Director dies before the thirty (30) day period has expired, the Option may be exercised by the Nonemployee Director's legal representative, or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death, for a period of twelve (12) months from the date of the Nonemployee Director's death.
- (3) If the Nonemployee Director dies while a member of the Board of Directors of the Company, the Option, to the extent exercisable by the Nonemployee Director at the date of death, may be exercised by the Nonemployee Director's legal

representative, or any person who acquires the right to exercise an Option by reason of the Nonemployee Director's death, for a period of twelve (12) months from the date of the Nonemployee Director's death.

- (4) In the event the Option is exercised by the executors, administrators, legatees, or distributees of the estate of a deceased optionee, the Company shall be under no obligation to issue stock thereunder unless and until the Company is satisfied that the person or persons exercising the Option are the duly appointed legal representatives of the deceased optionee's estate or the proper legatees or distributees thereof.
- b. If a Nonemployee Director ceases being a director of the Company due to an act of (a) fraud or intentional misrepresentation or (b) embezzlement, misappropriation or conversion of assets or opportunities of the Company or any Affiliate of the Company or (c) any other gross or willful misconduct, as determined by the Board, in its sole and conclusive discretion, the Option granted to such Nonemployee Director shall immediately be forfeited as of the date of the misconduct.

#### 4. Manner of Exercise

- a. The Option can be exercised only by Nonemployee Director or other proper party within the Option period by delivering written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the Option is being exercised and, except as provided in sections 4b(2) and 4b(3) below, accompanied by payment in full of one hundred percent (100%) of the Option price.
- b. The Nonemployee Director may, at his/her election, pay the Option price as follows:
  - (1) by cash or by certified check,
  - (2) by delivery of shares of common stock to the Company, which shall have been owned for at least six (6) months and have a fair market value per share on the date of surrender equal to the exercise price, or
  - (3) by delivery to Company of a properly executed exercise notice together with irrevocable instructions to a broker to promptly deliver to the Company from sale or loan proceeds the amount required to pay the exercise price.

For purposes of subsection 4b(2) hereunder, the fair market value per share is the last sale price reported on the composite tape by the New York Stock Exchange on the business day immediately preceding the date as of which fair market value is being determined or, if there were no sales of shares of the Company's common stock reported on the composite tape on such day, on the most recently preceding day on which there were sales, or if the shares of the Company's stock are not listed or admitted to trading on the New York Stock Exchange on the day as of which the determination is made, the amount determined by the Board or its delegate to be the fair market value of a share on such day.

- c. Such Option price shall be subject to adjustment as provided in Section 6 hereof.

#### 5. Change of Control

- a. Notwithstanding Section 2(a) hereof, all outstanding Options not yet exercisable shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by their terms. A "Change of Control" means:
  - (1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
    - (a) the then outstanding shares of common stock of the Company (the "Outstanding Company Common Stock") or
    - (b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

provided, however, that the following acquisitions will not result in a Change of Control:

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 9, a Trust Person shall not be deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Nonemployee Director or any group that includes the Nonemployee Director, or

- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of subsection (4) below; and

provided, further, that if any Person's beneficial ownership of the Outstanding Company Common Stock or Outstanding Company Voting Securities is 25% or more as a result of a transaction described in clause (i) or (ii) above, and such Person subsequently acquires beneficial ownership of additional Outstanding Company Common Stock or Outstanding Company Voting Securities as a result of a transaction other than that described in clause (i) or (ii) above, such subsequent acquisition will be treated as an acquisition that causes such Person to own 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities and be deemed a Change of Control; and provided further, that in the event any acquisition or other transaction occurs which results in the beneficial ownership of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities by any Trust Person, the Incumbent Board may by majority vote increase the threshold beneficial ownership percentage to a percentage above 32% for any Trust Person; or

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or
- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
- (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of common stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries) in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,
- (b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of common stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and
- (c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or
- (5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

b. A Change of Control shall not be deemed to have occurred with respect to a Nonemployee Director if:

- (1) the acquisition of the 25% or greater interest referred to in subsection a(1) of this Section 5 is by a group, acting in concert, that includes the Nonemployee Director or
- (2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in subsections (4) or (5) of this section by a group, acting in concert, that includes that Nonemployee Director.

