

GRAINGER W W INC  
Form 10-Q  
April 28, 2016

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 March 31, 2016  
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 36-1150280  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

100 Grainger Parkway, Lake Forest, Illinois 60045-5201  
(Address of principal executive offices) (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 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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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  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

There were 61,322,179 shares of the Company’s Common Stock outstanding as of March 31, 2016.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

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

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

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

(Unaudited)

|  | Three Months Ended |             |
|--|--------------------|-------------|
|  | March 31,          |             |
|  | 2016               | 2015        |
| Net sales  | \$2,506,538        | \$2,439,661 |
| Cost of merchandise sold                                   | 1,461,485          | 1,345,918   |
| Gross profit   | 1,045,053          | 1,093,743   |
| Warehousing, marketing and administrative expenses         | 727,961            | 742,496     |
| Operating earnings   | 317,092            | 351,247     |
| Other income and (expense):                                |                    |             |
| Interest income  | 165                | 192         |
| Interest expense   | (13,725)           | (1,636)     |
| Loss from equity method investment                         | (6,388)            | —           |
| Other non-operating income                                 | 694                | 241         |
| Other non-operating expense                                | (254)              | (2,405)     |
| Total other expense  | (19,508)           | (3,608)     |
| Earnings before income taxes                               | 297,584            | 347,639     |
| Income taxes   | 105,940            | 133,493     |
| Net earnings   | 191,644            | 214,146     |
| Less: Net earnings attributable to noncontrolling interest | 4,931              | 3,131       |
| Net earnings attributable to W.W. Grainger, Inc.           | \$186,713          | \$211,015   |
| Earnings per share:  |                    |             |
| Basic  | \$3.00             | \$3.11      |
| Diluted  | \$2.98             | \$3.07      |
| Weighted average number of shares outstanding:             |                    |             |
| Basic  | 61,668,682         | 67,229,653  |
| Diluted  | 62,099,801         | 67,982,362  |
| Cash dividends paid per share                              | \$1.17             | \$1.08      |

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<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2016                            | 2015      |
| Net earnings  | \$191,644                       | \$214,146 |
| Other comprehensive earnings (losses):  |                                 |           |
| Foreign currency translation adjustments:   |                                 |           |
| Foreign currency translation adjustments, net of tax benefit of \$0 and \$0, respectively                 | 51,490                          | (76,015 ) |
| Defined postretirement benefit plan:  |                                 |           |
| Reclassification adjustments related to amortization, net of tax expense of \$631 and \$509, respectively | (1,009 )                        | (813 )    |
| Derivative instrument change in fair value of cash flow hedge   | 304                             | 482       |
| Comprehensive earnings, net of tax  | 242,429                         | 137,800   |
| Less: Comprehensive earnings (losses) attributable to noncontrolling interest                             |                                 |           |
| Net earnings  | 4,931                           | 3,131     |
| Foreign currency translation adjustments  | 5,704                           | (294 )    |
| Comprehensive earnings attributable to W.W. Grainger, Inc.  | \$231,794                       | \$134,963 |

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 share and per share amounts)

| ASSETS   | (Unaudited)         |                     |
|--|---------------------|---------------------|
|  | March 31,<br>2016   | Dec 31,<br>2015     |
| <b>CURRENT ASSETS</b>  |                     |                     |
| Cash and cash equivalents  | \$ 279,906          | \$ 290,136          |
| Accounts receivable (less allowances for doubtful accounts of \$23,874 and \$22,288, respectively) | 1,304,560           | 1,209,641           |
| Inventories – net  | 1,420,897           | 1,414,177           |
| Prepaid expenses and other assets  | 102,435             | 85,670              |
| Prepaid income taxes   | 31,163              | 49,018              |
| Total current assets   | 3,138,961           | 3,048,642           |
| <b>PROPERTY, BUILDINGS AND EQUIPMENT</b>   | 3,407,770           | 3,370,313           |
| Less: Accumulated depreciation and amortization  | 1,965,579           | 1,939,072           |
| Property, buildings and equipment – net  | 1,442,191           | 1,431,241           |
| <b>DEFERRED INCOME TAXES</b>   | 66,251              | 83,996              |
| <b>GOODWILL</b>  | 595,487             | 582,336             |
| <b>INTANGIBLES - NET</b>   | 458,230             | 463,294             |
| <b>OTHER ASSETS</b>  | 263,719             | 248,246             |
| <b>TOTAL ASSETS</b>  | <b>\$ 5,964,839</b> | <b>\$ 5,857,755</b> |

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

|  | (Unaudited)        |                    |
|--|--------------------|--------------------|
|  | March 31,<br>2016  | Dec 31,<br>2015    |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                    |                    |
| <b>CURRENT LIABILITIES</b>   |                    |                    |
| Short-term debt  | \$569,367          | \$353,072          |
| Current maturities of long-term debt   | 135,834            | 247,346            |
| Trade accounts payable   | 620,410            | 583,474            |
| Accrued compensation and benefits  | 208,024            | 196,667            |
| Accrued contributions to employees' profit sharing plans   | 22,058             | 124,587            |
| Accrued expenses   | 274,458            | 266,702            |
| Income taxes payable   | 50,289             | 16,686             |
| Total current liabilities  | 1,880,440          | 1,788,534          |
| LONG-TERM DEBT (less current maturities)   | 1,387,124          | 1,388,414          |
| DEFERRED INCOME TAXES AND TAX UNCERTAINTIES  | 158,238            | 154,352            |
| EMPLOYMENT-RELATED AND OTHER NON-CURRENT LIABILITIES   | 174,837            | 173,741            |
| <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; 109,659,219 shares issued             | 54,830             | 54,830             |
| Additional contributed capital   | 1,007,933          | 1,000,476          |
| Retained earnings  | 6,916,043          | 6,802,130          |
| Accumulated other comprehensive losses   | (176,010 )         | (221,091 )         |
| Treasury stock, at cost – 48,337,040 and 47,630,511 shares, respectively                               | (5,535,497 )       | (5,369,711 )       |
| Total W.W. Grainger, Inc. shareholders' equity   | 2,267,299          | 2,266,634          |
| Noncontrolling interest  | 96,901             | 86,080             |
| Total shareholders' equity   | 2,364,200          | 2,352,714          |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$5,964,839</b> | <b>\$5,857,755</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)

