GRACO INC
Form 10-K
February 20, 2007

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

FORM 10-K

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 29, 2006, 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. 001-09249

Graco Inc.

(Exact name of Registrant as specified in its charter)

Minnesota	41-0285640
(State or other jurisdiction of incorporation or organization)	(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

Indicate by a check mark if the registrant is a well-known seasoned investor, as defined in Rule 405 of the Securities Act. Yes _X_ No __

Indicate by a check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ___ No _X_

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 _X_ 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 [ ]

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

Indicate by a check mark whether the registrant is a shell company, as defined by Rule 12b-2 of the Act.
Yes __ No _X_

The aggregate market value of approximately 67,018,000 shares held by non-affiliates of the registrant was approximately $3.1 billion on June 30, 2006.

As of February 16, 2007, 66,647,827 shares of Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company s definitive Proxy Statement for its Annual Meeting of Shareholders to be held on April 20, 2007, are incorporated by reference into Part III, as specifically set forth in said Part III.

INDEX TO ANNUAL REPORT

ON FORM 10-K

			Page
Part I			
	Item 1	Business	3
	Item 1A	Risk Factors	7
	Item 1B	Unresolved Staff Comments	8
	Item 2	Properties	8
	Item 3	Legal Proceedings	8
	Item 4	Submission of Matters to a Vote of Security Holders	8
		Executive Officers of the Company	8
Part II			
	Item 5	Market for the Company's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities	10
	Item 6	Selected Financial Data	12
	Item 7	Management's Discussion and Analysis of Financial Condition and Results of Operations	13
	Item 7A	Quantitative and Qualitative Disclosures About Market Risk	20
	Item 8	Financial Statements and Supplementary Data	22
		Management's Report on Internal Control Over Financial Reporting	22
		Reports of Independent Registered Public Accounting Firm	23
		Consolidated Statements of Earnings	25
		Consolidated Statements of Comprehensive Income	25
		Consolidated Balance Sheets	26
		Consolidated Statements of Cash Flows	27
		Consolidated Statements of Shareholders' Equity	28
	Item 9	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	45
	Item 9A	Controls and Procedures	45
	Item 9B	Other Information	45
Part III			
	Item 10	Directors, Executive Officers and Corporate Governance	46
	Item 11	Executive Compensation	46
	Item 12	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	46
	Item 13	Certain Relationships and Related Transactions and Director Independence	46
	Item 14	Principal Accounting Fees and Services	46
Part IV			
	Item 15	Exhibits and Financial Statement Schedule	47
Signatures			49
Exhibit Index			50

ACCESS TO REPORTS

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 other reports by visiting the Graco website at 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.

PART I

ITEM 1 BUSINESS

Our Company was originally incorporated in the state of South Dakota in 1926 as Gray Company, Inc. and in the state of Minnesota in 1947. It began business as a Minneapolis, Minnesota-based manufacturer of grease guns and lubricating pumps primarily for servicing vehicles. Our Company changed its name to Graco Inc. and first offered its common stock to the public in 1969. Today we provide fluid handling solutions to organizations involved in manufacturing, processing, construction and maintenance throughout the world.

Graco Inc. and its subsidiaries (which we refer to in this Form 10-K as us, we, or our Company) sells a full line of products in each of the following geographic markets: the Americas (North and South America), Europe (including the Middle East and Africa), and Asia Pacific. Sales in the Americas represent approximately 70 percent of our Company s total sales; sales in Europe approximately 20 percent; and sales in Asia Pacific approximately 10 percent. Part II, Item 7, *Results of Operations* and Note B to the Consolidated Financial Statements of this Form 10-K contain financial information about these geographic areas. Our Company provides marketing, product design and application assistance to, and employs sales personnel in, each of these geographic markets. Subsidiaries located in Belgium, the People s Republic of China, Japan, and Korea distribute our Company s products in their local geographies.

For more information about our Company, our products, services and solutions, visit our website at www.graco.com. The information on the website is not part of this report nor any other report filed or furnished to the Securities and Exchange Commission (SEC).

Business Segments

Our Company classifies its business into three reportable sales/engineering/marketing segments, each with a world-wide focus: Industrial, Contractor and Lubrication. Manufacturing for all three segments is centrally managed. Financial information concerning these segments is set forth in Part II, Item 7, *Results of Operations* and Note B to the Consolidated Financial Statements of this Form 10-K.

The equipment developed and distributed by our Company s segments is broadly described as fluid handling equipment. It is used to spray, dispense, measure and move a wide variety of fluids and semi-solids in a wide variety of applications in manufacturing, processing, construction and maintenance industries. Our Company s products make customers more productive by enabling them to reduce their use of labor and material.

The development of technologically superior, multiple-featured, reliable products is a key strategy of our Company. Our Company strives to generate approximately 30 percent of its annual sales from products introduced in the prior three years. In 2006, we generated 21 percent of our sales from new products. In 2005 and 2004, the percentage of sales represented by new products was 29 and 28 percent, respectively. Major product development efforts are carried out in facilities located in Minneapolis and Rogers, Minnesota. Some development work on Liquid Control-branded products is carried out in North Canton, Ohio. The product development and engineering group in each segment focuses on new product design, product improvements, applied engineering and strategic technologies for its specific customer base. Total product development expenditures for all segments were $30 million, $27 million and $22 million in 2006, 2005 and 2004 respectively.

Manufacturing is a key competency of Graco. Our Company invests significant resources in maximizing the quality, responsiveness and cost-effectiveness of its production operations by purchasing state-of-the-art equipment and doing most machining, assembly and testing in-house. Principal products are manufactured in vertically integrated focused factories and product cells. Raw materials and purchased components are sourced from suppliers around the world.

Other primary objectives of our Company include the expansion of distribution, the penetration of new markets and the completion of acquisitions. These subjects are discussed below in the context of each segment s business operations.