## 6. Adjustments and Changes in the Stock

- a. If Nonemployee Director exercises all or any portion of the Option subsequent to any change in the common stock of the Company by reason of any stock dividend, stock split, spin-off, split-up, merger, consolidation, recapitalization, reclassification, combination or exchange of shares, or any other similar corporate event, the aggregate number of shares available under the Plan, and the number and the price of shares of common stock subject to outstanding Options shall be appropriately adjusted automatically.
- b. No right to purchase fractional shares shall result from any adjustment in the Option pursuant to subsection 6a of this Agreement. In case of any such adjustment, the shares subject to the Option shall be rounded down to the nearest whole share.

- c. Notice of any adjustment shall be given by the Company to Nonemployee Director for the Option which shall have been so adjusted and such adjustment (whether or not such notice is given) shall be effective and binding for all purposes of the Plan.

**7. Miscellaneous**

- a. This Option is issued pursuant to the Company's Stock Incentive Plan and is subject to its terms. A copy of the Plan has been given to the Nonemployee Director. The terms of the Plan are also available for inspection during business hours at the principal offices of the Company.
- b. This Agreement shall not confer on Nonemployee Director or other person any claim or right to be granted an Option under the Plan, except as expressly provided in the Plan. Neither the Plan nor any action taken hereunder shall be construed as giving Nonemployee Director any right to be retained in the service of the Company.
- c. Neither Nonemployee Director, the Nonemployee Director's legal representative, nor any person who acquires the right to exercise this Option by reason of the Nonemployee Director's death shall be or have any of the rights or privileges of, a shareholder of the Company in respect of any shares of common stock receivable upon the exercise of this Option, in whole or in part, unless and until certificates for such shares shall have been issued upon exercise of this Option.
- d. The Company shall at all times during the term of the Option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.
- e. This Agreement will be governed by and constructed exclusively in accordance with the laws of the State of Minnesota.

**IN WITNESS WHEREOF**, the parties hereto have caused this Agreement to be executed on the day and year first above written.

GRACO INC.

By \_\_\_\_\_

Its Vice President, General Counsel  
and Secretary

\_\_\_\_\_  
«NAME»  
Nonemployee Director

**Stock Incentive Plan**  
*Schedule Identifying Non-Statutory Stock Option Agreements Executed and  
Material Details in which Executed Agreements Differ from Agreement Copy Filed  
Current as of June 28, 2002*

DATE	NAME	SHARES	PRICE
May 7, 2002	George Aristides	2,500	\$43.05
May 7, 2002	Ronald O. Baukol	2,500	\$43.05
May 7, 2002	Robert G. Bohn	2,500	\$43.05
May 7, 2002	William J. Carroll	2,500	\$43.05
May 7, 2002	J. Kevin Gilligan	2,500	\$43.05
May 7, 2002	David A. Koch	2,500	\$43.05
May 7, 2002	Lee R. Mitau	2,500	\$43.05
May 7, 2002	James H. Moar	2,500	\$43.05
May 7, 2002	Marth A.M. Morfitt	2,500	\$43.05
May 7, 2002	Mark H. Rauenhorst	2,500	\$43.05
May 7, 2002	William G. Van Dyke	2,500	\$43.05

**EMPLOYEE STOCK INCENTIVE PLAN**

**1. Purpose.** The purpose of the Graco Inc. Employee Stock Incentive Plan (the "Plan") is to promote the best interests of Graco Inc. (the "Company") and its shareholders by providing employees of the Company and its subsidiaries the opportunity to acquire a proprietary interest in the Company and thus develop a strong incentive to put forth their best efforts and support changes to further the growth in earnings and market appreciation of the Company. The Company intends that the Plan will thereby facilitate securing, retaining and motivating employees of high caliber.