|  | Three Months Ended |               |
|--|--------------------|---------------|
|  | March 31,          |               |
|  | 2016               | 2015          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                               |                    |               |
| Net earnings   | \$ 191,644         | \$ 214,146    |
| Provision for losses on accounts receivable                                | 3,454              | 2,558         |
| Deferred income taxes and tax uncertainties                                | 21,035             | 1,732         |
| Depreciation and amortization  | 56,294             | 52,411        |
| (Gains) from non-cash charges and sales of assets                          | (7,465 )           | —             |
| Stock-based compensation   | 7,456              | 9,161         |
| Losses from equity method investment                                       | 6,388              | —             |
| Change in operating assets and liabilities – net of business acquisitions: |                    |               |
| Accounts receivable  | (84,435 )          | (50,968 )     |
| Inventories  | 10,831             | (2,808 )      |
| Prepaid expenses and other assets  | 4,370              | 34,433        |
| Trade accounts payable   | 30,827             | (7,326 )      |
| Other current liabilities  | (111,458 )         | (160,239 )    |
| Current income taxes payable   | 32,757             | 62,893        |
| Accrued employment-related benefits cost                                   | 323                | 2,296         |
| Other – net  | (8,290 )           | (2,080 )      |
| Net cash provided by operating activities                                  | 153,731            | 156,209       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                               |                    |               |
| Additions to property, buildings and equipment                             | (51,797 )          | (99,489 )     |
| Proceeds from sales of assets  | 13,817             | 7,333         |
| Equity method investment   | (7,199 )           | —             |
| Other – net  | (206 )             | (48 )         |
| Net cash used in investing activities                                      | (45,385 )          | (92,204 )     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                               |                    |               |
| Net increase in commercial paper   | 214,645            | 190,000       |
| Borrowings under lines of credit   | 12,028             | 14,380        |
| Payments against lines of credit   | (11,060 )          | (28,333 )     |
| Payments of long-term debt   | (124,769 )         | (1,860 )      |
| Proceeds from stock options exercised                                      | 5,206              | 4,883         |
| Excess tax benefits from stock-based compensation                          | 17,287             | 4,319         |
| Purchase of treasury stock   | (172,047 )         | (149,992 )    |
| Cash dividends paid  | (72,632 )          | (73,393 )     |
| Net cash used in financing activities                                      | (131,342 )         | (39,996 )     |
| Exchange rate effect on cash and cash equivalents                          | 12,766             | (7,226 )      |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>(10,230 )</b>   | <b>16,783</b> |
| Cash and cash equivalents at beginning of year                             | 290,136            | 226,644       |
| Cash and cash equivalents at end of period                                 | \$ 279,906         | \$ 243,427    |

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. is a broad-line distributor of maintenance, repair and operating supplies, and other related products and services used by businesses and institutions. W.W. Grainger, Inc.'s operations are primarily in the United States and Canada, with a presence in Europe, Asia and Latin 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, 2015 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, 2015 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. NEW ACCOUNTING STANDARDS

In July 2015, the Financial Accounting Standards Board (FASB) announced a one-year delay in the effective date of Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers. The standard will now be effective for interim and annual periods beginning after December 15, 2017. The standard also permits adoption as early as the original effective date, which was for interim and annual periods beginning after December 15, 2016. The Company is evaluating the impact of this ASU but does not expect it to have a material impact on the Company's consolidated financial statements.

In July 2015, FASB issued ASU 2015-11, Simplifying the Measurement of Inventory, which simplifies the subsequent measurement of inventory by replacing the lower of cost or market test with a lower of cost or net realizable value (NRV) test. NRV is calculated as the estimated selling price less reasonably predictable costs of completion, disposal and transportation. This pronouncement is effective for fiscal years and for interim periods within those fiscal years beginning after December 15, 2016, and prospective adoption is required. The Company is evaluating the impact of this ASU.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments: Recognition and Measurement of Financial Assets and Financial Liabilities. This change to the financial instrument model primarily affects the accounting for equity investments, financial liabilities under the fair value options and the presentation and disclosure requirements for financial instruments. The effective date for the standard is for fiscal years and interim periods within those years beginning after December 15, 2017. Certain provisions for the new guidance can be adopted early. The Company is evaluating the impact of this ASU.

In February 2016, the FASB issued ASU 2016-02, Leases. The purpose of the standard is to improve transparency and comparability related to the accounting and reporting of leasing arrangements. The guidance will require balance sheet recognition for assets and liabilities associated with rights and obligations created by leases with terms greater than twelve months. The effective date for the standard is for fiscal year and interim periods within those years beginning

after December 15, 2018. Early adoption is permitted. The Company is evaluating the impact of this ASU.

In March 2016, the FASB issued ASU 2016-07, Investments - Equity Method and Joint Ventures; Simplifying the Transition to the Equity Method of Accounting. This update eliminates the requirement to retroactively adjust the investment, results of operations and retained earnings when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence. The amendment requires that the investor add the cost of acquiring the additional interest to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. The effective date for the standard is for fiscal years and interim periods within those years beginning after

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

December 15, 2016. The amendment should be applied prospectively and early application is permitted. This ASU is not expected to have a material impact on the Company's consolidated financial statements.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contract with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net). The amendment is meant to reduce the potential for diversity in practice arising from inconsistent application of the principal versus agent guidance as well as reduce the cost and complexity during the transition and on an ongoing basis. The effective date for the amendment to the standard is consistent with ASU 2014-09, Revenue from Contracts with Customers, which is interim and annual periods beginning after December 15, 2017. The Company is evaluating the impact of the ASU.