Our Company s headquarters are located in a 139,000 sq. ft. facility in Minneapolis, Minnesota. In 2006, the facility was also occupied by the management, marketing and product development personnel assigned to the Lubrication and Industrial segments. Information systems, accounting services and purchasing for our Company are housed in a 42,000 sq. ft. office building nearby.

A large percentage of our Company s facilities are devoted to manufacturing the various products offered for sale by the business segments. Office and warehouse space is often included in such facilities.

Products marketed by the Industrial segment are manufactured in owned facilities in Minneapolis, Minnesota (405,000 sq. ft. manufacturing/warehouse/office), Sioux Falls, South Dakota (149,000 sq. ft. manufacturing/office), North Canton, Ohio (132,000 sq. ft. manufacturing/office), and Wellingborough, U.K. (12,500 sq. ft. manufacturing/office), and leased facilities in Mississauga, Ontario (11,760 sq. ft. assembly/office) and Vilanova, Spain (29,000 sq. ft. manufacturing/warehouse/ office). During 2006, our Company transferred the manufacture of spray guns formerly made by Gusmer in Lakewood, New Jersey, to the Sioux Falls plant. Gusmer and Decker reaction injection molding (RIM) products were manufactured in leased facilities in Lakewood, New Jersey (23,000 sq. ft. office; 59,000 sq. ft. manufacturing/warehouse) through mid-December 2006, when operations were transferred to North Canton, Ohio. The lease for the Lakewood, New Jersey, facilities will terminate in April 2007. A 50,000 sq. ft. addition is being built in North Canton to accommodate the RIM operation and future growth. Our Company will cease manufacturing in the Vilanova, Spain facility in the first half of 2007; products formerly manufactured in this facility will be manufactured in Minneapolis, but warehousing for, and distribution to, Spanish customers will continue. Some Industrial segment products are assembled for the European market in an owned facility located in Maasmechelen, Belgium, site of our Company s European headquarters (75,000 sq. ft. warehouse/office).

Products marketed by the Contractor segment are manufactured in owned facilities in Rogers, Minnesota (333,000 sq. ft. manufacturing/warehouse/office). Segment management, marketing, engineering, customer service, warehouse, shipping, sales and training are also located at the Rogers facility. The Sioux Falls, South Dakota, plant manufactures spray guns and accessories for the Contractor segment.

During 2006, Lubrication segment products were produced in Minneapolis, Minnesota, in a facility shared with the Industrial segment, in an owned facility in Cleveland, Ohio (88,000 sq. ft. manufacturing/warehouse/office) and a leased facility in Madison, Wisconsin (47,000 sq. ft. manufacturing/warehouse/office). During the fourth quarter some Lubrication products were assembled in the new facility owned by our Company in Suzhou, People s Republic of China (P.R.C.) (79,000 gross sq. ft. assembly/warehouse/office). Currently the output of the Suzhou plant is shipped to Minneapolis, Minnesota, for subsequent worldwide distribution. The plant is expected to produce products designed specifically for the Asia Pacific market sometime in the future. In August 2006, our Company purchased a 180,000 sq. ft. facility in Anoka, Minnesota, that is being prepared to accept the consolidation of all U.S.-based Lubrication segment activities beginning in the first quarter of 2007. The Lubriquip plants located in Cleveland, Ohio, and Madison, Wisconsin, will be closed during 2007 as operations in Anoka commence. Manufacturing of traditional lubrication equipment and segment management, marketing, engineering, customer service, warehouse, shipping, sales and training will be moving from Minneapolis facilities to Anoka in 2007.

Industrial Segment

The Industrial segment is the largest part of our Company s businesses and represents approximately 50 percent of our total sales. This segment includes the Industrial Products and the Applied Fluid Technologies divisions. These divisions were created in 2005 to better manage the businesses acquired with the acquisitions of Liquid Control Corporation and Gusmer Corporation. While both divisions market their products and services to customers who manufacture, assemble, repair and refinish appliances, vehicles, airplanes, electronics, cabinets and furniture and other products, the divisions focus on different fluids applied in these industries.

Most Industrial segment equipment is sold worldwide through general and specialized distributors, integrators and original equipment manufacturers. 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. Sharpe® products are distributed by warehouse distributors and jobbers to auto body repair shops. Original equipment manufacturers incorporate our Company s Industrial segment products into the systems and assemblies that they supply to customers. RIM and Liquid Control-brand equipment is primarily sold directly to manufacturers.

Industrial Products

The Industrial Products division focuses its development and sales efforts on three main product families: equipment to apply paint and other coatings to motor vehicles, appliances, furniture and other industrial and consumer products; equipment to move and dispense chemicals and liquid and semi-solid foods; and equipment to refinish and repair automobiles.

Finishing equipment is offered to apply paints, varnishes, and other coatings to products such as automobiles and furniture. This equipment includes paint circulating and paint supply pumps, various accessories to filter, transport, agitate and regulate the fluid, spare parts such as spray tips, seals and filter screens, and a variety of applicators that use different methods of atomizing and spraying the paint or other coating depending on the viscosity of the fluid, the type of finish desired, and the need to maximize transfer efficiency and minimize overspray and the escape of volatile compounds (VOCs).

Our Company s double diaphragm and piston transfer pumps are offered to the chemical, petroleum and food processing industries. FDA-compliant pumps, including 3A1 sanitary pumps for use in dairies, easily dismantled diaphragm pumps, transfer pumps and drum and bin

unloaders are used in many processes which require sanitary conditions. These include pharmaceutical, cosmetic, beverage and food processing applications.

In addition to equipment designed to apply an original finish to various surfaces, Sharpe spray guns are used in the repair (refinishing) of automobiles. The Razor line of spray guns introduced in 2006 permits the painter to use a single gun platform to support all material needs from primer to clear coat.

