GRACO INC
Form 10-Q
October 22, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of the

Securities Exchange Act of 1934

For the quarterly period ended **September 26, 2014**

Commission File Number: 001-09249

GRACO INC.

(Exact name of registrant as specified in its charter)

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

88 - 11th Avenue N.E.

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

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

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

Yes X No ______

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

Yes X No ______

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer	X	Accelerated Filer	____
Non-accelerated Filer	____	Smaller reporting company	____

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

Yes ______ No X

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

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PART I Item 1.

GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited) (In thousands except per share amounts)

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

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited) (In thousands)

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

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

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands)

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

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

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited) (In thousands)

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

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

See notes to consolidated financial statements.

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GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of September 26, 2014 and the related statements of earnings for the thirteen and thirty-nine weeks ended September 26, 2014 and September 27, 2013, and cash flows for the thirty-nine weeks ended September 26, 2014 and September 27, 2013 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company as of September 26, 2014, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company s 2013 Annual Report on Form 10-K.

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

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

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

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Stock options to purchase 617,000 and 387,000 shares were not included in the September 26, 2014 and September 27, 2013 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Information on option shares outstanding and option activity for the thirty-nine weeks ended September 26, 2014 is shown below (in thousands, except per share amounts):

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

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

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

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

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Under the Company s Employee Stock Purchase Plan, the Company issued 193,000 shares in 2014 and 197,000 shares in 2013. The fair value of the employees purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

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

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

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

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

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

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

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

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

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

Assets by segment were as follows (in thousands):

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

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

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Geographic information follows (in thousands):

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

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

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

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

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

	Estimated Life (years)	Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
September 26, 2014					
Customer relationships	3 - 14	$ 118,975	$ (19,274)	$ (3,730)	$ 95,971
Patents, proprietary technology and product documentation	5 - 11	18,125	(6,684)	(382)	11,059
Trademarks, trade names and other	5	175	(35)	-	140
		137,275	(25,993)	(4,112)	107,170
Not Subject to Amortization:					
Brand names		47,800	-	(1,764)	46,036
Total		$ 185,075	$ (25,993)	$ (5,876)	$ 153,206
December 27, 2013					
Customer relationships	3 - 14	$ 121,205	$ (26,377)	$ 1,458	$ 96,286
Patents, proprietary technology and product documentation	3 - 11	16,125	(5,869)	118	10,374
Trademarks, trade names and other	5	175	(9)	-	166
		137,505	(32,255)	1,576	106,826
Not Subject to Amortization:					
Brand names		40,400	-	714	41,114
Total		$ 177,905	$ (32,255)	$ 2,290	$ 147,940

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

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

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

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

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

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

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

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

A liability is established for estimated future warranty and service claims that relate to current and prior period sales. The Company estimates warranty costs based on historical claim experience and other factors including evaluating specific product warranty issues. Following is a summary of activity in accrued warranty and service liabilities (in thousands):

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

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

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

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

Long-term notes payable with fixed interest rates have a carrying amount of $300 million and an estimated fair value of $320 million as of September 26, 2014 and $320 million as of December 27, 2013. The fair value of variable rate borrowings approximates carrying value. The Company uses significant other observable inputs to estimate fair value (level 2 of the fair value hierarchy) based on the present value of future cash flows and rates that would be available for issuance of debt with similar terms and remaining maturities.

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

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

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

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

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

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

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

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

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

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

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

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Item 2. **GRACO INC. AND SUBSIDIARIES**

MANAGEMENT S DISCUSSION AND ANALYSIS OF

FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

The Company designs, manufactures and markets systems and equipment to move, measure, control, dispense and spray fluid and coating materials. Management classifies the Company s business into three reportable segments: Industrial, Contractor and Lubrication. Key strategies include developing and marketing new products, expanding distribution globally, opening new markets with technology and channel expansion and completing strategic acquisitions.

The following Management s Discussion and Analysis reviews significant factors affecting the Company s results of operations and financial condition. This discussion should be read in conjunction with the financial statements and the accompanying notes to the financial statements.

Acquisition in 2012

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

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

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

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

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Consolidated Results

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

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

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

The following table presents components of changes in sales:

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

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

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