In March 2016, the FASB issued ASU 2016-09, Stock Based Compensation: Improvements to Employee Share-Based Payment Accounting. The standard simplifies several aspects of the accounting for employee share-based payment transactions, including accounting for income taxes, forfeitures and statutory tax withholdings requirements, as well as classification in the statement of cash flows. The effective date for the standard is for fiscal years and interim periods with those years beginning after December 15, 2016. Early adoption is permitted. If early adoption is elected, all amendments in the ASU that apply must be adopted in the same period. The Company is evaluating the impact of this ASU.

### 3. DIVIDEND

On April 27, 2016, the Company's Board of Directors declared a quarterly dividend of \$1.22 per share, payable June 1, 2016, to shareholders of record on May 9, 2016.

### 4. ACQUISITION

On September 1, 2015, the Company acquired all of the issued share capital of Cromwell Group (Holdings) Limited (Cromwell). With sales of approximately £285 million (\$437 million) for fiscal year ending August 31, 2015, prior to the acquisition, Cromwell was the largest independent MRO distributor in the United Kingdom, serving more than 35,000 industrial and manufacturing customers worldwide. The Company paid £310 million (\$464 million), subject to customary adjustments, for the Cromwell acquisition. The acquisition was partially funded with newly issued debt in the United Kingdom. Goodwill and intangibles recorded totaled approximately \$357 million. The goodwill is not deductible for tax purposes. The purchase price allocation has not been finalized and is subject to change as the Company obtains additional information during the measurement period related to the valuation of the acquired assets and liabilities. Disclosure of pro forma results was not required.

### 5. RESTRUCTURING RESERVES

The Company recorded one-time benefits with the majority expected to be paid in 2016 related to the reorganization of the business. Severance costs of approximately \$16 million were recorded in the three months ended March 31, 2016 and are included in Warehousing, marketing and administrative expenses. The reserve balance as of March 31, 2016 and December 31, 2015 was approximately \$37 million and \$24 million, respectively, and is included in Accrued compensation and benefits.

### 6. SHORT-TERM AND LONG-TERM DEBT

The following summarizes information concerning short-term debt (in thousands of dollars):

|                              | March<br>31,<br>2016 | December<br>31, 2015 |
|------------------------------|----------------------|----------------------|
| Outstanding lines of credit  | \$24,722             | \$ 23,072            |
| Outstanding commercial paper | 544,645              | 330,000              |

As of March 31, 2016 and December 31, 2015, there was \$545 million and \$330 million, respectively, of commercial paper outstanding. The increase in commercial paper from December 31, 2015 was used to fund the repayment of the Company's U.S. dollar term loan, the repurchase of treasury shares, as well as general working capital needs.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Long-term debt consisted of the following (in thousands of dollars):

|   | March 31,<br>2016 | December<br>31, 2015 |
|---|-------------------|----------------------|
| Senior notes                              | \$ 1,000,000      | \$ 1,000,000         |
| U.S. dollar term loan                     | —                 | 114,614              |
| British pound denominated term loan       | 223,984           | 235,808              |
| Euro denominated term loan                | 116,624           | 114,030              |
| Yen denominated term loans                | 53,305            | 49,875               |
| Canadian dollar revolving credit facility | 115,349           | 108,389              |
| Other                                     | 26,253            | 25,991               |
| Debt issuance costs                       | (12,557 )         | (12,947 )            |
| Less current maturities                   | (135,834 )        | (247,346 )           |
|   | 1,387,124         | \$ 1,388,414         |

On June 11, 2015, the Company issued \$1 billion of unsecured 4.60% Senior Notes (Notes) that mature on June 15, 2045. The Notes require no principal payments until the maturity date and interest is payable semi-annually on June 15 and December 15, beginning on December 15, 2015. Prior to December 15, 2044, the Company may redeem the Notes in whole at any time or in part from time to time at a “make-whole” redemption price. This redemption price is calculated by reference to the then-current yield on a US treasury security with a maturity comparable to the remaining term of the Notes plus 25 basis points, together with accrued and unpaid interest, if any, to the redemption date. On or after December 15, 2044, the Company may redeem the Notes in whole at any time or in part from time to time at 100% of their principal amount, together with accrued and unpaid interest, if any, to the redemption date. Costs of approximately \$10 million associated with the issuance of the Notes, representing underwriting fees and other expenses, have been recorded as a contra-liability within Long-term debt and will be amortized to interest expense over the term of the Notes.

The approximate fair value of the Company's Notes is \$1 billion as of March 31, 2016 and December 31, 2015 and approximates the carrying amount. The estimated fair value of the Company's Notes was based on available external pricing data and current market rates for similar debt instruments, among other factors, which are classified as level 2 inputs within the fair value hierarchy. The carrying value of other long-term debt approximates fair value due to the variable interest rates.

## 7. DERIVATIVE INSTRUMENTS

The Company uses derivative instruments to manage a portion of exposures to fluctuations in interest rates and foreign currency exchange rates. The Company does not enter into derivative financial instruments for trading or speculative purposes. The fair values of these instruments are determined by using quoted market forward rates (level 2 inputs) and reflect the present value of the amount that the Company would pay for contracts involving the same notional amounts and maturity dates. These instruments qualify for hedge accounting and the changes in fair value are reported as a component of other comprehensive earnings (losses) net of tax effects.