Applied Fluid Technologies

The Applied Fluid Technologies division directs its engineering, sales and marketing efforts toward three broad product families: equipment to apply high performance coatings and foam (protective coatings); equipment to apply sealants and adhesives; and equipment to create reaction injection molded polyurethane parts.

Our Company offers a full line of plural component proportioning equipment to apply protective coatings to a wide variety of surfaces. The Reactor® line of plural component pumps (air, electric or hydraulically-powered) is used to apply foam and polyurea to insulate walls, coat tanks, pipes, roofs and truck beds, waterproof and apply adhesives and caulks to joists, rims and seams, where accurate temperatures and pressures are required to achieve optimum coating results. These pumps are incorporated into systems with our Company s heated hose, diaphragm supply pumps and Fusion spray guns with accurate mix capability. The Reactor systems are also available installed in trailer rigs for mobility and flexibility at remote job sites.

Our Company offers sealant and adhesive equipment (SAE) pumps, applicators and accessories, to the automotive industry, insulated glass, furniture assembly, window manufacturing, bookbinding and other industrial manufacturers. The Therm-O-Flow® bulk melt system was introduced during 2006 and offers a new generation air motor called the NXT with an embedded control structure (provides runaway protection, diagnostics and material usage data), modular air valve, and integrated air controls. The Liquid Control line of equipment meters, mixes and dispenses precision beads of sealants and adhesives and is customized for use in the electronics and automotive industries and in bonding, molding, sealing, doming and gasketing other products.

Our Company acquired the reaction injection molding (RIM) equipment business when it acquired Liquid Control Corporation and Gusmer Corporation in 2005. RIM manufacturing and engineering operations were consolidated in North Canton, Ohio at the end of 2006. Polyurethane RIM systems are used to reduce road noise and vibration in motor vehicles and to produce a wide variety of injection molded parts for automobiles, trucks, consumer products and general industrial use. RIM systems are highly customized and material suppliers and end-user customers play a significant role in the development of RIM systems for specific applications.

Contractor Segment

Generating approximately 40 percent of our Company s 2006 total sales, the Contractor segment represents our second largest business. This segment markets a complete line of airless paint and texture sprayers (air, gas, hydraulically- and electrically-powered), accessories such as spray guns, hoses and filters and spare parts such as tips and seals, to professional and semi-professional painters in the construction and maintenance industries. The products are distributed primarily through stores whose main products are paint and other coatings. Contractor products are also sold through general equipment distributors. A limited line of sprayers are distributed through the home center channel. In 2006 sales to The Sherwin-Williams Company, a manufacturer and retailer of paint and related products, represented 10 percent of the Company s consolidated sales.

Contractor equipment includes a wide variety of sprayers, including sprayers that apply lines to roads, parking lots, fields and floors; texture to walls and ceilings; highly viscous coatings to roofs; and paint to walls and structures. Many of these sprayers and their accessories contain one or more advanced technological features such as micro-processor based controls for consistent spray and protective shut-down, a pump that may be removed and re-installed without tools; an easy clean feature; gas/electric convertibility; and an extremely durable pump finish. Continual technological innovation and broad product families with multiple offerings are characteristic of our Company s Contractor equipment business. Painters are encouraged to upgrade their equipment regularly to take advantage of the new and/or more advanced features. As an example, the GH 833 (gas-hydraulic) sprayer was introduced in 2006. This unit, which replaced a number of hydraulically-driven sprayers, can spray abrasive materials with 4000 psi of pressure, is portable and has features previously appearing on several other Contractor product families, such as a pump lower with an extremely durable finish and an easily dismantled pump system and intake valve.

A large percentage of our Contractor sales come from the North American market, although Contractor products are marketed and sold in all major geographic areas. In recent years, the segment has increased its effort to appeal to customers outside of North America by developing products specifically for these markets, like the Mark X texture sprayer, a 240 volt, 2.4 gallons per minute electric sprayer used to fill in rough areas on plaster and concrete walls and designed to be sold in Europe and Asia Pacific where less drywall is used.

In Europe and Asia Pacific, where the application of paint by brush and roller is more prevalent than by spraying, local sales personnel have pursued a strategy of end-user conversion, which relies heavily on in-person demonstrations to acquaint local painters with the efficiency and

superior finish quality of spray painting.

Lubrication Segment

Traditionally, the Lubrication segment has focused on pumps, applicators and accessories, such as meters and hose reels, for the motor vehicle lubrication market. In this market, our Company s customers include fast oil change facilities, service garages, fleet service centers, automobile dealerships, and auto parts stores. Recent acquisitions have expanded the segment s product offering, providing access to new markets. In November 2005, our Company acquired the assets of PBL Industries, a manufacturer of small electric fuel and oil transfer pumps for use in remote locations to supply fuel and oil to ranch, farm and construction machinery and off-road vehicles. In July 2006, Lubriquip, Inc., a manufacturer of automatic lubrication systems, was acquired. The Lubrication segment represents approximately 10 percent of our Company s sales during 2006.

Although the bulk of the Lubrication segment s sales come from North America, the segment is responsible for world-wide marketing and sales of our Company s lubrication equipment. Products are distributed in each of our Company s major geographic markets, primarily through independent distributors serviced by independent sales representatives, a dedicated sales force in the automatic lubrication systems market and direct sales generalists in foreign markets. Some automatic lubrication systems are marketed to original equipment manufacturers (OEMs). Fuel and oil transfer pumps are marketed through OEMs and to retail customers in select home centers and auto parts stores. In addition, these pumps were made available to our Company s traditional Lubrication equipment distribution channel in the fall of 2006.

In an effort to expand its market for oil and grease pumps beyond the traditional vehicle service user, the Lubrication segment introduced the Hurricane electric oil dispense pump during 2006. This pump-in-a-box provides a light-weight bulk dispense system that requires neither plumbing nor hard wiring prior to operation.

