

GRAINGER W W INC  
Form 10-Q  
October 30, 2008

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008

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 number 1-5684

W.W. Grainger, Inc.

(Exact name of registrant as specified in its charter)

Illinois  
(State or other jurisdiction of incorporation or  
organization)

36-1150280  
(I.R.S. Employer Identification No.)

100 Grainger Parkway, Lake Forest, Illinois  
(Address of principal executive offices)

60045-5201  
(Zip Code)

(847) 535-1000  
(Registrant's telephone number including area code)

Not Applicable  
(Former name, former address and former fiscal year; if changed since last report)

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 (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 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.

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Large accelerated filer  T

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

There were 76,067,844 shares of the Company's Common Stock outstanding as of September 30, 2008.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

## W.W. Grainger, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands of dollars, except for per share amounts)

(Unaudited)

|   | Three Months Ended<br>September 30, |              | Nine Months Ended<br>September 30, |              |
|---|-------------------------------------|--------------|------------------------------------|--------------|
|   | 2008                                | 2007         | 2008                               | 2007         |
| Net sales   | \$ 1,839,475                        | \$ 1,658,592 | \$ 5,257,377                       | \$ 4,806,261 |
| Cost of merchandise sold                                  | 1,097,127                           | 999,003      | 3,129,218                          | 2,874,119    |
| Gross profit  | 742,348                             | 659,589      | 2,128,159                          | 1,932,142    |
| Warehousing, marketing and<br>administrative expenses     | 510,891                             | 485,257      | 1,526,044                          | 1,428,650    |
| Operating earnings  | 231,457                             | 174,332      | 602,115                            | 503,492      |
| Other income and (expense):                               |                                     |              |                                    |              |
| Interest income   | 1,602                               | 3,144        | 3,642                              | 11,182       |
| Interest expense  | (4,393)                             | (721)        | (9,591)                            | (1,817)      |
| Equity in net income (loss) of<br>unconsolidated entities | 755                                 | 470          | 2,835                              | 353          |
| Unclassified – net  | (731)                               | (41)         | 569                                | (53)         |
| Total other income and<br>(expense)                       | (2,767)                             | 2,852        | (2,545)                            | 9,665        |
| Earnings before income taxes                              | 228,690                             | 177,184      | 599,570                            | 513,157      |
| Income taxes  | 88,667                              | 68,034       | 232,130                            | 197,429      |
| Net earnings  | \$ 140,023                          | \$ 109,150   | \$ 367,440                         | \$ 315,728   |
| Earnings per share:                                       |                                     |              |                                    |              |
| Basic   | \$ 1.84                             | \$ 1.33      | \$ 4.78                            | \$ 3.78      |
| Diluted   | \$ 1.79                             | \$ 1.29      | \$ 4.65                            | \$ 3.67      |
| Weighted average number of<br>shares<br>outstanding:      |                                     |              |                                    |              |
| Basic   | 75,967,774                          | 82,233,231   | 76,813,709                         | 83,437,184   |

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|                               |            |            |            |            |
|-------------------------------|------------|------------|------------|------------|
| Diluted                       | 78,279,422 | 84,864,258 | 79,085,640 | 86,119,670 |
| Cash dividends paid per share | \$ 0.40    | \$ 0.35    | \$ 0.40    | \$ 0.99    |

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS  
 (In thousands of dollars)  
 (Unaudited)

|  | Three Months Ended |            | Nine Months Ended |            |
|--|--------------------|------------|-------------------|------------|
|  | September 30,      |            | September 30,     |            |
|  | 2008               | 2007       | 2008              | 2007       |
| Net earnings   | \$ 140,023         | \$ 109,150 | \$ 367,440        | \$ 315,728 |
| Other comprehensive earnings (losses):   |                    |            |                   |            |
| Foreign currency translation adjustments, net of tax benefit (expense) of \$2,534, \$(4,181), \$4,133, and \$(9,229), respectively | (18,636)           | 24,317     | (26,075)          | 52,552     |
| Comprehensive earnings   | \$ 121,387         | \$ 133,467 | \$ 341,365        | \$ 368,280 |

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands of dollars, except for per share amounts)  
(Unaudited)

|   | Sept. 30,<br>2008   | Dec. 31,<br>2007    |
|---|---------------------|---------------------|
| <b>ASSETS</b>   |                     |                     |
| <b>CURRENT ASSETS</b>   |                     |                     |
| Cash and cash equivalents   | \$ 364,417          | \$ 113,437          |
| Marketable securities at cost,<br>which approximates market value                                     | –                   | 20,074              |
| Accounts receivable (less allowances for doubtful<br>accounts of \$29,345 and \$25,830, respectively) | 721,387             | 602,650             |
| Inventories   | 961,094             | 946,327             |
| Prepaid expenses and other assets   | 63,028              | 61,666              |
| Deferred income taxes   | 61,395              | 56,663              |
| <b>Total current assets</b>   | <b>2,171,321</b>    | <b>1,800,817</b>    |
| <b>PROPERTY, BUILDINGS AND EQUIPMENT</b>  | <b>2,116,796</b>    | <b>2,004,276</b>    |
| Less accumulated depreciation and amortization  | 1,188,300           | 1,125,931           |
| <b>Property, buildings and equipment – net</b>  | <b>928,496</b>      | <b>878,345</b>      |
| <b>DEFERRED INCOME TAXES</b>  | <b>72,760</b>       | <b>54,658</b>       |
| <b>INVESTMENT IN UNCONSOLIDATED ENTITIES</b>  | <b>23,089</b>       | <b>14,759</b>       |
| <b>GOODWILL</b>   | <b>231,945</b>      | <b>233,028</b>      |
| <b>OTHER ASSETS AND INTANGIBLES – NET</b>   | <b>108,830</b>      | <b>112,421</b>      |
| <b>TOTAL ASSETS</b>   | <b>\$ 3,536,441</b> | <b>\$ 3,094,028</b> |

W.W. Grainger, Inc. and Subsidiaries  
CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)  
(In thousands of dollars, except for per share amounts)  
(Unaudited)

| LIABILITIES AND SHAREHOLDERS' EQUITY   | Sept. 30,<br>2008   | Dec. 31,<br>2007    |
|--|---------------------|---------------------|
| <b>CURRENT LIABILITIES</b>   |                     |                     |
| Short-term debt  | \$ 16,431           | \$ 102,060          |
| Current maturities of long-term debt   | 12,923              | 4,590               |
| Trade accounts payable   | 314,445             | 297,929             |
| Accrued compensation and benefits  | 164,524             | 182,275             |
| Accrued contributions to employees' profit sharing plans   | 110,566             | 126,483             |
| Accrued expenses   | 99,386              | 102,607             |
| Income taxes payable   | 16,589              | 10,459              |
| Total current liabilities  | 734,864             | 826,403             |
| <b>LONG-TERM DEBT (less current maturities)</b>  | 496,562             | 4,895               |
| <b>DEFERRED INCOME TAXES AND TAX UNCERTAINTIES</b>   | 23,531              | 20,727              |
| <b>ACCRUED EMPLOYMENT-RELATED BENEFITS</b>   | 153,393             | 143,895             |
| <b>SHAREHOLDERS' EQUITY</b>  |                     |                     |
| Cumulative Preferred Stock – \$5 par value – 12,000,000 shares authorized; none issued nor outstanding | –                   | –                   |
| Common Stock – \$0.50 par value – 300,000,000 shares authorized; issued 109,659,219 shares             | 54,830              | 54,830              |
| Additional contributed capital   | 555,410             | 475,350             |
| Retained earnings  | 3,593,931           | 3,316,875           |
| Accumulated other comprehensive earnings   | 46,096              | 72,171              |
| Treasury stock, at cost – 33,591,375 and 30,199,804 shares, respectively                               | (2,122,176)         | (1,821,118)         |
| Total shareholders' equity   | 2,128,091           | 2,098,108           |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 3,536,441</b> | <b>\$ 3,094,028</b> |

The accompanying notes are an integral part of these financial statements.