The fair value of the Company's interest rate swap was \$1 million as of March 31, 2016 and December 31, 2015 and was included on the balance sheet as a liability under Accrued expenses. The purpose of the interest rate swap is to partially hedge the future interest expense of the euro-denominated term loan entered into to fund a portion of the Fabory acquisition in 2011. The swap matures in August 2016. All remaining derivative instruments were immaterial individually and in the aggregate as of March 31, 2016 and December 31, 2015.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

**8. EQUITY METHOD INVESTMENT**

In addition to the investment made in 2015, in January 2016, the Company invested in a second limited liability company established to produce refined coal, which is then sold to a utility to produce electricity. The production and sale of refined coal is eligible for renewable energy tax credits under Section 45 of the Internal Revenue Code. Under the terms of the investment, effective control lies with a co-investor who manages the day-to-day operations of the entity.

The Company will fund its share of operating expenses of the entity through February 2019 and receive tax credits in proportion to its equity investment. The investment will be accounted for under the equity method of accounting. As of March 31, 2016, the balance of the combined refined coal investments was \$9 million and is included on the balance sheet under Other assets. During the three months ended March 31, 2016, the Company recorded \$6 million in equity losses and a total tax benefit of \$10 million, including energy tax credits, as reflected in the Company's effective tax rate. The investments contributed \$4 million to net earnings for the three months ended March 31, 2016.

**9. EMPLOYEE BENEFITS - POSTRETIREMENT**

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its United States employees hired prior to January 1, 2013, and their dependents should they elect to maintain such coverage upon retirement. Covered employees become eligible for participation when they qualify for retirement while working for the Company. Participation in the plan is voluntary and requires participants to make contributions toward the cost of the plan, as determined by the Company.

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 (in thousands of dollars):

|                                       | Three Months<br>Ended March 31, |          |
|---------------------------------------|---------------------------------|----------|
|                                       | 2016                            | 2015     |
| Service cost                          | \$2,059                         | \$2,532  |
| Interest cost                         | 2,464                           | 2,412    |
| Expected return on assets             | (2,528 )                        | (2,594 ) |
| Amortization of unrecognized losses   | 32                              | 378      |
| Amortization of prior service credits | (1,672 )                        | (1,700 ) |
| Net periodic benefit costs            | \$355                           | \$1,028  |

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. The Company did not make a contribution to the trust during the three months ended March 31, 2016.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 10. SEGMENT INFORMATION

The Company has two reportable segments: the United States and Canada. The United States operating segment reflects the results of the Company's U.S. business. The Canada operating segment reflects the results for Acklands – Grainger Inc. (Acklands-Grainger), the Company's Canadian business. Other businesses include Zoro, the single channel business in the United States, and business units in Europe, Asia and Latin America. Other businesses do not meet the definition of a reportable segment. Operating segments generate revenue almost exclusively through the distribution of maintenance, repair and operating supplies, as service revenues account for less than 1% of total revenues for each operating segment. Following is a summary of segment results (in thousands of dollars):

|                                 | Three Months Ended March 31, 2016 |             |                  |             |
|---------------------------------|-----------------------------------|-------------|------------------|-------------|
|                                 | United States                     | Canada      | Other Businesses | Total       |
| Total net sales                 | \$1,966,267                       | \$178,771   | \$445,333        | \$2,590,371 |
| Intersegment net sales          | (82,499 )                         | (36 )       | (1,298 )         | (83,833 )   |
| Net sales to external customers | \$1,883,768                       | \$178,735   | \$444,035        | \$2,506,538 |
| Segment operating earnings      | \$331,857                         | \$(12,347 ) | \$21,783         | \$341,293   |

|                                 | Three Months Ended March 31, 2015 |           |                  |             |
|---------------------------------|-----------------------------------|-----------|------------------|-------------|
|                                 | United States                     | Canada    | Other Businesses | Total       |
| Total net sales                 | \$1,971,455                       | \$234,530 | \$297,800        | \$2,503,785 |
| Intersegment net sales          | (63,191 )                         | (36 )     | (897 )           | (64,124 )   |
| Net sales to external customers | \$1,908,264                       | \$234,494 | \$296,903        | \$2,439,661 |
| Segment operating earnings      | \$366,089                         | \$9,387   | \$9,526          | \$385,002   |

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

|                   | United<br>States | Canada    | Other<br>Businesses | Total       |
|-------------------|------------------|-----------|---------------------|-------------|
| Segment assets:   |                  |           |                     |             |
| March 31, 2016    | \$2,244,942      | \$335,980 | \$ 535,566          | \$3,116,488 |
| December 31, 2015 | \$2,191,045      | \$317,504 | \$ 507,116          | \$3,015,665 |

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

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2016                            | 2015      |
| Operating earnings:                             |                                 |           |
| Total operating earnings for operating segments | \$341,293                       | \$385,002 |
| Unallocated expenses and eliminations           | (24,201 )                       | (33,755 ) |
| Total consolidated operating earnings           | \$317,092                       | \$351,247 |

|                                      | Mar 31,<br>2016 | Dec 31,<br>2015 |
|--------------------------------------|-----------------|-----------------|
| Assets:                              |                 |                 |
| Total assets for operating segments  | \$3,116,488     | \$3,015,665     |
| Other current and non-current assets | 2,718,224       | 2,624,966       |
| Unallocated assets                   | 130,127         | 217,124         |
| Total consolidated assets            | \$5,964,839     | \$5,857,755     |

Assets for operating segments include net accounts receivable and first-in, first-out inventory which are reported to the Company's Chief Operating Decision Maker. Other current and non-current assets include all other asset balances for the operating segments.