**2. Administration.** (a) The Plan shall be administered by a committee (the "Committee") selected by the Board of Directors of the Company (the "Board") and consisting of members of the Board. The Committee shall have full and final authority, in its discretion, to interpret the provisions of the Plan and to decide all questions of fact arising in its application; to determine the employees to whom awards shall be made under the Plan; to determine the type of award to be made and the amount, size, terms and conditions of each such award; to determine and establish additional terms and conditions not inconsistent with the Plan and any agreements entered into with participants in connection with the Plan or any stock option award document issued pursuant to the Plan; to determine the time when awards will be granted and when rights may be exercised, which may be after termination of employment; and to make all other determinations necessary or advisable for the administration of the Plan.

(b) The Committee shall select one of its members as its Chairman and shall hold its meetings at such times and places as it may determine. A majority of its members shall constitute a quorum. All determinations of the Committee shall be made by not less than a majority of its members. Any decision or determination reduced to writing and signed by all of the members of the Committee shall be fully effective as if it had been made by a majority vote at a meeting duly called and held. The Committee may appoint a Secretary and may make such rules and regulations for the conduct of its business as it shall deem advisable.

(c) The Committee may delegate all or any part of its authority under this Plan to the Chief Executive Officer of the Company for purposes of making the determinations set forth in subparagraph (a) above and elsewhere in the Plan. The Chief Executive Officer may, in turn, delegate such authority to such other executive officer of the Company as the Chief Executive Officer may determine.

**3. Participants.** Persons eligible to participate in the Plan shall be those employees of the Company or its subsidiaries who are not officers of the Company, as officer is defined in Section 16 of the Securities Exchange Act of 1934 and the rules thereunder. Such officers shall not be eligible to receive awards under the Plan. For the purpose of all awards made under the Plan, the term "subsidiary" shall have the meaning given to it by Rule 405 promulgated under the Securities Act of 1933, as amended. References to "the Company" in this Plan or in any option or other award granted pursuant to the Plan shall be deemed to include a reference to subsidiaries if appropriate.

**4. Awards under the Plan.** Awards by the Committee under the Plan shall be in the form of stock options which do not qualify for special tax treatment under Section 422 of the Internal Revenue Code of 1986, as amended from time to time.

**5. Shares Subject to the Plan.** The shares that may be issued under the Plan shall not exceed in the aggregate 2,250,000 common shares, \$1.00 par value, of the Company. Except as otherwise provided herein, any shares subject to an option which for any reason expires or terminates without issuance or final vesting of such shares shall again be available under the Plan. No fractional shares shall be issued under the Plan.

**6. Stock Options.** Stock options shall be evidenced by a stock option award document in such form not inconsistent with the Plan as the Committee shall approve from time to time, which document shall contain in substance the following terms and conditions.

**6.1. Option Price.** The purchase price per common share deliverable upon the exercise of an option shall not be less than 100% of the fair market value of the stock on the day the option is granted, as determined by the Committee.

**6.2. Exercise of Option.** Each stock option document shall state the period or periods of time within which the option may be exercised by the participant, in whole or in part, which shall be such period or periods of time as may be determined by the Committee, provided that the option period shall not end later than ten years after the date of the grant of the option.

**6.3. Payment of Shares.** A person holding an option ("optionee") awarded under the plan shall notify the Company in writing when the person wishes to exercise the option and designate the number of shares the person wishes to exercise. The full purchase price of such shares shall be tendered with such notice of exercise or, at the discretion of the Committee, pursuant to any arrangements satisfactory to the Committee which provide that the Company will be paid at the time the shares are delivered to the optionee or his or her designee. Payment shall be made either in cash (including check, bank draft or money order) or, at the discretion of the Committee, (i) by delivering the Company's common shares already owned by the optionee having a fair market value equal to the full purchase price of the shares, or (ii) by a reduction in the number of shares delivered upon exercise of the option (iii) a combination of cash and such shares (in each case such shares having an aggregate fair market value on the date of exercise equal to the amount of the purchase price being paid through such delivery or reduction of shares).