W.W. Grainger, Inc. and Subsidiaries  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands of dollars)  
 (Unaudited)

|   | Nine Months Ended<br>Sept. 30, |                     |
|---|--------------------------------|---------------------|
|   | 2008                           | 2007                |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                              |                                |                     |
| Net earnings  | \$ 367,440                     | \$ 315,728          |
| Provision for losses on accounts receivable                               | 11,867                         | 7,824               |
| Deferred income taxes and tax uncertainties                               | (18,432)                       | (7,437)             |
| Depreciation and amortization:  |                                |                     |
| Property, buildings and equipment   | 81,507                         | 75,113              |
| Capitalized software and other intangibles                                | 19,258                         | 18,486              |
| Stock-based compensation  | 36,655                         | 28,988              |
| Tax benefit of stock incentive plans                                      | 1,612                          | 2,820               |
| Net gains on sales of property, buildings and equipment                   | (4,760)                        | (5,433)             |
| (Income) losses from unconsolidated entities – net                        | (2,835)                        | (353)               |
| Change in operating assets and liabilities – net of business acquisitions |                                |                     |
| (Increase) in accounts receivable   | (125,936)                      | (105,145)           |
| (Increase) in inventories   | (17,360)                       | (39,532)            |
| Decrease in prepaid expenses  | 645                            | 7,410               |
| Increase in trade accounts payable  | 13,069                         | 39,188              |
| (Decrease) in other current liabilities                                   | (42,191)                       | (16,324)            |
| Increase in current income taxes payable                                  | 6,466                          | 3,598               |
| Increase in accrued employment-related benefits cost                      | 9,498                          | 17,697              |
| Other – net   | (1,186)                        | (4,876)             |
| <b>Net cash provided by operating activities</b>                          | <b>335,317</b>                 | <b>337,752</b>      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                              |                                |                     |
| Additions to property, buildings and equipment – net of dispositions      | (125,020)                      | (128,744)           |
| Additions to capitalized software   | (6,570)                        | (5,726)             |
| Cash paid for business acquisitions                                       | (33,995)                       | (4,684)             |
| Proceeds from sale of marketable securities                               | 19,627                         | 12,765              |
| Purchases of marketable securities  | –                              | (17,079)            |
| Investments in unconsolidated entities                                    | (6,486)                        | –                   |
| Other – net   | (416)                          | (405)               |
| <b>Net cash used in investing activities</b>                              | <b>\$ (152,860)</b>            | <b>\$ (143,873)</b> |

W.W. Grainger, Inc. and Subsidiaries  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
 (In thousands of dollars)  
 (Unaudited)

|   | Nine Months Ended<br>Sept. 30, |                  |
|---|--------------------------------|------------------|
|   | 2008                           | 2007             |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                |                                |                  |
| Net (decrease) in commercial paper                          | \$ (95,356)                    | \$ —             |
| Net increase in short term debt                             | —                              | 144,428          |
| Borrowings under line of credit                             | 19,136                         | —                |
| Payments against line of credit                             | (8,799)                        | —                |
| Proceeds from issuance of long-term debt                    | 500,000                        | —                |
| Stock options exercised                                     | 41,103                         | 103,465          |
| Excess tax benefits from stock-based compensation           | 11,733                         | 27,050           |
| Purchase of treasury stock                                  | (307,552)                      | (647,293)        |
| Cash dividends paid   | (90,384)                       | (84,766)         |
| <b>Net cash provided by (used in) financing activities</b>  | <b>69,881</b>                  | <b>(457,116)</b> |
| Exchange rate effect on cash and cash equivalents           | (1,358)                        | 4,132            |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b> | <b>250,980</b>                 | <b>(259,105)</b> |
| Cash and cash equivalents at beginning of year              | 113,437                        | 348,471          |
| Cash and cash equivalents at end of period                  | \$ 364,417                     | \$ 89,366        |

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. BACKGROUND AND BASIS OF PRESENTATION

W.W. Grainger, Inc. distributes facilities maintenance products and provides services and related information used by businesses and institutions in North America. In this report, the words “Company” or “Grainger” mean W.W. Grainger, Inc. and its subsidiaries.

The Condensed Consolidated Financial Statements of the Company and the related notes are unaudited and should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2007, included in the Company’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC).

The Condensed Consolidated Balance Sheet as of December 31, 2007, has been derived from the audited consolidated financial statements at that date, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements.

The unaudited financial information reflects all adjustments (primarily consisting of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the statements contained herein.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NEW ACCOUNTING STANDARDS

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 161, “Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (SFAS No. 161). SFAS No. 161 amends and expands the disclosure requirements related to derivative instruments and hedging activities which will enable investors to better understand the effects on an entity’s financial statements, financial position and cash flows. The statement is effective for fiscal years beginning after November 15, 2008. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its results of operations or financial position.

In April 2008, the FASB issued Staff Position FSP 142-3, “Determination of the Useful Life of Intangible Assets” (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, “Goodwill and Other Intangible Assets.” FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of FSP 142-3 to have a material effect on its results of operations or financial position.

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, "The Hierarchy of Generally Accepted Accounting Principles" (SFAS No. 162). SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with US GAAP for nongovernmental entities. The FASB believes that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. The Company does not expect the adoption of SFAS No. 162 to have a material effect on its results of operations or financial position.

In June 2008, the FASB issued Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (FSP 03-6-1). FSP 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. Upon adoption, a company is required to retrospectively adjust its earnings per share data presentation to conform with the FSP 03-6-1 provisions. FSP 03-6-1 is effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact that adoption may have on its results of operation and financial position.

### 3. ACQUISITIONS

Effective July 21, 2008 the Company acquired a 49.9% interest in Asia Pacific Brands India Ltd. (Asia Pacific Brands) from its sole shareholder. Asia Pacific Brands, one of India's largest industrial and electrical wholesale distributors, is headquartered in Mumbai, India. With 27 locations and more than 6,200 dealer relationships across India, Asia Pacific Brands had revenue of US\$47 million for its fiscal year ended March 31, 2008. The Company paid \$5.4 million for its ownership interest. In addition, the Company and its joint venture partner each made a \$1.1 million capital infusion which is intended to help grow the business. The Company is using the equity method to account for this investment.