Lubriquip, Inc. is a manufacturer of systems for the automatic lubrication of factory machine tools, compressors and pumps used in petrochemical and gas transmissions plants; bearings and gears on equipment in metal, pulp and paper mills; conveyors and material handling equipment; and off-road and over-the-road trucks. Lubriquip systems are primarily sold through distribution.

Raw Materials

The primary materials and components used in the manufacturing process are steel of various alloys, sizes and hardness; specialty stainless steel and aluminum bar stock, tubing and castings; tungsten carbide; electric motors; injection molded plastics; sheet metal; forgings; powdered metal; hoses; and electronic components. In general, the raw materials and components used are adequately available through multiple sources of supply. In order to manage cost, our Company continues to increase its global sourcing of materials and components, primarily in the Asia Pacific region.

During 2006, our Company experienced increases in the price of stainless steel, copper, zinc, and aluminum. Our Company is endeavoring to address fluctuations in the price and availability of various materials and components through close management of current suppliers, long-term agreements and an intensive search for new suppliers. A lack of capacity at a major castings supplier resulted in delays in the delivery of finished products to our customers during 2006.

Intellectual Property

We own a number of patents and have patent applications pending both in the United States and in other countries, license our patents to others, and are a licensee of patents owned by others. In our opinion, our business is not materially dependent upon any one or more of these patents or licenses. Our 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, Decker, Gusmer, Lubriquip and various product trademarks which are material to our business, inasm as they identify Graco and our products to our customers.

Competition

We face substantial competition in all of our markets. The nature and extent of this competition varies in different markets due to the depth and breadth of our Company s product lines. Product quality, reliability, design, customer support and service, personal relationships, specialized engineering and pricing are the major competitive factors in our markets. Although no competitor duplicates all of our products, some competitors are larger than our Company, both in terms of sales of directly competing products and in terms of total sales and financial resources. We also face competitors with different cost structures and expectations of profitability and these companies offer competitive products at lower prices. We believe we are one of the world s leading producers of high-quality specialized fluid handling equipment. It is not possible to determine our relative market position because of the absence of reliable industry-wide third-party data.

Environmental Protection

Our 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 our Company during the fiscal year ended December 29, 2006.

Employees

As of December 29, 2006, we employed approximately 2,300 persons on a full-time basis. Of this total, approximately 350 were employees based outside the United States, and 950 were hourly factory workers in the United States. With the exception of the approximately 40 factory workers at the Lubriquip plant in Cleveland, Ohio, who are represented by the United Automobile, Aerospace and Agricultural Workers of America, none of our Company s U.S. employees are 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 our Company or its operations.

Item 1A. Risk Factors

Foreign Operations Conditions in foreign countries and changes in foreign exchange rates may impact our results of operations by reducing our sales volume or rate of growth.

We have operations in North America, Europe and Asia. In 2006, approximately 42 percent of our sales was generated by customers located outside the United States. Sales to customers located outside the United States exposes us to special risks, including the risk of terrorist activities and civil disturbances, and special taxes, regulations and restrictions. We are increasing our presence in the Asia Pacific region. We began assembling products at our factory in Suzhou, P.R.C. in the fourth quarter of 2006 and are sourcing many of the components used in the assembly process from the local market. In addition, sales in Eastern Europe are increasing at a faster rate than in Western Europe. Our revenues and net income may be adversely affected by more volatile economic and political conditions in the Middle East, Asia Pacific and Europe. Changes in exchange rates between the U.S. dollar and other currencies will impact our reported sales and earnings.

Foreign Suppliers Our Company has increased its sourcing of raw materials and components from vendors located outside the United States. Interruption or delays in delivery may adversely affect our profitability.

We are sourcing an increasing percentage of our materials and components from suppliers outside the United States. Long lead times may reduce our flexibility and make it more difficult to respond promptly to fluctuations in demand. Changes in exchange rates between the U.S. dollar and other currencies may impact the manufacturing costs of our products and affect our profitability.

Major Customers Our Contractor Equipment segment depends on a few large customers for a significant portion of its sales. Significant declines in the level of purchases by these customers could reduce our sales.

We derive a significant amount of revenue from a few large customers. Substantial decreases in purchases by these customers, difficulty in collecting amounts due or the loss of their business would adversely affect the profitability of our Company s Contractor Equipment segment. The business of these customers is dependent upon the economic vitality of the construction and home maintenance markets. If these markets decline, the business of our customers could be adversely affected and their purchases of our equipment could decrease.

Acquisitions Our growth strategy includes acquisitions. Suitable acquisitions must be located, completed and integrated into our existing businesses in order for this strategy to be successful.

We have identified acquisitions as one of the strategies by which we intend to grow our business. If we do not successfully acquire and integrate businesses into our current business model, or realize projected efficiencies and cost-savings from acquired businesses, we may be unable to meet our growth or profit objectives.

Natural Disasters Our operations are at risk of damage or destruction by natural disasters, such as earthquakes, tornadoes or unusually heavy precipitation.

The loss of, or substantial damage to, one of our facilities could make it difficult to supply our customers with product and provide our employees with work. Our manufacturing and distribution facility in Minneapolis, which supplies our Industrial and Lubrication products, is on the banks of the Mississippi River where it is exposed to flooding. Flooding could also damage our European headquarters and warehouse in Maasmechelen, Belgium or our factory in Suzhou, P.R.C. Tornadoes could damage or destroy our facilities in Sioux Falls, Rogers or Minneapolis and a typhoon could do the same to our facilities in Suzhou. An earthquake may adversely impact our operations in Suzhou.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

The information concerning the location and general character of the physical properties of our Company contained under the heading Business-Business Segments in Part I of this 2006 Annual Report on Form 10-K is incorporated herein by reference.

Sales activities in the countries of Japan, Korea, and the P.R.C. are conducted out of leased facilities Yokohama, Japan (18,500 gross sq. ft. office); and Gwangju-Gun, Korea (15,750 sq. ft. total for two separate facilities-warehouse and office). Our Company also leases space for liaison offices in the P.R.C. and India and for a sales office in Australia.