**7. Fair Market Value.** The fair market value of a share of the Company's common stock is the last sale price reported on the composite tape by the New York Stock Exchange on the business day immediately preceding the date as of which fair market value is being determined or, if there were no sales of shares of the Company's common stock reported on the composite tape on such day, on the most recently preceding day on which there were sales, or if the shares of the Company's stock are not listed or admitted to trading on the New York Stock Exchange on the day as of which the determination is made, the amount determined by the Committee to be the fair market value of a share on such day.

**8. General Restrictions.** Each award under the Plan shall be subject to the requirement that if, at anytime the Committee shall determine that (a) the listing, registration or qualification of the common shares subject or related thereto upon any securities exchange or under any state or federal law, or (b) the consent or approval of any government regulatory body, or (c) an agreement by the recipient of an award with respect to the disposition of common shares, is necessary or desirable in connection with the granting of such award or the issue or purchase of common shares thereunder, such award may not be consummated in whole or in part unless such listing, registration, qualification, consent, approval or agreement shall have been effected or obtained free of any conditions not acceptable to the Committee. A participant shall, as a condition of receiving any award under the Plan, execute any documents, make any representations, comply with restrictions on stock transferability and take any actions which in the opinion of legal counsel to the Company is required by any applicable law, ruling or regulation.

**9. Rights of a Shareholder.** The recipient of any award under the Plan, unless otherwise provided by the Plan, shall have no rights as a shareholder with respect thereto unless and until certificates for common shares are issued to the recipient.

**10. Right to Terminate Employment.** Nothing in the Plan or in any agreement entered into pursuant to the Plan, or in any stock option award document, shall confer upon any participant the right to continue in the employment of the Company or its subsidiaries, or affect any right which the Company or such subsidiaries may have to terminate the employment of the participant.

## **11. Withholding.**

**11.1. Payment of Withholding Taxes.** Whenever the Company proposes or is required to issue or transfer common shares under the Plan, the Company shall have the right to require the recipient to remit to the Company, or provide indemnification satisfactory to the Company for, an amount sufficient to satisfy any federal, state or local withholding tax requirements prior to the issuance or delivery of any certificate or certificates for such shares.

**11.2. Use of Common Shares to Satisfy Tax Obligation.** In order to assist an optionee or grantee in paying all federal, state and local taxes to be withheld or collected upon exercise of an option, the Committee in its sole discretion and subject to such rules as it may adopt, may permit the optionee or grantee to satisfy such tax obligation, in whole or in part, by (i) electing to have the Company withhold common shares otherwise to be delivered with a fair market value equal to the amount of such tax obligation, or (ii) electing to surrender to the Company previously owned common shares with a fair market value equal to the amount of such tax obligation. The election must be made on or before the date that the amount of tax to be withheld is determined.

**12. Non-Assignability.** No award under the Plan shall be assignable or transferable by the participant except by will or by laws of descent and distribution. During the life of a participant, such award shall be exercisable only by the participant or by the participant's guardian or legal representative.

**13. Non-Uniform Determinations.** The Committee's determinations under the Plan (including, without limitation, determinations of the persons to receive awards, the form, amount and timing of such awards, the terms and provisions of awards and the stock option award documents evidencing the awards, and the establishment of values and performance targets) need not be uniform and may be made by it selectively among persons who receive, or are eligible to receive, awards under the Plan whether or not such persons are similarly situated.