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

Intersegment net sales for the U.S. segment increased by \$19 million for the three months of 2016 compared to the prior year, driven by increased sales from the U.S. business to Zoro. The U.S. business' supply chain network is Zoro's primary source of inventory.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 11. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share under the two-class method (in thousands of dollars, except for share and per share amounts):

|  | Three Months Ended<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2016                            | 2015       |
| Net earnings attributable to W.W. Grainger, Inc. as reported   | \$186,713                       | \$211,015  |
| Distributed earnings available to participating securities   | (626 )                          | (768 )     |
| Undistributed earnings available to participating securities   | (1,121 )                        | (1,461 )   |
| Numerator for basic earnings per share – Undistributed and distributed earnings available to common shareholders   | 184,966                         | 208,786    |
| Undistributed earnings allocated to participating securities   | 1,121                           | 1,461      |
| Undistributed earnings reallocated to participating securities   | (1,114 )                        | (1,445 )   |
| Numerator for diluted earnings per share – Undistributed and distributed earnings available to common shareholders | \$184,973                       | \$208,802  |
| Denominator for basic earnings per share – weighted average shares   | 61,668,682                      | 67,229,653 |
| Effect of dilutive securities  | 431,119                         | 752,709    |
| Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities              | 62,099,801                      | 67,982,362 |
| Earnings per share two-class method  |                                 |            |
| Basic  | \$3.00                          | \$3.11     |
| Diluted  | \$2.98                          | \$3.07     |

## 12. CONTINGENCIES AND LEGAL MATTERS

From time to time the Company is involved in various legal and administrative proceedings that are incidental to its business, including claims related to product liability, general negligence, contract disputes, environmental issues, wage and hour laws, intellectual property, employment practices, regulatory compliance or other matters and actions brought by employees, consumers, competitors, suppliers or governmental entities. As a government contractor selling to federal, state and local governmental entities, the Company is also subject to governmental or regulatory inquiries or audits or other proceedings, including those related to pricing compliance. It is not expected that the ultimate resolution of any of these matters will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

## TCPA Matter

On April 5, 2013, David Davies filed a putative class action lawsuit in the Circuit Court of Cook County, Illinois on behalf of all those who received faxes in connection with a 2009 marketing campaign. The complaint alleges, among other things, that the Company violated the Telephone Consumer Protection Act of 1991, as amended by the Junk Fax Prevention Act of 2005 (the "TCPA"), by sending fax advertisements that either were unsolicited and/or did not contain a valid opt-out notice. The TCPA provides for penalties of \$500 to \$1,500 for each non-compliant individual fax.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

On May 13, 2013, the Company removed the case to the Federal District Court for the Northern District of Illinois (the "District Court"). On June 27, 2014, the District Court granted the Company's motion for a determination that the court should not certify a class, finding that Davies was not an adequate class representative. On October 2, 2014, the United States Court of Appeals for the Seventh Circuit denied Davies' petition for immediate review of the June 27, 2014 ruling. Davies may seek to pursue an appeal of the June 27, 2014 ruling at the conclusion of the District Court proceedings.

The Company subsequently moved to dismiss Davies' individual claims based on the position that he had suffered no injury relating to his notice-related claims on account of the single fax he received, or otherwise. On April 4, 2016, the District Court issued an opinion denying the Company's motion. The District Court set a status hearing for late May 2016.

We believe we have strong legal and factual defenses and intend to continue defending the Company vigorously in the pending lawsuit. While the Company is unable to predict the outcome of this proceeding, the Company believes that the ultimate outcome of this matter will not have a material adverse effect on the Company's consolidated financial position or results of operations.

W.W. Grainger, Inc. and Subsidiaries

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

General

Grainger is a broad-line distributor of maintenance, repair and operating supplies, and other related products and services used by businesses and institutions. Grainger's operations are primarily in the United States and Canada, with a presence in Europe, Asia and Latin America. Grainger uses a combination of multichannel and single channel business models to provide customers with a range of options for finding and purchasing products utilizing sales representatives, catalogs, direct marketing materials and eCommerce. Grainger serves approximately 3 million customers worldwide through a network of highly integrated branches, distribution centers and websites.

Business Environment

Given Grainger's large number of customers and the diverse industries it serves, several economic factors and industry trends tend to shape Grainger's business environment. The overall economy and leading economic indicators provide general insight into projecting Grainger's growth. Grainger's sales in the United States and Canada tend to positively correlate with Business Investment, Business Inventory, Exports and Industrial Production. In the United States, sales tend to positively correlate with Gross Domestic Product (GDP). In Canada, sales tend to positively correlate with oil prices. The table below provides these estimated indicators for 2016:

|                       | 2016 Forecasted<br>Growth |             |
|-----------------------|---------------------------|-------------|
|                       | United States             | Canada      |
| Business Investment   | 1.8%                      | (3.3)%      |
| Business Inventory    | 1.8%                      | —%          |
| Exports               | 1.4%                      | 2.2%        |
| Industrial Production | (0.8)%                    | (1.1)%      |
| GDP                   | 2.1%                      | 1.3%        |
| Oil Prices            | —                         | \$40/barrel |

Source: Global Insight (March & April 2016)

In the United States, business investment and exports are two major indicators of MRO spending. Business investment is forecast to remain weak in 2016 primarily due to three factors: the decrease in the number of rigs active in the oil industry, manufacturing companies' exposure to exports or energy markets spending cuts, and companies scaling back due to lower than expected profits and a downgraded economic outlook for 2016. The stronger U.S. dollar had a negative impact on U.S. exports. The three month moving average for real exports was down 2.4% year over year in February. The rapid decline in exports has caused the real trade deficit to widen sharply over the past year. As a result, net exports cut GDP growth by about 0.3 percentage points in the third and fourth quarters of last year. Based on the most recent international trade release the first-quarter negative impact on GDP growth from net exports will be approximately 0.8%.

The most recent report on the Canadian economy showed a stronger than anticipated advance in industrial output in the first quarter. The 0.6% January 2016 over January 2015 increase was the strongest growth in several years. Solid advances in manufacturing and retail trade led to the increase in activity. However, the Canadian business is heavily dependent on the oil and gas industries and weakness in oil prices is expected to continue to suppress economic performance in 2016. The results for the business in Canada were not in line with the overall economy. GDP growth is forecasted to be 1.3% for the full year 2016.