On July 10, 2008, Lab Safety Supply, a direct marketing subsidiary of the Company, acquired substantially all of the assets of Highsmith Inc. (Highsmith), located in Fort Atkinson, Wisconsin. Highsmith is a direct marketing leader in the library equipment, furniture and supplies market and had sales of \$64 million in 2007. The purchase price and costs of the acquisition were \$27.0 million in cash and \$6.1 million in assumed liabilities. The estimated goodwill recognized in the transaction amounted to \$4.1 million and is expected to be deductible for tax purposes. The integration of Highsmith into existing operations should be completed by the end of the year. As part of the integration Lab Safety is discontinuing the contract sales group of Highsmith which represented approximately \$19 million of sales in 2007. The results of Highsmith are included in the Company's consolidated results from the date of acquisition. Due to the immaterial nature of this transaction, disclosure of pro forma results were not considered necessary.

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

On June 6, 2008, Acklands - Grainger Inc., a wholly owned subsidiary of the Company, acquired substantially all of the assets and assumed certain liabilities of Excel F.I.G. Inc. (Excel). Excel, located in Granby, Quebec, Canada, is a business-to-business broad line distributor of maintenance, repair and operating supplies. In 2007, Excel had sales of approximately US\$12 million. The purchase price and costs of the acquisition were US\$6.9 million in cash and US\$0.7 million in assumed liabilities. The estimated goodwill recognized in the transaction amounted to US\$4.4 million and is expected to be partially deductible for tax purposes. The results of Excel are included in the Company's consolidated results from the date of acquisition. Due to the immaterial nature of this transaction, disclosure of pro forma results were not considered necessary.

#### 4. DIVIDEND

On October 29, 2008, the Company's Board of Directors declared a quarterly dividend of 40 cents per share, payable December 1, 2008, to shareholders of record on November 10, 2008.

#### 5. WARRANTY RESERVES

The Company generally warrants the products it sells against defects for one year. For a significant portion of warranty claims, the manufacturer of the product is responsible for the expenses associated with this warranty program. For warranty expenses not covered by the manufacturer, the Company provides a reserve for future costs based on historical experience. The warranty reserve activity was as follows:

|                   | Nine Months Ended September 30, |          |
|-------------------|---------------------------------|----------|
|                   | 2008                            | 2007     |
|                   | (In thousands of dollars)       |          |
| Beginning balance | \$ 3,442                        | \$ 4,651 |
| Returns           | (10,218)                        | (9,266)  |
| Provision         | 10,495                          | 8,630    |
| Ending balance    | \$ 3,719                        | \$ 4,015 |

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

6. LONG-TERM DEBT

On May 6, 2008, the Company entered into a four year term loan of \$500 million. Proceeds were used to pay down short-term debt, fund additional share repurchases and for general corporate purposes.

At the election of the Company, the term loan shall bear interest at the Base Rate plus the Applicable Margin or the LIBOR Rate plus the Applicable Margin as defined within the contract. At September 30, 2008 the Company has elected a one month LIBOR Interest Period. The weighted average interest rate during the period outstanding was 3.26%.

The Company may prepay the loan in whole or in part at its option. The scheduled loan repayment of the outstanding principal amount is as follows:

| Year | Payment Amount   |
|------|------------------|
| 2009 | \$ 16.7 million  |
| 2010 | \$ 45.8 million  |
| 2011 | \$ 50.0 million  |
| 2012 | \$ 387.5 million |

The Company's debt instruments include only standard affirmative and negative covenants that are normal in debt instruments of similar amounts and structure. The Company's debt instruments do not contain financial or performance covenants restrictive to the business of the Company. The Company is in compliance with all debt covenants for the nine months ended September 30, 2008.

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

## 7. EMPLOYEE BENEFITS

## Retirement Plans

A majority of the Company's employees are covered by a noncontributory profit sharing plan. This plan provides for annual employer contributions based upon a formula related primarily to earnings before federal income taxes, limited to a percentage of total eligible compensation paid to all eligible employees. Retroactive to January 1, 2008, the plan was amended on July 30, 2008 to establish a minimum contribution of 8% and a maximum contribution of 18% of total eligible compensation paid to all eligible employees. Previously, there was no minimum percentage and the maximum percentage was 25%.

## Postretirement Benefits

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its retired employees and their dependents should they elect to maintain such coverage. Covered employees become eligible for participation when they qualify for retirement. Participation in the plan is voluntary and requires participants to make contributions, as determined by the Company, toward the cost of the plan.

The net periodic benefit costs charged to operating expenses, which are valued at the measurement date of January 1 and recognized evenly throughout the year, consisted of the following components:

|                                       | Three Months Ended September 30, |          | Nine Months Ended September 30, |           |
|---------------------------------------|----------------------------------|----------|---------------------------------|-----------|
|                                       | 2008                             | 2007     | 2008                            | 2007      |
|                                       | (In thousands of dollars)        |          |                                 |           |
| Service cost                          | \$ 2,425                         | \$ 2,714 | \$ 7,275                        | \$ 8,142  |
| Interest cost                         | 2,373                            | 2,243    | 7,118                           | 6,730     |
| Expected return on assets             | (1,117)                          | (1,012)  | (3,349)                         | (3,037)   |
| Amortization of transition asset      | (36)                             | (36)     | (108)                           | (107)     |
| Amortization of unrecognized losses   | 328                              | 523      | 984                             | 1,570     |
| Amortization of prior service credits | (304)                            | (109)    | (912)                           | (328)     |
| Net periodic benefit costs            | \$ 3,669                         | \$ 4,323 | \$ 11,008                       | \$ 12,970 |

The Company has established a Group Benefit Trust to fund the plan and process benefit payments. The funding of the trust is an estimated amount, which is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended. There are no minimum funding requirements and the Company intends to follow its practice of funding the maximum deductible contribution under the IRC. During the three and nine months ended September 30, 2008, the Company contributed \$1.0 million and \$3.1 million, respectively, to the trust.