Our Company s facilities are in satisfactory condition, suitable for their respective uses and are generally adequate to meet current needs. With the exception of delays engendered by a lack of capacity at a major casting supplier and an unanticipated surge in orders for several newly introduced products, manufacturing capacity generally met business demand during 2006. Production requirements in the immediate future are expected to be met through the purchase of the facility in Anoka, Minnesota, additions to the North Canton, Ohio, and Sioux Falls, South Dakota facilities, the installation of new automatic and semi-automatic machine tools, efficiency and productivity improvements, and the use of available subcontract services.

Item 3. Legal Proceedings

Our Company is engaged in routine litigation incident to our business, which management believes will not have a material adverse effect upon our operations or consolidated financial position. We have also been named as a defendant in a number of lawsuits alleging bodily injury as a result of exposure to asbestos, and a number of lawsuits alleging bodily injury as a result of exposure to silica. All of these lawsuits have multiple (most in excess of 100) defendants, and several have multiple plaintiffs. None of the suits make specific allegations regarding our Company or any of its products. A portion of the cost and potential liability for these claims is covered by insurance. Management does not expect that resolution of these matters will have a material adverse effect on our Company, although the ultimate outcome cannot be determined based on available information.

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 2006.

Executive Officers of Our Company

The following are all the executive officers of Graco Inc. as of February 16, 2007:

David A. Roberts, 59, is Chairman, President and Chief Executive Officer, a position he has held since April 2006. He served as President and Chief Executive Officer from June 2001 to April 2006. Prior to joining Graco, he was Group Vice President of the Marmon Group, from 1996 to June 2001. Mr. Roberts has been a director of Graco since June 2001.

Karen Park Gallivan, 50, became Vice President, General Counsel and Secretary in September 2005. She was Vice President, Human Resources from January 2003 to September 2005. Prior to joining Graco, she was Vice President of Human Resources and Communications at Syngenta Seeds, Inc., from January 1999 through December 2003. From 1992 through January 1999, she served as Vice President, Human Resources, Communications and General Counsel for Novartis Nutrition Corporation, and from October 1988 until 1992, she held the position of General Counsel for Novartis Nutrition Corporation. Prior to joining Novartis, Ms. Gallivan was an attorney with the law firm of Rider, Bennett, Egan and Arundel. She joined the Company in January 2003.

James A. Graner, 62, became Chief Financial Officer and Treasurer in September 2005. He was Vice President and Controller from March 1994 to September 2005. He was Treasurer from May 1993 through 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, 52, became Vice President and General Manager, Contractor Equipment Division in April 2001. From January 2000, through March 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, 42, became Vice President and General Manager, Asia Pacific in January 2004. From June 2003 through December 2003, he served as Vice President, Asia Pacific and Latin America. Prior to becoming Vice President, Lubrication Equipment Division in June 2003, he held various sales and marketing positions in the Industrial and Lubrication Equipment Divisions. Mr. Koch joined the Company in December 1998.

David M. Lowe, 51, became Vice President and General Manager, Industrial Products Division in February 2005. He was Vice President and General Manager, European Operations from September 1999 to February 2005. Prior to becoming Vice President, Lubrication Equipment Division in December 1996, he was Treasurer. Mr. Lowe joined the Company in February 1995.

Patrick J. McHale, 45, became Vice President and General Manager, Lubrication Equipment Division in June 2003. He was Vice President of Manufacturing and Distribution Operations from April 2001 until June 2003. He served as Vice President, Contractor Equipment Division from February 2000 to March 2001. Prior to becoming Vice President, Lubrication Equipment Division in September 1999, he held other various manufacturing management positions in Minneapolis, Minnesota; Plymouth, Michigan; and Sioux Falls, South Dakota. Mr. McHale joined the Company in December 1989.

Simon J. W. Paulis, 59, became Vice President and General Manager, Europe in September 2005. From February 2005 to September 2005, he served as Director and General Manager, Europe. He served as Sales and Marketing Director, CED Europe from January 1999 to September 2005. Prior to joining Graco, he served as business unit manager for Black & Decker N.V., general sales manager for Alberto Culver, and marketing manager for Ralston Purina/Quaker Oats. Mr. Paulis joined the Company in January 1999.

Charles L. Rescorla, 55, became Vice President of Manufacturing/Distribution Operations in September 2005. He served as Vice President, Manufacturing/Distribution Operations and Information Services from June 2003 to September 2005. From April 2001 until June 2003, he was Vice President of the Industrial/Automotive Equipment Division. Prior to June 2003, he held various positions in manufacturing and engineering management. Mr. Rescorla joined the Company in June 1988.

Mark W. Sheahan, 42, became Chief Administrative Officer in September 2005. He was Vice President and Treasurer from December 1998 to September 2005. Prior to becoming Treasurer in December 1996, he was Manager, Treasury Services where he was responsible for strategic and financial activities. He joined the Company in September 1995.

Fred A. Sutter, 46, became Vice President and General Manager, Applied Fluid Technologies Division in February 2005. He was Vice President and General Manager, Industrial/Automotive Equipment Division from June 2003 to February 2005. He was Vice President, Asia Pacific and Latin America from January 1999 to June 2003. Prior to January 1999, he held a marketing director position in the Industrial Equipment Division. He joined the Company in March 1995.

The Board of Directors elected the above executive officers on April 21, 2006, to hold office for the next year, or until their successors are elected and qualify.

PART II

Item 5. Market for the Company's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Graco Common Stock

Graco common stock is traded on the New York Stock Exchange under the ticker symbol GGG. As of February 16, 2007, the share price was $41.26 and there were 66,647,827 shares outstanding and 2,641 common shareholders of record, which includes nominees or broker dealers holding stock on behalf of an estimated 26,000 beneficial owners.

