

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

(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)

(847) 535-1000

(Registrant's telephone number including area code)

60045-5201

(Zip 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

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

59,569,554 shares of the Company’s common stock, \$0.50 par value per share, were outstanding as of September 30, 2016.

1

---

TABLE OF CONTENTS

|  | Page No.  |
|--|-----------|
| PART I FINANCIAL INFORMATION   |           |
| Item 1. Financial Statements (Unaudited).  |           |
| Condensed Consolidated Statements of Earnings<br>for the Three and Nine Months Ended September 30, 2016 and 2015               | <u>3</u>  |
| Condensed Consolidated Statements of Comprehensive<br>Earnings for the Three and Nine Months Ended September 30, 2016 and 2015 | <u>4</u>  |
| Condensed Consolidated Balance Sheets<br>as of September 30, 2016 and December 31, 2015  | <u>5</u>  |
| Condensed Consolidated Statements of Cash Flows<br>for the Nine Months Ended September 30, 2016 and 2015                       | <u>7</u>  |
| Notes to Condensed Consolidated Financial Statements   | <u>8</u>  |
| Item 2. Management's Discussion and Analysis of Financial<br>Condition and Results of Operations.                              | <u>17</u> |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk.  | <u>28</u> |
| Item 4. Controls and Procedures.   | <u>28</u> |
| PART II OTHER INFORMATION  | <u>28</u> |
| Item 1. Legal Proceedings.   | <u>28</u> |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.   | <u>29</u> |
| Item 6. Exhibits.  | <u>29</u> |
| Signatures   | <u>30</u> |
| EXHIBITS   |           |

## 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 |             | Nine Months Ended |             |
|--|--------------------|-------------|-------------------|-------------|
|  | September 30,      |             | September 30,     |             |
|  | 2016               | 2015        | 2016              | 2015        |
| Net sales  | \$2,596,288        | \$2,532,900 | \$7,666,494       | \$7,495,126 |
| Cost of merchandise sold                                   | 1,556,536          | 1,471,021   | 4,541,629         | 4,266,073   |
| Gross profit   | 1,039,752          | 1,061,879   | 3,124,865         | 3,229,053   |
| Warehousing, marketing and administrative expenses         | 717,165            | 721,150     | 2,179,596         | 2,180,359   |
| Operating earnings   | 322,587            | 340,729     | 945,269           | 1,048,694   |
| Other income and (expense):                                |                    |             |                   |             |
| Interest income  | 147                | 464         | 474               | 934         |
| Interest expense   | (18,024)           | (13,899)    | (48,556)          | (19,719)    |
| Loss from equity method investment                         | (10,333)           | (5,972)     | (22,147)          | (10,273)    |
| Other non-operating expense                                | (1,192)            | (1,875)     | (1,291)           | (3,864)     |
| Total other expense  | (29,402)           | (21,282)    | (71,520)          | (32,922)    |
| Earnings before income taxes                               | 293,185            | 319,447     | 873,749           | 1,015,772   |
| Income taxes   | 99,776             | 122,825     | 309,251           | 379,769     |
| Net earnings   | 193,409            | 196,622     | 564,498           | 636,003     |
| Less: Net earnings attributable to noncontrolling interest | 7,536              | 4,421       | 19,236            | 12,239      |
| Net earnings attributable to W.W. Grainger, Inc.           | \$185,873          | \$192,201   | \$545,262         | \$623,764   |
| Earnings per share:  |                    |             |                   |             |
| Basic  | \$3.07             | \$2.94      | \$8.88            | \$9.33      |
| Diluted  | \$3.05             | \$2.92      | \$8.82            | \$9.24      |
| Weighted average number of shares outstanding:             |                    |             |                   |             |
| Basic  | 60,016,550         | 64,720,037  | 60,854,548        | 66,188,236  |
| Diluted  | 60,416,151         | 65,289,144  | 61,268,119        | 66,849,766  |
| Cash dividends paid per share                              | \$1.22             | \$1.17      | \$3.61            | \$3.42      |

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,     |            |
|  | 2016               | 2015       | 2016              | 2015       |
| Net earnings   | \$ 193,409         | \$ 196,622 | \$ 564,498        | \$ 636,003 |
| Other comprehensive earnings (losses):   |                    |            |                   |            |
| Foreign currency translation gain (loss)   | (12,866 )          | (53,062 )  | 31,709            | (120,016 ) |
| Defined postretirement benefit plan:   |                    |            |                   |            |
| Reclassification adjustments related to amortization, net of tax benefit of \$631, \$510, and \$1,893, \$1,531, respectively | (1,008 )           | (813 )     | (3,026 )          | (2,436 )   |
| Derivative instrument change in fair value of cash flow hedge  | 188                | 256        | 844               | 983        |
| Comprehensive earnings, net of tax   | 179,723            | 143,003    | 594,025           | 514,534    |
| Less: Comprehensive earnings attributable to noncontrolling interest   |                    |            |                   |            |
| Net earnings   | 7,536              | 4,421      | 19,236            | 12,239     |
| Foreign currency translation adjustments   | 2,188              | 1,521      | 16,621            | (281 )     |
| Comprehensive earnings attributable to W.W. Grainger, Inc.   | \$ 169,999         | \$ 137,061 | \$ 558,168        | \$ 502,576 |