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

## 8. SEGMENT INFORMATION

The three reportable segments are Grainger Branch-based, Acklands - Grainger Branch-based (Acklands - Grainger) and Lab Safety Supply, Inc. (Lab Safety). Grainger Branch-based is an aggregation including the following: Grainger Industrial Supply, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico), Grainger China LLC (China) and Grainger Panama S.A. (Panama). Acklands - Grainger is the Company's Canadian branch-based distribution business. Lab Safety is a direct marketer of safety and other industrial products. Following is a summary of segment results (in thousands of dollars):

|                                 | Three Months Ended September 30, 2008 |  |            |              |
|---------------------------------|---------------------------------------|--|------------|--------------|
|                                 | Grainger<br>Branch-based              | Acklands -<br>Grainger<br>Branch-based | Lab Safety | Total        |
| Total net sales                 | \$ 1,523,543                          | \$ 190,754                             | \$ 127,321 | \$ 1,841,618 |
| Intersegment net sales          | (1,021)                               | (127)                                  | (995)      | (2,143)      |
| Net sales to external customers | \$ 1,522,522                          | \$ 190,627                             | \$ 126,326 | \$ 1,839,475 |
| Segment operating earnings      | \$ 226,602                            | \$ 14,168                              | \$ 12,212  | \$ 252,982   |

|                                 | Three Months Ended September 30, 2007 |  |            |              |
|---------------------------------|---------------------------------------|--|------------|--------------|
|                                 | Grainger<br>Branch-based              | Acklands -<br>Grainger<br>Branch-based | Lab Safety | Total        |
| Total net sales                 | \$ 1,385,278                          | \$ 163,519                             | \$ 111,199 | \$ 1,659,996 |
| Intersegment net sales          | (487)                                 | -                                      | (917)      | (1,404)      |
| Net sales to external customers | \$ 1,384,791                          | \$ 163,519                             | \$ 110,282 | \$ 1,658,592 |
| Segment operating earnings      | \$ 173,115                            | \$ 10,243                              | \$ 14,213  | \$ 197,571   |



W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

|                                 | Nine Months Ended September 30, 2008 |  |            |              |
|---------------------------------|--------------------------------------|--|------------|--------------|
|                                 | Grainger<br>Branch-based             | Acklands -<br>Grainger<br>Branch-based | Lab Safety | Total        |
| Total net sales                 | \$ 4,346,857                         | \$ 565,924                             | \$ 350,032 | \$ 5,262,813 |
| Intersegment net sales          | (2,330)                              | (127)                                  | (2,979)    | (5,436)      |
| Net sales to external customers | \$ 4,344,527                         | \$ 565,797                             | \$ 347,053 | \$ 5,257,377 |
| Segment operating earnings      | \$ 596,411                           | \$ 41,856                              | \$ 40,596  | \$ 678,863   |

|                                 | Nine Months Ended September 30, 2007 |  |            |              |
|---------------------------------|--------------------------------------|--|------------|--------------|
|                                 | Grainger<br>Branch-based             | Acklands -<br>Grainger<br>Branch-based | Lab Safety | Total        |
| Total net sales                 | \$ 4,014,522                         | \$ 464,851                             | \$ 330,653 | \$ 4,810,026 |
| Intersegment net sales          | (1,211)                              | -                                      | (2,554)    | (3,765)      |
| Net sales to external customers | \$ 4,013,311                         | \$ 464,851                             | \$ 328,099 | \$ 4,806,261 |
| Segment operating earnings      | \$ 505,027                           | \$ 29,710                              | \$ 43,191  | \$ 577,928   |

|                                       | Grainger<br>Branch-based | Acklands -<br>Grainger<br>Branch-based | Lab Safety | Total        |
|---------------------------------------|--------------------------|--|------------|--------------|
| Segment assets:<br>September 30, 2008 | \$ 2,225,971             | \$ 506,897                             | \$ 240,572 | \$ 2,973,440 |
| December 31, 2007                     | \$ 2,107,408             | \$ 502,414                             | \$ 212,627 | \$ 2,822,449 |

W.W. Grainger, Inc. and Subsidiaries  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

Following are reconciliations of segment information with the consolidated totals per the financial statements (in thousands of dollars):

|  | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|------------|------------------------------------|---------------|
|  | 2008                                | 2007       | 2008                               | 2007          |
| Operating earnings:                              |                                     |            |                                    |               |
| Total operating earnings for reportable segments | \$ 252,982                          | \$ 197,571 | \$ 678,863                         | \$ 577,928    |
| Unallocated expenses and eliminations            | (21,525)                            | (23,239)   | (76,748)                           | (74,436)      |
| Total consolidated operating earnings            | \$ 231,457                          | \$ 174,332 | \$ 602,115                         | \$ 503,492    |
|  |                                     |            |                                    |               |
|  |                                     |            | Sept. 30,<br>2008                  | Dec. 31, 2007 |
| Assets:  |                                     |            |                                    |               |
| Total assets for reportable segments             |                                     |            | \$ 2,973,440                       | \$ 2,822,449  |
| Elimination of intersegment assets               |                                     |            | (34,579)                           | (167)         |
| Unallocated assets                               |                                     |            | 597,580                            | 271,746       |
| Total consolidated assets                        |                                     |            | \$ 3,536,441                       | \$ 3,094,028  |

Unallocated expenses and unallocated assets primarily relate to the Company headquarters' support services, which are not part of any business segment. Unallocated expenses include payroll and benefits, depreciation and other costs associated with headquarters-related support services. Unallocated assets primarily include non-operating cash and cash equivalents, certain prepaid expenses, deferred income taxes and non-operating property, buildings and equipment – net.

The increase in unallocated assets as of September 30, 2008 is primarily due to the Company's higher cash balance.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

## 9. EARNINGS PER SHARE

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

|   | Three Months Ended Sept. 30, |                | Nine Months Ended Sept. 30, |                |
|---|------------------------------|----------------|-----------------------------|----------------|
|   | 2008                         | 2007           | 2008                        | 2007           |
| Net earnings  | \$ 140,023,000               | \$ 109,150,000 | \$ 367,440,000              | \$ 315,728,000 |
| Denominator for basic earnings per share –<br>weighted average shares                                       | 75,967,774                   | 82,233,231     | 76,813,709                  | 83,437,184     |
| Effect of dilutive securities –<br>stock-based compensation   | 2,311,648                    | 2,631,027      | 2,271,931                   | 2,682,486      |
| Denominator for diluted earnings per share –<br>weighted average shares adjusted for<br>dilutive securities | 78,279,422                   | 84,864,258     | 79,085,640                  | 86,119,670     |
| Basic earnings per common share   | \$ 1.84                      | \$ 1.33        | \$ 4.78                     | \$ 3.78        |
| Diluted earnings per common share   | \$ 1.79                      | \$ 1.29        | \$ 4.65                     | \$ 3.67        |

## 10. LEGAL PROCEEDINGS

As previously reported, the Company received a letter in December 2007 from the Commercial Litigation Branch of the Civil Division of the Department of Justice (the “DOJ”) regarding the Company’s contract with the United States General Services Administration (the “GSA”). The letter suggested that the Company had not complied with its disclosure obligations and the contract’s pricing provisions, and had potentially overcharged government customers under the contract.

Discussions relating to the Company’s compliance with its disclosure obligations and the contract’s pricing provisions are ongoing. The timing and outcome of these discussions are uncertain and could include settlement or civil litigation by the DOJ to recover, among other amounts, treble damages and penalties under the False Claims Act. While this matter is not expected to have a material adverse effect on the Company’s financial position, an unfavorable resolution could result in material payments by the Company. The Company continues to believe that it has complied with the GSA contract in all material respects.

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Item 2.

Overview

General

Grainger is the leading broad-line supplier of facilities maintenance and other related products in North America. Grainger distributes a wide range of products used by businesses and institutions to keep their facilities and equipment up and running. Grainger uses a multichannel business model to provide customers with a range of options for finding and purchasing products through a network of branches, sales representatives, direct marketing including catalogs, and a variety of electronic and Internet channels. Grainger serves customers through a network of more than 600 branches, 18 distribution centers and multiple Web sites.