The graph below compares the cumulative total shareholder return on the common stock of the Company for the last five fiscal years with the cumulative total return of the S&P 500 Index and the Dow Jones Factory Equipment Index over the same period (assuming the value of the investment in Graco common stock and each index was $100 on December 31, 2001, and all dividends were reinvested).

Five Year* Cumulative Total Shareholder Return

*Fiscal Year Ended Last Friday in December

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

2006	First Quarter	Second Quarter	Third Quarter	Fourth Quarter

Net sales	$192,216	$218,632	$202,199	$203,421
Gross profit	103,227	116,946	106,611	107,173
Net earnings	35,422	41,335	37,392	35,617
Per common share				
Basic net earnings	.52	.61	.55	.53
Diluted net earnings	.51	.60	.54	.52
Dividends declared	.15	.15	.15	.17
Stock price (per share)				
High	$45.43	$48.95	$46.37	$43.60
Low	36.50	42.50	37.00	38.61
Close[1]	45.43	45.98	39.06	39.62
Volume (# of shares)	19,428	21,925	24,882	26,326

2005	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net sales	$170,944	$198,221	$176,934	$185,603
Gross profit	85,866	102,292	94,722	96,470
Net earnings	27,039	35,638	30,898	32,279
Per common share				
Basic net earnings	.39	.52	.45	.47
Diluted net earnings	.38	.51	.44	.46
Dividends declared	.13	.13	.13	.15
Stock price (per share)				
High	$40.68	$40.25	$38.23	$37.55
Low	34.00	31.83	33.89	32.05
Close[1]	40.36	34.07	34.28	36.48
Volume (# of shares)	18,642	31,776	17,328	25,149

[1] As of the last trading day of the calendar quarter.

Issuer Purchases of Equity Securities

On February 20, 2004, the Board of Directors authorized the Company to purchase up to a total of 3,000,000 shares of its outstanding common stock, primarily through open-market transactions. This authorization effectively expired February 17, 2006, upon Board approval authorizing the purchase of up to 7,000,000 shares, expiring on February 29, 2008.

In addition to shares purchased under the plan, the Company purchases shares of common stock held by employees who wish to tender owned shares to satisfy the exercise price or tax withholding on stock option exercises.

Information on issuer purchases of equity securities follows:

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (at end of period)
Sep 30, 2006 - Oct 27, 2006	--	$ --	--	5,501,300

Oct 28, 2006 - Nov 24, 2006	120,000	$ 40.99	120,000	5,381,300
Nov 25, 2006 - Dec 29, 2006	337,800	$ 41.15	337,800	5,043,500

Item 6. Selected Financial Data

Graco Inc. and Subsidiaries

(In thousands, except per share amounts)	2006	2005	2004	2003	2002
Net sales	$816,468	$731,702	$605,032	$535,098	$487,048
Net earnings	149,766	125,854	108,681	86,713	75,625
Per common share[1]					
Basic net earnings	$ 2.21	$ 1.83	$ 1.57	$ 1.25	$ 1.06
Diluted net earnings	2.17	1.80	1.55	1.23	1.05
Total assets	$511,603	$445,630	$371,714	$397,390	$355,850
Long-term debt (including current portion)	--	--	--	--	--
Cash dividends declared per common share[1,2]	.60	.54	.41	1.76	0.20

1 All share and per share data has been restated for the three-for-two stock splits distributed in 2004 and 2002.

2 2003 includes a special dividend of $1.50 per share declared on December 12, 2003, paid on March 25, 2004, to shareholders of record as of March 11, 2004.

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

Overview

Graco s growth strategies include development of new products, expansion of distribution, new market penetration and completion of acquisitions. Long-term financial growth targets accompany these operating strategies, including 10 percent revenue growth, 12 percent net earnings and earnings per share growth.

Graco s business is classified by management into three reportable segments, each responsible for product development, sales and marketing of their products. The segments are headquartered in North America. They have responsibility for sales and marketing in the Americas and joint responsibility with Europe and Asia Pacific regional management for sales and marketing in those geographic areas.

The Company s primary manufacturing facilities are in the United States. A new assembly factory in Suzhou, China began production in 2006. Distribution facilities are located in the United States, Belgium, Japan, Korea and China.

Results of Operations

(In millions, except per share amounts)	2006	2005	2004
Net Sales	$816.5	$731.7	$605.0
Operating Earnings	226.0	191.1	161.5
Net Earnings	149.8	125.9	108.7
Diluted Net Earnings per Common Share	$ 2.17	$ 1.80	$ 1.55

Highlights include:

Sales growth of 12 percent and 21 percent in 2006 and 2005, respectively

Increased net earnings of 19 percent and 16 percent in 2006 and 2005, respectively

- Investment in new products of 4 percent of sales in both 2006 and 2005
- Acquisition of Lubriquip business in 2006; acquisition of Gusmer, Liquid Control and PBL businesses in 2005
- Strong cash flows from operations in both 2006 and 2005.

The following discussion notes significant factors affecting the consolidated results of operations, financial condition and liquidity for the three-year period ended December 29, 2006. This discussion should be read in conjunction with the Consolidated Financial Statements and Notes to Consolidated Financial Statements.