**14. Dissolution, Liquidation, Merger.** In the event of (a) the proposed dissolution or liquidation of the Company, (b) a proposed sale of substantially all of the assets of the Company, or (c) a proposed merger, consolidation of the Company with or into any other entity, regardless of whether the Company is the surviving corporation, or a proposed statutory share exchange with any other entity (the actual effective date of the dissolution, liquidation, sale, merger, consolidation or exchange being herein called an "Event"), the Committee may, but shall not be obligated to, either (i) if the Event is a merger, consolidation or statutory share exchange, make appropriate provision for the protection of outstanding options granted under this Plan by the substitution, in lieu of such options, of options to purchase appropriate voting common stock (the "Survivor's Stock") of the corporation surviving any such merger or consolidation or, if appropriate, the parent corporation of the Company or such surviving corporation, or, alternatively, by the delivery of a number of shares of the Survivor's Stock which has a Fair Market Value as of the effective date of such merger, consolidation or statutory share exchange equal to the product of (x) the excess of (A) the Event Proceeds per Share (as hereinafter defined) covered by the option as of such effective date over (B) the exercise price per Share of the Shares subject to such option, times (y) the number of Shares covered by such option, or (ii) declare, at least twenty days prior to the Event, and provide written notice to each optionee of the declaration, that each outstanding option, whether or not then exercisable, shall be canceled at the time of, or immediately prior to the occurrence of, the Event (unless it shall have been exercised prior to the occurrence of the Event). In connection with any declaration pursuant to clause (ii) of the preceding sentence, the Committee may, but shall not be obligated to, cause payment to be made, within twenty days after the Event, in exchange for each cancelled option to each holder of an option that is cancelled, of cash equal to the amount (if any), for each Share covered by the canceled option, by which the Event Proceeds per Share (as hereinafter defined) exceeds the exercise price per Share covered by such option. At the time of any declaration pursuant to clause (ii) of the first sentence of this paragraph 14, each option that has not previously expired or been cancelled pursuant to any stock option award document issued shall immediately become exercisable in full and each holder of an option shall have the right, during the period preceding the time of cancellation of the option, to exercise his or her option as to all or any part of the Shares covered thereby. In the event of a declaration pursuant to clause (ii) of the first sentence of this paragraph 14, each outstanding option granted pursuant to this Plan that shall not have been exercised prior to the Event shall be canceled at the time of, or immediately prior to, the Event, as provided in the declaration, and this Plan shall terminate at the time of such cancellation, subject to the payment obligations of the Company provided in this Paragraph 14. Notwithstanding the foregoing, no person holding an option shall be entitled to the payment provided in this paragraph 14 if such option shall have expired or been cancelled pursuant to any stock option award document issued to this Plan. For purposes of this paragraph 14, "Event Proceeds per Share" shall mean the cash plus the fair market value, as determined in good faith by the Committee, of the non-cash consideration to be received per Share by the shareholders of the Company upon the occurrence of the Event.

**15. Adjustments in Shares.** In the event of any reorganization, merger, consolidation, recapitalization, liquidation, reclassification, stock dividend, stock split, combination of shares, rights offering, or extraordinary dividend or divestiture (including a spin-off), or any other change in the corporate structure or shares of the Company, the Committee (or if the Company does not survive any such transaction, a comparable committee of the Board of Directors of the surviving corporation) may, without the consent of any holder of an option, make such adjustment as it determines in its discretion to be appropriate as to the number and kind of securities subject to and reserved under this Plan and, in order to prevent dilution or enlargement of rights of participants in this Plan, the number and kind of securities issuable upon exercise of outstanding options and the exercise price thereof.

## **16. Miscellaneous**

**16.1. Adoption.** This Plan was originally adopted in February 1999 as the Graco Inc. Employee Stock Incentive Plan.

**16.2. Amendment.** The Board may amend, suspend, or terminate the Plan at any time.

**16.3. Termination.** Unless the Plan shall have been discontinued at an earlier date, the Plan shall terminate on February 28, 2009. No option may be granted after such termination, but termination of the Plan shall not, without the consent of the optionee or grantee, alter or impair any rights or obligations under any award theretofore granted.