Grainger's three reportable segments are Grainger Branch-based, Acklands - Grainger Branch-based (Acklands - Grainger) and Lab Safety Supply, Inc. (Lab Safety). Grainger Branch-based is an aggregation including the following business units: Grainger Industrial Supply, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico), Grainger China LLC (China) and Grainger Panama S.A. (Panama). Acklands - Grainger is the Company's Canadian branch-based distribution business. Lab Safety is a direct marketer of safety and other industrial products.

Business Environment

Several economic factors and industry trends shape Grainger's business environment. Historically, Grainger's sales trends have tended to correlate positively with industrial production growth, particularly manufacturing output, as well as employment growth, particularly non-farm payrolls. According to the Federal Reserve, overall industrial production decreased 4.5% from September 2007 to September 2008. Manufacturing output decreased 4.8% from September 2007 to September 2008, and manufacturing employment levels declined 3.2%. Non-farm employment was essentially flat from September 2007 to September 2008. Grainger's sales to manufacturing customers, as well as to most other customer-end markets, continued to grow in the third quarter of 2008. This reflects the success of Grainger's on-going market expansion and product line expansion initiatives, as well as Grainger's growing diversification into markets other than manufacturing. Current economic growth projections for 2008 industrial production and GDP are (0.4%) and 1.4%, respectively.

For the first nine months of 2008, the Company had \$142.0 million of capital expenditures, of which \$35.3 million related to its U.S. market expansion program. The Company is targeting completion of its investments in the U.S. market expansion program in 2008.

Matters Affecting Comparability

There were 64 sales day in the third quarter of 2008 compared to 63 sales days in the third quarter of 2007. There were 192 sales days in the first nine months of 2008 compared to 191 sales days in the first nine months of 2007.

Grainger's operating results for the first nine months of 2008 include the operating results of the Highsmith acquisition made by Lab Safety in July 2008. Since the acquisition date, those results have been included in the Lab Safety segment. See the Segment Analysis in the following Management's Discussion and Analysis.

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## Results of Operations – Three Months Ended September 30, 2008

The following table is included as an aid to understanding the changes in Grainger's Condensed Consolidated Statements of Earnings:

Three Months Ended September 30,

Items in Condensed Consolidated Statements of Earnings

|                          | As a Percent of Net Sales |        | Percent<br>Increase<br>(Decrease) |
|--------------------------|---------------------------|--------|-----------------------------------|
|                          | 2008                      | 2007   |                                   |
| Net sales                | 100.0%                    | 100.0% | 10.9%                             |
| Cost of merchandise sold | 59.6                      | 60.2   | 9.8                               |
| Gross profit             | 40.4                      | 39.8   | 12.5                              |
| Operating expenses       | 27.8                      | 29.3   | 5.3                               |
| Operating earnings       | 12.6                      | 10.5   | 32.8                              |
| Other income (expense)   | (0.2)                     | 0.2    | (197.0)                           |
| Income taxes             | 4.8                       | 4.1    | 30.3                              |
| Net earnings             | 7.6%                      | 6.6%   | 28.3%                             |

Grainger's net sales of \$1,839.5 million for the third quarter of 2008 increased 10.9% compared with sales of \$1,658.6 million for the comparable 2007 quarter. Daily sales were up 9.2%. An increase in net sales was realized in all three segments of the business. The overall increase in net sales was led by low double-digit growth in the government sector and high single-digit growth in the reseller sector. Approximately 3 percentage points of the sales growth came from Grainger's ongoing strategic initiatives, market expansion and product line expansion. For the quarter, sales were positively affected by price increases of approximately 4 percentage points and there was minimal effect from foreign exchange. Sales were negatively affected by 1 percentage point due to a decline in the sales of seasonal products. Prices were increased to offset cost inflation. Refer to the Segment Analysis below for further detail of sales and ongoing strategic initiatives.

Gross profit of \$742.3 million for the third quarter of 2008 increased 12.5%. The gross profit margin during the third quarter of 2008 increased 0.6 percentage point when compared to the same period in 2007, primarily due to positive inflation recovery partially offset by unfavorable selling price category mix.

Operating expenses of \$510.9 million for the third quarter of 2008 increased 5.3%. Operating expenses grew slower than the sales growth primarily due to non-payroll operating expenses including lower advertising expenses, and a lower provision for bad debts due to improved collection effectiveness. Comparisons also benefited from one extra sales day which increased the leverage on fixed costs.

Operating earnings for the third quarter of 2008 totaled \$231.5 million, an increase of 32.8% over the third quarter of 2007. This earnings growth exceeded the sales growth due to an improvement in gross profit margin and positive

operating expense leverage.

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Net earnings for the third quarter of 2008 increased by 28.3% to \$140.0 million from \$109.1 million in 2007. The growth in net earnings for the quarter primarily resulted from the improvement in operating earnings, partially offset by lower interest income, higher interest expense and a higher income tax rate versus 2007. Diluted earnings per share of \$1.79 in the third quarter of 2008 were 38.8% higher than the \$1.29 for the third quarter of 2007. This improvement was higher than the percentage increase for net earnings due to lower shares outstanding primarily a result of the Company's share repurchase program.

#### Segment Analysis

The following comments at the segment level refer to external and intersegment net sales. Comments at the business unit level include external and inter- and intrasegment net sales. See Note 8 to the Condensed Consolidated Financial Statements.

#### Grainger Branch-based

Net sales were \$1,523.5 million for the third quarter of 2008, an increase of \$138.2 million, or 10.0%, when compared with net sales of \$1,385.3 million for the same period in 2007. Daily sales were up 8.3%.

Sales in the United States were up 9.6%. Daily sales were up 7.9% with growth in all customer end markets except retail, which was flat. The increase in net sales was led by low double-digit growth in the government sector and high single-digit growth in the reseller sector. Sales were negatively affected by 1 percentage point due to a decline in the sales of seasonal products. Market expansion and product line expansion added approximately 3 percentage points to overall growth in the quarter.

Results for the market expansion program were as follows:

|  | 2008 Third Quarter |                     |
|--|--------------------|---------------------|
|  | Sales<br>Increase  | Percent<br>Complete |
| Phase 1 (Atlanta, Denver, Seattle)   | 11%                | 100%                |
| Phase 2 (Four markets in Southern<br>California)   | 5%                 | 100%                |
| Phase 3 (Houston, St. Louis, Tampa)  | 10%                | 100%                |
| Phase 4 (Baltimore, Cincinnati, Kansas<br>City,<br>Miami, Philadelphia, Washington D.C.) | 4%                 | 100%                |
| Phase 5 (Dallas, Detroit, Greater New York,<br>Phoenix)                                  | 5%                 | 95%                 |
| Phase 6 (Chicago, Minneapolis, Pittsburgh,<br>San Francisco)                             | 7%                 | 95%                 |

The Company is targeting completion of phases 5 and 6 in 2008 and expects to see continued incremental sales growth from the program for another five years.