Outlook

On April 18, 2016, Grainger revised the 2016 sales growth guidance from a range of -1 to 7 percent to a range of 0 to 6 percent and also revised the 2016 earnings per share guidance from a range of \$10.80 to \$13.00 to a range of \$11.00

to \$12.80. The narrowed sales and earnings per share guidance reflects increased gross profit pressure for the year and increased operating expense favorability, although not to the same extent as the first quarter, through improved pricing over the remainder of the year and the ongoing execution of cost savings initiatives.

**Matters Affecting Comparability**

There were 64 sales days in the first quarter of 2016 compared to 63 sales days in 2015. Grainger completed the Cromwell Group (Holdings) Limited acquisition in the third quarter of 2015 and operating results of Cromwell have been included in the results of the Company since the acquisition date.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

## Results of Operations – Three Months Ended March 31, 2016

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

|  | Three Months Ended March 31, |             |                     |    | As a Percent of |         |
|--|------------------------------|-------------|---------------------|----|-----------------|---------|
|  | 2016<br>(A)                  | 2015<br>(A) | Percent             |    | Net Sales       |         |
|  |                              |             | Increase/(Decrease) |    | 2016            | 2015    |
| Net sales  | \$2,507                      | \$2,440     | 3                   | %  | 100.0 %         | 100.0 % |
| Cost of merchandise sold                         | 1,461                        | 1,346       | 9                   | %  | 58.3            | 55.2    |
| Gross profit                                     | 1,045                        | 1,094       | (4)                 | )% | 41.7            | 44.8    |
| Operating expenses                               | 728                          | 742         | (2)                 | )% | 29.0            | 30.4    |
| Operating earnings                               | 317                          | 351         | (10)                | )% | 12.7            | 14.4    |
| Other expense                                    | (20)                         | (4)         | )NM                 |    | (0.8)           | (0.1)   |
| Income taxes                                     | 106                          | 133         | (21)                | )% | 4.3             | 5.5     |
| Noncontrolling interest                          | 5                            | 3           | 57                  | %  | 0.2             | 0.1     |
| Net earnings attributable to W.W. Grainger, Inc. | \$187                        | \$211       | (12)                | )% | 7.4             | 8.7 %   |

(A) May not sum due to rounding

Grainger's net sales of \$2,507 million for the first quarter of 2016 increased 3% compared with sales of \$2,440 million for the comparable 2015 quarter. On a daily basis, sales increased 1%. The 1% daily increase for the quarter consisted of the following:

|                      | Percent Increase/(Decrease) |
|----------------------|-----------------------------|
| Business acquisition | 4                           |
| Volume               | 1                           |
| Foreign exchange     | (1)                         |
| Price                | (3)                         |
| Total                | 1%                          |

The increase in net sales was primarily driven by the acquisition of Cromwell in September 2015 and single channel online businesses in the U.S. and Japan. Refer to the Segment Analysis below for further details.

In the three months ended March 31, 2016, eCommerce sales for Grainger were \$1,124 million, as increase of 15% over the prior year and represented 45% of total sales. The increase was primarily driven by an increase in sales via EDI and electronic purchasing platforms in the United States.

Gross profit of \$1,045 million for the first quarter of 2016 decreased 4%. The gross profit margin of 41.7% during the first quarter of 2016 decreased 3.1 percentage points when compared to the same period in 2015, primarily driven by price deflation greater than cost deflation, increased sales to lower margin customers and changes in the classification of trade show funding received from vendors.

W.W. Grainger, Inc. and Subsidiaries

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

Operating expenses of \$728 million for the first quarter of 2016 decreased 2% from \$742 million for the comparable 2015 quarter. Operating expenses in 2016 included \$16 million in costs associated with the anticipated closing of 55 branches in the United States and other restructuring costs. Excluding these charges, operating expenses decreased 4%, driven primarily by restructuring benefits, the timing of planned spending and a \$7 million gain from the sale of a property in Canada.

Operating earnings for the first quarter of 2016 were \$317 million, a decrease of 10% compared to the first quarter of 2015. Excluding the charges mentioned above, operating earnings decreased 5%, driven by lower gross profit margins, partially offset by lower operating expenses.

Net earnings attributed to W.W. Grainger, Inc. for the first quarter of 2016 decreased 12% to \$187 million from \$211 million in the first quarter of 2015. Diluted earnings per share of \$2.98 in the first quarter of 2016 were down 3% versus the \$3.07 for the first quarter of 2015, due to lower earnings, partially offset by lower average shares outstanding.

The table below reconciles reported diluted earnings per share determined in accordance with United States generally accepted accounting principles (GAAP) to adjusted diluted earnings per share, a non-GAAP measure. Management believes adjusted diluted earnings per share is an important indicator of operations because it excludes items that may not be indicative of core operating results. Because non-GAAP financial measures are not standardized, it may not be possible to compare this financial measure with other companies' non-GAAP financial measures having the same or similar names.

|                                     | Three<br>Months<br>Ended<br>March 31,<br>2016 2015 % |             |
|-------------------------------------|--|-------------|
| Diluted earnings per share reported | \$2.98   | \$3.07 (3)% |
| Restructuring (United States)       | 0.16   | —           |
| Restructuring (Canada)              | 0.04   | —           |
| Restructuring (Other Businesses)    | —  | 0.03        |
| Subtotal                            | \$0.20   | 0.03        |
| Diluted earnings per share adjusted | \$3.18   | \$3.10 3 %  |

#### Segment Analysis

Grainger's two reportable segments are the United States and Canada. The United States operating segment reflects the results of Grainger's U.S. business. The Canada operating segment reflects the results for Acklands – Grainger Inc., Grainger's Canadian business. Other businesses include Zoro U.S. and business units in Europe, Asia and Latin America.