Consolidated Net Sales Three Years Ended December 29, 2006:

The following table presents net sales by business segment and geographic region:

(In millions)	2006	2005	2004
Segment Sales			
Industrial	$416.5	$367.1	$274.6
Contractor	320.5	305.3	278.7
Lubrication	79.5	59.3	51.7
Consolidated	$816.5	$731.7	$605.0
Geographic Sales			
Americas [1]	$534.9	$486.2	$401.0
Europe [2]	175.7	151.0	124.5
Asia Pacific	105.9	94.5	79.5
Consolidated	$816.5	$731.7	$605.0

[1] North and South America, including the United States. Sales in the United States were $474 million in 2006, $435 million in 2005 and $363 million in 2004.
[2] Europe, Africa and Middle East

The following table presents components of net sales change:

	2006							
	Industrial	Contractor	Lubrication	Consolidated	Americas	Europe	Asia Pacific	Consolidated
Volume & price	11.8%	4.4%	8.1%	8.5%	6.2%	13.8%	11.3%	8.5%
Acquisitions	0.9%	0.0%	25.1%	2.5%	3.3%	1.3%	0.5%	2.5%
Currency	0.8%	0.6%	0.9%	0.6%	0.5%	1.3%	0.3%	0.6%
Total	13.5%	5.0%	34.1%	11.6%	10.0%	16.4%	12.1%	11.6%

	2005							
	Industrial	Contractor	Lubrication	Consolidated	Americas	Europe	Asia Pacific	Consolidated
Volume & price	8.5%	9.1%	13.1%	9.2%	8.8%	11.2%	8.3%	9.2%
Acquisitions	24.6%	0.0%	0.7%	11.2%	11.9%	10.1%	9.0%	11.2%
Currency	0.6%	0.4%	0.8%	0.5%	0.5%	(0.1)%	1.6%	0.5%

					2005			
Total	33.7%	9.5%	14.6%	20.9%	21.2%	21.2%	18.9%	20.9%

Consolidated net sales increased by 12 percent and 21 percent in 2006 and 2005, respectively. Sales increased in each of the three segments and the three regions due to strong global demand for capital goods, successful new product launches and increased distribution. Except for the recent slowing housing market in the United States that has affected growth in the Contractor segment, the sales gains were generally characterized by strong demand for the Company s products throughout the entire year.

In 2006, the Lubriquip acquisition and the full year impact of businesses acquired in 2005, increased net sales by $18 million or 2 percent. In 2005, acquisitions increased net sales by $68 million or 11 percent.

In 2006, favorable foreign currency translation rates increased net sales and net earnings by approximately $5 million and $2 million for the year, respectively. In 2005, favorable foreign currency translation rates increased net sales and net earnings by approximately $3.5 million and $1.5 million for the year, respectively.

Management looks at economic and financial indicators relevant to each segment and geography to gauge the business environment, as noted in discussion below for each segment.

Industrial. In 2006, sales in the Industrial segment increased by 13 percent, with growth in all geographic regions. Sales in the Americas were $221 million or 53 percent of segment sales, sales in Europe were $116 million or 28 percent of segment sales and sales in Asia Pacific were $79 million or 19 percent of segment sales. Growth in various product categories, such as high performance coatings and foam (HPCF) equipment, and full year impact of acquired businesses contributed to the strong sales growth in the Industrial segment in 2006. Europe also continued to experience strong sales growth in Eastern Europe and the Middle East.

In 2005, sales in the Industrial segment grew by 34 percent. The Gusmer and Liquid Control acquisitions increased sales by $68 million or 25 percentage points of the 34 percent growth in sales for that segment. Gusmer designed and manufactured specialized two-component dispensing equipment systems. Liquid Control designed and manufactured highly engineered resin dispensing equipment. Sales in the Americas were $191 million or 52 percent of segment sales. In the Americas, sales grew in most product categories, especially the protective coatings product group. Sales in Europe were $102 million or 28 percent of segment sales and sales in Asia Pacific were $74 million or 20 percent of segment sales. Sales growth in Europe was driven by increased sales in Eastern Europe and the Middle East.

In this segment, sales in each geographic region are significant and management looks at economic and financial indicators in each region, including gross domestic product, industrial production, capital investment rates and the level of the U.S. dollar versus the euro, Japanese yen, South Korean won and the Canadian dollar.

Contractor. In 2006, sales in the Contractor segment increased by 5 percent. The Americas represent the majority of sales for the Contractor segment and 2006 sales in that region were $244 million or 76 percent of segment sales, an increase of 1 percent from the prior year. The slower sales growth reflected the slowing housing market in the United States. Sales in Europe and Asia Pacific increased by 20 percent and 25 percent respectively due to new product introductions and increased distribution throughout the two regions.

In 2005, overall sales in the Contractor segment increased $27 million due to successful new product launches, new distribution outlets and a strong housing market in the Americas. Sales in the Americas were $242 million or 79 percent of segment sales in 2005. Compared to the prior year, sales grew by 8 percent in this region, with increases in the paint store and home center channel of 7 percent and 10 percent, respectively. Management believes that new product introductions, new distribution outlets and a strong housing market drove paint store revenue gains in the Americas. In Europe, sales were up 21 percent, primarily due to successful new product introductions, incremental distribution and strong business in Southern Europe, Middle East/Africa and Eastern Europe. In Asia Pacific, sales were approximately the same as the prior year.

Since the Americas represent the majority of sales for the segment, indicators in that region are the most important and include levels of residential, commercial and institutional building and remodeling and interest rates.

Lubrication.

In 2006, sales in the Lubrication segment increased by 34 percent overall, with the acquired Lubriquip business providing 19 percentage points of the overall sales growth and full year impact of the 2005 PBL acquisition providing 6 percentage points of the overall sales growth. Sales in the Americas were $69 million or 87 percent of segment sales.

In 2005, sales in the Lubrication segment increased by 15 percent, with strong revenue growth in most major product categories. Sales in the Americas were $53 million or 89 percent of segment sales. The PBL acquisition increased sales by 1 percentage point of the 15 percent growth in sales for that segment. PBL manufactured and marketed fuel and oil transfer pumps.