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The U.S. branch-based business has added approximately 60,000 new products in 2008 which will be featured in the February 2009 catalog but are currently for sale on grainger.com. The 2008 catalog includes a total of 183,000 products.

Sales in Mexico increased 16.8% in the third quarter of 2008 versus 2007. Daily sales were up 15.0%. In local currency, daily sales were up 8.2% primarily driven by increased market share coming from the ongoing branch expansion program. Daily sales were led by growth to the natural resources sector of the economy, partially offset by weakness in manufacturing and hospitality.

The segment gross profit margin increased 0.8 percentage point in the 2008 third quarter over the comparable quarter of 2007, primarily due to positive inflation recovery partially offset by unfavorable selling price category mix.

Operating expenses in this segment were up 3.6% in the third quarter of 2008 versus the third quarter of 2007. Operating expenses grew slower than the sales growth primarily due to non-payroll operating expenses including lower advertising expenses, and a lower provision for bad debts due to improved collection effectiveness. Comparisons also benefited from one extra sales day which increased the leverage on fixed costs.

For the segment, operating earnings of \$226.6 million for the third quarter of 2008 increased 30.9% over the \$173.1 million for the third quarter of 2007. This earnings improvement exceeded the sales growth rate due to improved gross profit margin and positive operating expense leverage. Included in these results were lower profits in Mexico primarily due to branch expansion related expenses, ongoing losses in China and start up expenses related to the new branch in Panama.

Acklands - Grainger Branch-based

Net sales at Acklands - Grainger were \$190.8 million for the third quarter of 2008, an increase of \$27.3 million, or 16.7%, when compared with \$163.5 million for the same period in 2007. On a daily basis sales increased 14.8%. There was minimal effect from foreign exchange as sales increased 16.2% in local currency, or 14.4% on a daily basis. The results benefited from continued strength from sales to oil sands, natural gas, construction, government, mining, and agriculture customers, partially offset by weakness in the forestry sector.

The gross profit margin increased 0.7 percentage point in the 2008 third quarter versus the third quarter of 2007, primarily due to positive inflation recovery, partially offset by increased freight and handling costs.

Operating expenses were up 14.9% in the third quarter of 2008. The segment achieved positive operating expense leverage as operating expenses increased 14.4% in local currency.

Operating earnings of \$14.2 million for the third quarter of 2008 were up \$3.9 million, or 38.3%. The earnings improvement was primarily a result of an improved gross profit margin and operating expenses which grew at a slower rate than sales.

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Lab Safety

Net sales at Lab Safety were \$127.3 million for the third quarter of 2008, an increase of \$16.1 million, or 14.5%, when compared with the same period in 2007. Daily sales were up 12.7%.

Sales from the Highsmith acquisition made in July 2008 contributed all of the sales growth for the quarter. Excluding this acquisition sales growth for the remainder of the business was down 4.6% on a daily basis.

The gross profit margin decreased 1.7% in the third quarter of 2008 from the third quarter of 2007. Gross profit margin was down primarily due to product mix, as the Highsmith acquisition negatively impacted margins due to lower margin rates, and from a negative selling price category mix.

Operating expenses were up 20.2% in the third quarter of 2008, primarily due to costs associated with the Highsmith acquisition. Excluding Highsmith, operating expenses were down 1.3% for the third quarter of 2008.

Operating earnings of \$12.2 million for the third quarter of 2008 decreased 14.1% over the same period in 2007. Operating earnings decreased due to a decline in gross profit margin and operating expenses which grew at a higher rate than sales.

Other Income and Expense

Other income and expense was an expense of \$2.8 million in the third quarter of 2008 compared with \$2.9 million of income in the third quarter of 2007. This decrease was primarily attributable to lower interest income due to lower interest rates and higher interest expense in 2008 due to increased borrowings.

Income Taxes

Grainger's effective income tax rates were 38.8% and 38.4% for the third quarter of 2008 and 2007, respectively. Excluding the effect of equity in net income of unconsolidated entities, the effective income tax rate was 38.9% for the third quarter of 2008 and 38.5% for the third quarter of 2007.

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## Results of Operations – Nine Months Ended September 30, 2008

The following table is included as an aid to understanding the changes in Grainger's Condensed Consolidated Statements of Earnings:

Nine Months Ended September 30,  
Items in Condensed Consolidated Statements of Earnings

|                          | As a Percent of Net Sales |        | Percent<br>Increase<br>(Decrease) |
|--------------------------|---------------------------|--------|-----------------------------------|
|                          | 2008                      | 2007   |                                   |
| Net sales                | 100.0%                    | 100.0% | 9.4%                              |
| Cost of merchandise sold | 59.5                      | 59.8   | 8.9                               |
| Gross profit             | 40.5                      | 40.2   | 10.1                              |
| Operating expenses       | 29.0                      | 29.7   | 6.8                               |
| Operating earnings       | 11.5                      | 10.5   | 19.6                              |
| Other income (expense)   | (0.1)                     | 0.2    | (126.3)                           |
| Income taxes             | 4.4                       | 4.1    | 17.6                              |
| Net earnings             | 7.0%                      | 6.6%   | 16.4%                             |

Grainger's net sales of \$5,257.4 million for the first nine months of 2008 increased 9.4% compared with sales of \$4,806.3 million for the comparable 2007 period. Daily sales were up 8.8%. An increase in net sales was realized in all three segments of the business. The increase in net sales was led by low double-digit sales growth in the government sector and mid single-digit growth in the light manufacturing, commercial and reseller sectors. Approximately 3 percentage points of the sales growth came from Grainger's ongoing strategic initiatives, market expansion and product line expansion, with another 1 percentage point from foreign exchange. For the first nine months of 2008, sales were positively affected by price increases of approximately 3 percentage points. Sales were negatively affected by approximately 1 percentage point due to a decline in the sales of seasonal products. Refer to the Segment Analysis below for further detail of sales and ongoing strategic initiatives.

Gross profit of \$2,182.2 million for the first nine months of 2008 increased 10.1%. The gross profit margin during the first nine months of 2008 increased 0.3 percentage point when compared to the same period in 2007 primarily due to positive inflation recovery, partially offset by unfavorable selling price category mix.

Operating expenses of \$1,526.0 million for the first nine months of 2008 increased 6.8%. Operating expenses grew at a slower rate than sales due primarily to non-payroll operating expenses including advertising and professional services. Comparisons also benefited from one extra sales day which increased the leverage on fixed costs.

Operating earnings for the first nine months of 2008 totaled \$602.1 million, an increase of 19.6% over the first nine months of 2007. This earnings growth exceeded the sales growth due to an improvement in gross profit margin and positive operating expense leverage.



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Net earnings for the first nine months of 2008 increased 16.4% to \$367.4 million from \$315.7 million in 2007. The growth in net earnings for the first nine months primarily resulted from the improvement in operating earnings, partially offset by lower interest income, higher interest expense and a higher income tax rate versus 2007. Diluted earnings per share of \$4.65 in the first nine months of 2008 were 26.7% higher than the \$3.67 for the first nine months of 2007. This improvement was higher than the percentage increase for net earnings due to lower shares outstanding primarily a result of the Company's share repurchase program.