The following comments at the segment and business unit level include external and intersegment net sales and operating earnings. See Note 10 to the Condensed Consolidated Financial Statements.

#### United States

Net sales were \$1,966 million for the first quarter of 2016, essentially flat when compared with net sales of \$1,971 million for the same period in 2015. On a daily basis, sales decreased 2%. The 2% daily decrease for the quarter consisted of the following:

Percent Increase/(Decrease)

Intercompany sales to Zoro 1

Price (3)

Total (2)%

Sales to natural resource customers were down in the mid-teens and the reseller market was down in the low double digits. Contractor customers and heavy manufacturing end markets were down in the mid-single digits and commercial customers were down low single digits. Mid-single digit growth to government and low single digit growth in light

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W.W. Grainger, Inc. and Subsidiaries

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

manufacturing and retail were offset by decreases across other customer end markets. Low oil prices negatively impacted the performance of the heavy manufacturing and natural resources customer end markets. Sales to Zoro continue to contribute to sales growth as the U.S. business' supply chain network is Zoro's primary source of inventory.

In the three months ended March 31, 2016, eCommerce sales for the United States business were \$883 million, an increase of 13% over the prior year and represented 45% of total sales. The increase was primarily driven by an increase in sales via EDI and electronic purchasing platforms.

The gross profit margin for the first quarter of 2016 decreased 2.8 percentage points compared to the same period in 2015, primarily driven by unfavorable selling mix, price deflation outpacing cost deflation and changes in the classification of certain funding received from vendors related to the annual trade show. Such changes resulted in gross margin reduction of approximately 80 basis points. Excluding sales to Zoro, the gross profit margin decreased 2.4 percentage points versus prior year.

Operating expenses of \$512 million in the first quarter of 2016 were down \$22 million, or 4% versus the first quarter of 2015. Operating expenses in 2016 included \$13 million in restructuring costs related to planned branch closures as well as a reorganization of the sales force. Excluding restructuring costs, operating expenses decreased 7 percent driven by lower payroll and benefit costs and timing of planned spending as well as \$10 million of supplier funding for the trade show.

Operating earnings of \$332 million for the first quarter of 2016 decreased 9% from \$366 million for the first quarter of 2015. Excluding the restructuring charges mentioned above, operating earnings decreased 5%, driven primarily by lower gross profit margins.

#### Canada

Net sales were \$179 million for the first quarter of 2016, a decrease of \$56 million, or 24%, when compared with \$235 million for the same period in 2015. In local currency, sales decreased 16%. On a daily sales basis, sales decreased 25% for the quarter and consisted of the following:

|                    | Percent Increase/(Decrease) |
|--------------------|-----------------------------|
| Price              | 3                           |
| SAP implementation | (6)                         |
| Foreign exchange   | (8)                         |
| Volume             | (14)                        |
| Total              | (25)%                       |

Sales performance in Canada continues to be affected by weak oil and gas prices and lower commodity prices, resulting in lower sales to all customer end markets. The Alberta region, which represents about one-third of the sales in the Canadian business, decreased 26% versus prior year, on a daily basis, as it was negatively impacted by lower oil prices. Sales growth for the remaining regions in aggregate was down 10% in local currency.

In the three months ended March 31, 2016, eCommerce sales in Canada were \$23 million, a decrease of 17% over the prior year and represented 13% of total sales.

The gross profit margin decreased 6.7 percentage points in the first quarter of 2016 versus the first quarter of 2015 largely due to cost of goods inflation exceeding price inflation due to unfavorable foreign exchange and no supplier funding received from vendors due to not having a trade show in 2016.

Operating expenses decreased 14% in the first quarter of 2016 versus the first quarter of 2015, benefiting from a \$7 million gain from the sale of a property, partially offset by \$3 million in restructuring costs.

Operating losses were \$12 million for the first quarter of 2016 versus operating earnings of \$9 million in the first quarter of 2015. In local currency, operating earnings decreased \$27 million. Excluding the restructuring costs mentioned above, the operating losses would have been \$9 million driven by the sales decline, lower gross profit margin and negative expense leverage.

W.W. Grainger, Inc. and Subsidiaries

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
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Other Businesses

Net sales for other businesses, which include Zoro U.S. and business units in Europe, Asia, Latin America, and the newly acquired Cromwell, were \$445 million for the first quarter of 2016, an increase of \$147 million, or 50%, when compared with net sales of \$298 million for the same period in 2015. On a daily sales basis, sales were up 47%. The drivers of the increase in daily sales for the quarter consisted of the following:

|                      | Percent Increase/(Decrease) |
|----------------------|-----------------------------|
| Business acquisition | 33                          |
| Price/volume         | 17                          |
| Foreign exchange     | (3)                         |
| Total                | 47%                         |

Operating earnings of \$22 million for the first quarter of 2016 were up \$12 million compared to the first quarter of 2015. The earnings performance for the quarter versus prior year was primarily driven by strong results from Zoro U.S. and the business in Japan as well as the acquisition of Cromwell, which reported modest profit as expected.

Other Income and Expense

Other income and expense was \$20 million of expense in the first quarter of 2016 compared to \$4 million of expense in the first quarter of 2015. The increase in expense was primarily due to interest expense from the \$1 billion of debt the Company issued in 2015, as well as expected losses from the Company's investments in clean energy.

Income Taxes

Grainger's tax rates were 35.6% and 38.4% for the three months ended March 31, 2016 and 2015, respectively. The decrease in the tax rate was primarily due to tax credits earned from the Company's clean energy investments.

Financial Condition

Cash Flow

Net cash provided by operating activities was \$154 million and \$156 million for the three months ended March 31, 2016 and 2015, respectively.