Since the Americas represents the vast majority of sales for the Lubrication Equipment segment, indicators in that region are the most important. The indicators used by management include levels of capital investment, industrial production and gross domestic product

Analysis of Consolidated Operating Income Three Years Ended December 29, 2006

The following table presents an overview of costs as percentage of net sales:

	As a Percentage of Net Sales		
	2006	2005	2004
Net Sales	**100.0**	**100.0**	**100.0**
Cost of products sold	46.8	48.2	45.7
Gross profit	53.2	51.8	54.3
Product development	3.7	3.7	3.6
Selling, marketing and distribution	14.6	15.0	17.3
General and administrative	7.2	7.0	6.7
Operating earnings	27.7	26.1	26.7
Interest expense	0.1	0.2	0.1
Other expense, net	0.1	0.0	0.0
Earnings before income taxes	27.5	25.9	26.6
Income taxes	9.2	8.7	8.6
Net Earnings	**18.3**	**17.2**	**18.0**

Operating expenses in 2006 were $208 million compared to $188 million in the prior year. Acquired businesses had approximately $4 million of operating expenses in 2006. Although spending increased for product development (increase of $3 million), selling (increase of $9 million) and general and administrative (increase of $8 million), total operating expenses as a percentage of sales was consistent with the prior year at 26 percent. Included in cost of goods sold and operating expenses were costs and inventory charges related to closure of the Gusmer Lakewood facility and move of production totaling $5 million for the year. Operating expenses included $7 million of stock compensation due to adoption of SFAS No. 123(R) in 2006.

Operating expenses in 2005 were $188 million versus $167 million in 2004. Acquired businesses had $24 million of operating expenses in 2005. Although the Company incurred higher expenses for product development (increase of $5 million) and general and administrative expense (increase of $10 million), total operating expenses without acquisitions were lower than 2004, with a reduction in selling, marketing and distribution expenses. Contributions made to the Company s charitable foundation were also lower (decrease of $3 million). Product development expenses for 2005 were 4 percent of sales, approximately the same as 2004. Selling, marketing and distribution expenses for 2005 were 15 percent of sales, a decrease of 2 percentage points with lower warehousing and sales incentives costs compared to the prior year.

Consolidated operating earnings increased 18 percent to $226 million, or 28 percent of sales in fiscal 2006. The increase in earnings as a percentage of sales was primarily due to stronger gross profit margin of 53.2 percent in 2006 compared to 51.8 percent in 2005. A substantial portion of this difference is due to the higher cost of inventory of the acquired businesses in 2005. Improved manufacturing efficiencies and higher sales volume have more than offset the negative impact of higher material, labor and overhead costs for the year.

Consolidated operating earnings increased 18 percent to $191 million, or 26 percent of sales in fiscal 2005, compared to $162 million, or 27 percent of sales in fiscal 2004. The decrease in earnings as a percentage of sales in 2005 was primarily due to lower gross profit margins of 52 percent compared to 54 percent in 2004. The lower gross profit margin was primarily due to the impact of acquired businesses in 2005.

The following table presents operating earnings by business segment:

(In millions)	2006	2005	2004
Operating earnings			
Industrial	$ 128.5	$ 98.3	$ 87.0
Contractor	89.1	77.6	68.0
Lubrication	18.7	15.6	11.8
Unallocated corporate	(10.3)	(0.4)	(5.3)
Consolidated	$ 226.0	$ 191.1	$ 161.5

Industrial. In 2006, operating earnings in the Industrial segment were up 31 percent. Sales increased by 13 percent and gross profit margin, as a percentage of sales, increased by 2 percentage points. The increase in gross profit margin was primarily due to the higher cost of inventory of the acquired businesses in the prior year.

In 2005, operating earnings in the Industrial segment were up 13 percent compared to 2004. The increase was primarily due to higher net sales, up 34 percent in total, with acquired businesses contributing 25 percentage points of the overall growth in the segment. Gross profit margins, as a percentage of sales, declined by 4 percentage points, primarily due to the impact of acquired businesses, including lower margins on acquired products and the recognition of costs assigned to inventories as part of the valuation of assets acquired.

Contractor. In 2006, operating earnings in the Contractor segment increased by 15 percent. Sales increased by 5 percent, the gross profit margin, expressed as a percentage of sales, improved slightly and operating expenses as a percentage of sales were also slightly lower.

In 2005, operating earnings in the Contractor Equipment segment increased 14 percent. The increase was primarily due to higher net sales, which were up 10 percent. Operating expenses were approximately the same as the prior year.

Lubrication. In 2006, operating earnings in the Lubrication Equipment segment increased by 20 percent with an increase in segment sales of 34 percent. Lubriquip contributed approximately one half of the sales growth and $4 million of incremental operating expenses in 2006.

In 2005, operating earnings in the Lubrication Equipment segment were up 32 percent on a 15 percent increase in net sales. Operating expenses declined slightly from the prior year, with higher selling costs partially offsetting lower warranty and distribution costs.

Unallocated corporate. Unallocated corporate includes items such as stock compensation, bad debt expense, contributions to the Company s charitable foundation and certain other charges or credits driven by corporate decisions. In 2006, unallocated corporate was $10 million, and included $8 million of stock compensation and $2 million of contributions to the Company s charitable foundation. In 2005, unallocated corporate was $0.4 million versus $5 million in 2004. The primary reason for the lower expense was decreased contributions to the Company s charitable foundation (down $3 million) and a reduction in the items classified as unallocated corporate.

Provision for income taxes. The Company s net effective tax rate was 33 percent in 2006, consistent with the net effective tax rate in 2005. The rate in both periods is lower than the U.S. federal statutory rate of 35 percent due primarily to U.S. business credits, the Extraterritorial Income Exclusion (ETI); the Domestic Production Deduction (DPD) and expiring statutes of limitation and resolution of prior years income tax audits. 2006 was the final year of the ETI tax benefit.

Backlog. Total backlog was $34 million at the end of 2006, the same as total backlog at the end of 2005. The backlog for Europe and Asia Pacific increased in 2006 compared to the prior year, offsetting decreases in the backlog for North America. The Company s backlog is typically small compared to annual sales and is not a good indicator of future business levels.

Financial Condition

Working Capital.

The following table highlights several key measures of asset performance.