#### Segment Analysis

The following comments at the segment level refer to external and intersegment net sales. Comments at the business unit level include external and inter- and intrasegment net sales. See Note 8 to the Condensed Consolidated Financial Statements.

#### Grainger Branch-based

Net sales were \$4,346.9 million for the first nine months of 2008, an increase of \$332.4 million, or 8.3%, when compared with net sales of \$4,014.5 million for the same period in 2007. Daily sales were up 7.7%.

Sales in the United States were up 8.0%. Daily sales were up 7.5% with growth in all customer end markets, except the retail customer market, which was flat. The increase in net sales was led by low double-digit sales growth in the government sector, and mid single-digit growth in the light manufacturing, commercial and reseller sectors. Sales were negatively affected by approximately 1 percentage point due to a decline in the sales of seasonal products. Market expansion and product line expansion added approximately 4 percentage points to overall growth for the first nine months of 2008.

Results for the market expansion program were as follows:

|  | 2008 Year-to-Date |                     |
|--|-------------------|---------------------|
|  | Sales<br>Increase | Percent<br>Complete |
| Phase 1 (Atlanta, Denver, Seattle)   | 11%               | 100%                |
| Phase 2 (Four markets in Southern<br>California)   | 8%                | 100%                |
| Phase 3 (Houston, St. Louis, Tampa)  | 12%               | 100%                |
| Phase 4 (Baltimore, Cincinnati, Kansas<br>City,<br>Miami, Philadelphia, Washington D.C.) | 4%                | 100%                |
| Phase 5 (Dallas, Detroit, Greater New York,<br>Phoenix)                                  | 6%                | 95%                 |
| Phase 6 (Chicago, Minneapolis, Pittsburgh,<br>San Francisco)                             | 8%                | 95%                 |

The Company is targeting completion of phases 5 and 6 in 2008 and expects to see continued incremental sales growth from the program for another five years.

The U.S. branch-based business has added approximately 60,000 new products in 2008 which will be featured in the February 2009 catalog but are currently for sale on grainger.com. The 2008 catalog includes a total of 183,000 products.

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Sales in Mexico increased 19.8% in the first nine months of 2008 versus 2007. Daily sales were up 19.2%. In local currency, daily sales were up 14.3% primarily driven by increased market share coming from the ongoing branch expansion program.

The segment gross profit margin increased 0.4 percentage point in the first nine months of 2008 over the comparable 2007 period, primarily driven by positive inflation recovery, partially offset by unfavorable selling price category mix and increased freight and handling costs.

Operating expenses in this segment were up 5.3% in the first nine months of 2008. Operating expenses grew at a slower rate than sales due primarily to non-payroll operating expenses including advertising and professional services. Comparisons also benefited from one extra sales day which increased the leverage on fixed costs.

For the segment, operating earnings of \$596.4 million for the first nine months of 2008 increased 18.1% over the \$505.0 million for the first nine months of 2007. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and positive operating expense leverage. Included in these results were lower profits in Mexico primarily due to branch expansion related expenses, ongoing losses in China and start up expenses related to the new branch in Panama.

Acklands - Grainger Branch-based

Net sales at Acklands - Grainger were \$565.9 million for the first nine months of 2008, an increase of \$101.0 million, or 21.7%, when compared with \$464.9 million for the same period in 2007. Daily sales were up 21.1%. In local currency, daily sales increased 12.0%. The results benefited from continued strength from sales to government, construction, oil sands, natural gas, mining and agriculture customers, partially offset by weakness in the forestry sector.

The gross profit margin increased 0.4 percentage point in the first nine months of 2008 over the first nine months of 2007. The increase was primarily driven by positive inflation recovery.

Operating expenses were up 19.3% in the first nine months of 2008. The segment achieved positive operating expense leverage as operating expenses increased 10.3% in local currency. The increase in operating expenses was primarily due to payroll and benefits as a result of increased headcount and merit increases, and other operating expenses.

Operating earnings of \$41.9 million for the first nine months of 2008 were up \$12.1 million, or 40.9%. This earnings improvement exceeded the sales growth rate primarily due to an improved gross profit margin and positive operating expense leverage.

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Lab Safety

Net sales at Lab Safety were \$350.0 million for the first nine months of 2008, an increase of \$19.3 million, or 5.9%, when compared with \$330.7 million for the same period in 2007. Daily sales were up 5.3%. Excluding sales from the Highsmith acquisition, sales growth for the remainder of the business was down approximately 1%.

The gross profit margin decreased 0.5 percentage point in the first nine months of 2008 from the first nine months of 2007. Gross profit margin was down as a result of unfavorable selling price category mix and product mix partially offset by positive inflation recovery.

Operating expenses were up 9.2% in the first nine months of 2008. Expenses grew at a faster rate than sales primarily due to the costs associated with the Highsmith acquisition. Excluding Highsmith, operating expenses were up approximately 2% for the first nine months of 2008.

Operating earnings of \$40.6 million for the first nine months of 2008 decreased 6.0% versus the same period in 2007. Operating earnings decreased due to a decline in gross profit margin and operating expenses which grew at a higher rate than sales.

Other Income and Expense

Other income and expense was an expense of \$2.5 million in the first nine months of 2008 compared with income of \$9.7 million in the first nine months of 2007. This decrease was primarily attributable to lower interest income due to lower interest rates and lower average cash balances and higher interest expense in 2008 due to increased borrowings.

Income Taxes

Grainger's effective income tax rates were 38.7% and 38.5% for the first nine months of 2008 and 2007, respectively. Excluding the effect of equity in net income of unconsolidated entities, the effective income tax rate was 38.9% for the first nine months of 2008 and 38.5% for the first nine months of 2007.



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Financial Condition

For the nine months ended September 30, 2008, working capital of \$1,436.5 million increased by \$462.1 million when compared to \$974.4 million at December 31, 2007. The increase in working capital primarily relates to increases in cash and receivables and the replacement of short-term borrowings with long-term debt. The ratio of current assets to current liabilities was 3.0 at September 30, 2008, versus 2.2 at December 31, 2007.

Net cash provided by operating activities was \$335.3 million and \$337.8 million for the nine months ended September 30, 2008 and 2007, respectively. Net cash flows from operating activities serve as Grainger's primary source to fund its growth initiatives. Contributing to cash flows from operations were net earnings in the first nine months ended September 30, 2008 of \$367.4 million and the effect of non-cash expenses such as stock-based compensation, and depreciation and amortization. Partially offsetting these amounts were changes in operating assets and liabilities, which resulted in a net use of cash of \$155.8 million for the first nine months of 2008. The principal operating uses of cash were increases in accounts receivable and inventory, as well as a reduction of other current liabilities. The increase in receivables was due to a higher sales volume. The increase in inventories was due to the product line expansion initiative and higher inventories to improve customer service through better product availability. Other current liabilities declined primarily due to annual cash payments for profit sharing and bonuses. Partially offsetting these uses in cash was an increase in trade accounts payable.