Net cash used in investing activities was \$45 million and \$92 million for the three months ended March 31, 2016 and 2015, respectively. The lower use of cash was driven by lower additions to property, buildings and equipment compared to the prior year, partially offset by higher proceeds from the sales of assets. Additionally, in 2015, Grainger made a new investment in a limited liability company established to produce clean energy. The investment provided Grainger with energy tax credits that lowered the tax effective rate and positively impacted net earnings and cash flow.

Net cash used in financing activities was \$131 million and \$230 million in the three months ended March 31, 2016 and 2015, respectively. Financing activity for the 2016 period was primarily driven by payments of long-term debt and an increase in the purchase of treasury stock, partially offset by increases in the amount of commercial paper.

Working Capital

Working capital consists of current assets (less non-operating cash) and current liabilities (less short-term debt and current maturities of long-term debt).

Working capital at March 31, 2016, was \$1,862 million, an increase of \$68 million when compared to \$1,794 million at December 31, 2015 primarily as a result of the annual cash contribution to the employees' profit sharing plan. The working capital assets to working capital liabilities ratio increased to 2.6 at March 31, 2016, from 2.5 at December 31, 2015.

#### Debt

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 bank borrowings under lines of credit. Total debt as a percent of total capitalization was 46.9% at March 31, 2016, and 45.8% at December 31, 2015.

W.W. Grainger, Inc. and Subsidiaries

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS

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 highly uncertain at the time the estimates are made and when there are different estimates that management reasonably could have made, which would 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 Grainger's Annual Report on Form 10-K for the year ended December 31, 2015.

Forward-Looking Statements

From time to time, in this Quarterly Report on Form 10-Q, as well as in other written reports and verbal statements, Grainger makes forward-looking statements that are not historical in nature but concern forecasts of future results, business plans, analyses, prospects, strategies, objectives and other matters that may be deemed to be "forward-looking statements" under the federal securities laws. Such forward-looking statements are identified by words such as "anticipate," "estimate," "believe," "expect," "could," "forecast," "may," "intend," "plan," "predict," "project" and similar terms and 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, many of which are beyond the Company's control, which could cause Grainger's results to differ materially from those which are presented.

Important 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; loss or disruption of source of supply; 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, including with respect to wage and hour, anti-bribery and corruption, environmental, advertising, privacy and cybersecurity matters; investigations, inquiries, audits and changes in laws and regulations; disruption of information technology or data security systems; general industry or market conditions; general global economic conditions; currency exchange rate fluctuations; market volatility; commodity price volatility; labor shortages; facilities disruptions or shutdowns; higher fuel costs or disruptions in transportation services; natural and other catastrophes; unanticipated weather conditions; loss of key members of management; the Company's ability to operate, integrate and leverage acquired businesses and the factors identified in the Company's Annual Report on Form 10-K for the year-ended December 31, 2015 and other filings with the SEC.

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

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 Grainger's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

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 Grainger's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of the end of the period covered by this report. 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 in (i) ensuring that information required to be disclosed by Grainger in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

On February 1, 2016, the Company implemented a new SAP enterprise resource planning system at its Canadian subsidiary, Acklands-Grainger. While new to its Canadian operations, the SAP system is the same one currently utilized by the Company's business in the United States. The Company has evaluated the impact of this change on its internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act), and has concluded that there were no changes in the Company's internal controls over financial reporting for the quarter ended March 31, 2016, that have materially affected, or are reasonably likely to materially affect, Grainger's internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

Environmental Matters

On August 5, 2015, Environment Canada initiated a proceeding against the Company's Canadian subsidiary, Acklands-Grainger, in the Provincial Court of Alberta. The proceeding seeks monetary sanctions and is based on allegations that Acklands-Grainger sold certain products containing an ozone-depleting substance in violation of the Canadian Environmental Protection Act, 1999 and prohibited by the Ozone-Depleting Substances Regulations, 1998. On January 19, 2016, Acklands-Grainger indicated to the Provincial Court that it would contest the charges. While the Company is unable to predict the outcome of this proceeding, it is believed that the ultimate outcome of this matter will not have a material adverse effect on the Company's consolidated financial position or results of operations.

Other Matters

For a description of other legal proceedings, see Note 12 - Contingencies and Legal Matters to the Condensed Consolidated Financial Statements included under Item 1 - Financial Statements of Part I of this report.

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

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

## Issuer Purchases of Equity Securities – First quarter

| Period         | Total Number of Shares Purchased (A) | Average Price Paid per Share (B) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (C) | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs |
|----------------|--------------------------------------|----------------------------------|--|--|
| Jan 1 - Jan 31 | 323,101                              | \$190.17                         | 323,101  | 9,165,287  |
| Feb 1 - Feb 29 | 233,246                              | \$209.89                         | 233,246  | 8,932,041  |
| Mar 1 - Mar 31 | 336,757                              | \$224.29                         | 336,757  | 8,595,284  |
| Total          | 893,104                              | \$208.19                         | 893,104  |  |

(A) There were no shares withheld to satisfy tax withholding obligations.

(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.

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors on April 6, 2015. The program has no specified expiration date. Activity is reported on a trade date basis.

## Item 6. Exhibits.

A list of exhibits filed with this report on Form 10-Q is provided in the Exhibit Index on page 25 of this report.

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: April 28, 2016

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

Date: April 28, 2016

By: /s/ W. Lomax  
W. Lomax, Vice President  
and Controller

EXHIBIT INDEX

| EXHIBIT NO. | DESCRIPTION  |
|-------------|--|
| 31.1        | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2        | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32          | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS     | XBRL Instance Document.  |
| 101.SCH     | XBRL Taxonomy Extension Schema Document.   |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document.   |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase Document.  |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document.   |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase Document.  |