Net cash used in investing activities was \$152.9 million and \$143.9 million for the nine months ended September 30, 2008 and 2007, respectively. Cash expended for additions to property, buildings, equipment and capitalized software was \$140.5 million in the first nine months of 2008 versus \$143.5 million in the first nine months of 2007. Capital expenditures included the continued funding of the market expansion initiatives in the United States and Mexico. Cash expended for business acquisitions was \$34.0 million for the first nine months of 2008 versus \$4.7 million in the first nine months of 2007.

Net cash provided by financing activities was \$69.9 million for the nine months ended September 30, 2008, versus net cash used of \$457.1 million for the nine months ended September 30, 2007. For the nine months ended September 30, 2008, cash provided by financing activities included proceeds from long-term borrowings of \$500 million, and proceeds and excess tax benefits realized from stock options exercised of \$52.8 million in 2008 versus \$130.5 million in 2007. Amounts used in financing activities included treasury stock purchases of \$307.6 million for the first nine months of 2008 versus \$647.3 million for the first nine months of 2007. Grainger repurchased 4.3 million shares compared to 7.1 million shares in the first nine months of 2007. As of September 30, 2008, approximately 8.8 million shares of common stock remained available under Grainger's repurchase authorization. Grainger also used cash in financing activities to pay dividends to shareholders of \$90.4 million and \$84.8 million for the first nine months of 2008 and 2007, respectively, and paid off \$85.0 million of short-term borrowings in the first nine months of 2008 versus an increase of \$144.4 million in the first nine months of 2007.

W.W. Grainger, Inc. and Subsidiaries  
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Grainger maintains a debt ratio and liquidity position that provide flexibility in funding working capital needs and long-term cash requirements. In addition to internally generated funds, Grainger has various sources of financing available, including commercial paper sales and bank borrowings under lines of credit. Total debt as a percent of total capitalization was 19.8% at September 30, 2008, and 5.0% at December 31, 2007. The increase in total debt as a percent of total capitalization was primarily the result of long-term borrowings. See Note 6 to the Condensed Consolidated Financial Statements for additional borrowings detail.

Critical Accounting Policies and Estimates

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the financial statements. Management bases its estimates on historical experience and other assumptions, which it believes are reasonable. If actual amounts are ultimately different from these estimates, the revisions are included in Grainger's results of operations for the period in which the actual amounts become known.

Accounting policies are considered critical when they require management to make assumptions about matters that are uncertain at the time the estimate is made and when different estimates than those management reasonably could have made have a material impact on the presentation of Grainger's financial condition, changes in financial condition or results of operations. For a description of Grainger's critical accounting policies see the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

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Forward-Looking Statements

This Form 10-Q contains statements that are not historical in nature but concern future results and business plans, strategies and objectives and other matters that may be deemed to be "forward-looking statements" under the federal securities laws. Grainger has generally identified such forward-looking statements by using words such as "continued incremental sales growth, continues to believe it complies, could, expect, expected, expects, intended, intends, is targeting, may, percent complete, projections, should be completed, timing and outcome are uncertain, and will" or similar expressions.

Grainger cannot guarantee that any forward-looking statement will be realized although Grainger does believe that its assumptions underlying its forward-looking statements are reasonable. Achievement of future results is subject to risks and uncertainties which could cause Grainger's results to differ materially from those which are presented.

Factors that could cause actual results to differ materially from those presented or implied in a forward-looking statement include, without limitation: higher product costs or other expenses; a major loss of customers; increased competitive pricing pressures; failure to develop or implement new technologies or business strategies; the outcome of pending and future litigation or governmental or regulatory proceedings; changes in laws and regulations; disruption of information technology or data security systems; general industry or market conditions; general economic conditions; labor shortages; facilities disruptions or shutdowns; higher fuel costs or disruptions in transportation services; natural and other catastrophes; and unanticipated weather conditions.

Caution should be taken not to place undue reliance on Grainger's forward-looking statements and Grainger undertakes no obligation to publicly update the forward-looking statements, whether as a result of new information, future events or otherwise.

W.W. Grainger, Inc. and Subsidiaries

PART I – FINANCIAL INFORMATION

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk, see “Item 7A: Quantitative and Qualitative Disclosures About Market Risk” in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Grainger carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of Grainger’s disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that Grainger’s disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There were no changes in Grainger’s internal control over financial reporting that occurred during the third quarter, that have materially affected, or are reasonably likely to materially affect, Grainger’s internal control over financial reporting.

PART II – OTHER INFORMATION

Items 1A, 3, 4 and 5 not applicable.

Item 1. Legal Proceedings

As previously reported, the Company received a letter in December 2007 from the Commercial Litigation Branch of the Civil Division of the Department of Justice (the “DOJ”) regarding the Company’s contract with the United States General Services Administration (the “GSA”). The letter suggested that the Company had not complied with its disclosure obligations and the contract’s pricing provisions, and had potentially overcharged government customers under the contract.

Discussions relating to the Company’s compliance with its disclosure obligations and the contract’s pricing provisions are ongoing. The timing and outcome of these discussions are uncertain and could include settlement or civil litigation by the DOJ to recover, among other amounts, treble damages and penalties under the False Claims Act. While this matter is not expected to have a material adverse effect on the Company’s financial position, an unfavorable resolution could result in material payments by the Company. The Company continues to believe that it has complied with the GSA contract in all material respects.

## W.W. Grainger, Inc. and Subsidiaries

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

## Issuer Purchases of Equity Securities – Third Quarter

| Period               | Total Number of<br>Shares Purchased<br>(A) | Average Price<br>Paid per Share<br>(B) | Total Number of<br>Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans<br>or Programs (C) | Maximum Number of<br>Shares that May Yet be<br>Purchased Under the<br>Plans or Programs |
|----------------------|--|--|---|---|
| July 1 – July 31     | 350,000                                    | \$83.38                                | 350,000   | 8,811,100shares   |
| August 1 – August 31 | 3,375                                      | \$89.15                                | –   | 8,811,100shares   |
| Sept. 1 – Sept. 30   | –  | –                                      | –   | 8,811,100shares   |
| Total                | 353,375                                    | \$83.44                                | 350,000   |   |

(A) There were 3,375 shares withheld to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.

(B) Average price paid per share includes any commissions paid and includes only those amounts related to purchases as part of publicly announced plans or programs. Activity is reported on a trade date basis.

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors. On April 30, 2008, Grainger announced that its Board of Directors granted authority to repurchase up to 10 million shares. The program has no specified expiration date. No share repurchase plan or program expired or was terminated during the period covered by this report.

## Item 6. Exhibits

(a) Exhibits (numbered in accordance with Item 601 of Regulation S-K)

(31) Rule 13a – 14(a)/15d – 14(a) Certifications

(a) Chief Executive Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

(b) Chief Financial Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

(32) Section 1350 Certifications

(a) Chief Executive Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Chief Financial Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

W.W. Grainger, Inc.  
(Registrant)

Date: October 30, 2008

By: /s/ R. L. Jadin  
R. L. Jadin, Senior Vice President  
and Chief Financial Officer

Date: October 30, 2008

By: /s/ G. S. Irving  
G. S. Irving, Vice President  
and Controller

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