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)

|  | (Unaudited)         |                     |
|--|---------------------|---------------------|
|  | September 30,       | December 31,        |
| ASSETS   | 2016                | 2015                |
| <b>CURRENT ASSETS</b>  |                     |                     |
| Cash and cash equivalents  | \$ 285,981          | \$ 290,136          |
| Accounts receivable (less allowances for doubtful accounts of \$30,204 and \$22,288, respectively) | 1,326,359           | 1,209,641           |
| Inventories – net  | 1,381,468           | 1,414,177           |
| Prepaid expenses and other assets  | 91,526              | 85,670              |
| Prepaid income taxes   | 43,858              | 49,018              |
| Total current assets   | 3,129,192           | 3,048,642           |
| <b>PROPERTY, BUILDINGS AND EQUIPMENT</b>   | 3,421,322           | 3,370,313           |
| Less: Accumulated depreciation and amortization  | 1,984,384           | 1,939,072           |
| Property, buildings and equipment – net  | 1,436,938           | 1,431,241           |
| DEFERRED INCOME TAXES  | 37,513              | 83,996              |
| GOODWILL   | 594,511             | 582,336             |
| INTANGIBLES - NET  | 420,087             | 463,294             |
| OTHER ASSETS   | 267,268             | 248,246             |
| <b>TOTAL ASSETS</b>  | <b>\$ 5,885,509</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)           |                      |
|--|-----------------------|----------------------|
|  | September 30,<br>2016 | December 31,<br>2015 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                      |
| <b>CURRENT LIABILITIES</b>   |                       |                      |
| Short-term debt  | \$ 387,684            | \$ 353,072           |
| Current maturities of long-term debt   | 16,488                | 247,346              |
| Trade accounts payable   | 623,745               | 583,474              |
| Accrued compensation and benefits  | 181,456               | 196,667              |
| Accrued contributions to employees' profit sharing plans   | 47,412                | 124,587              |
| Accrued expenses   | 269,057               | 266,702              |
| Income taxes payable   | 10,469                | 16,686               |
| Total current liabilities  | 1,536,311             | 1,788,534            |
| LONG-TERM DEBT (less current maturities)   | 1,874,132             | 1,388,414            |
| DEFERRED INCOME TAXES AND TAX UNCERTAINTIES  | 132,761               | 154,352              |
| EMPLOYMENT-RELATED AND OTHER NON-CURRENT LIABILITIES   | 181,269               | 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   | 1,023,469             | 1,000,476            |
| Retained earnings  | 7,125,727             | 6,802,130            |
| Accumulated other comprehensive losses   | (208,126 )            | (221,091 )           |
| Treasury stock, at cost – 50,089,665 and 47,630,511 shares, respectively                               | (5,953,187 )          | (5,369,711 )         |
| Total W.W. Grainger, Inc. shareholders' equity   | 2,042,713             | 2,266,634            |
| Noncontrolling interest  | 118,323               | 86,080               |
| Total shareholders' equity   | 2,161,036             | 2,352,714            |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$ 5,885,509</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)

|  | Nine Months Ended |               |
|--|-------------------|---------------|
|  | September 30,     |               |
|  | 2016              | 2015          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                               |                   |               |
| Net earnings   | \$564,498         | \$636,003     |
| Provision for losses on accounts receivable                                | 14,753            | 6,416         |
| Deferred income taxes and tax uncertainties                                | 24,259            | (6,906 )      |
| Depreciation and amortization  | 177,395           | 164,200       |
| Gains from sales of assets, net of asset impairment                        | (16,928 )         | (709 )        |
| Stock-based compensation   | 27,545            | 35,627        |
| Losses from equity method investment                                       | 22,147            | 10,273        |
| Change in operating assets and liabilities – net of business acquisitions: |                   |               |
| Accounts receivable  | (123,922 )        | (69,784 )     |
| Inventories  | 41,938            | 12,627        |
| Prepaid income taxes and other expenses                                    | 3,478             | 27,858        |
| Trade accounts payable   | 36,594            | 19,126        |
| Other current liabilities  | (86,911 )         | (102,951 )    |
| Current income taxes payable   | (9,714 )          | 2,451         |
| Accrued employment-related benefits cost                                   | 5,591             | 2,401         |
| Other – net  | (10,340 )         | (702 )        |
| Net cash provided by operating activities                                  | 670,383           | 735,930       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                               |                   |               |
| Additions to property, buildings and equipment                             | (213,622 )        | (253,197 )    |
| Proceeds from sales of assets  | 48,089            | 12,351        |
| Equity method investment   | (19,299 )         | (15,687 )     |
| Net cash paid for business acquisitions                                    | (159 )            | (463,302 )    |
| Other – net  | (405 )            | (206 )        |
| Net cash used in investing activities                                      | (185,396 )        | (720,041 )    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                               |                   |               |
| Net increase in commercial paper   | 39,887            | 177,000       |
| Borrowings under lines of credit   | 26,681            | 48,032        |
| Payments against lines of credit   | (32,515 )         | (65,764 )     |
| Proceeds from issuance of long-term debt                                   | 516,058           | 1,241,356     |
| Payments of long-term debt   | (257,109 )        | (33,938 )     |
| Proceeds from stock options exercised                                      | 29,553            | 53,688        |
| Excess tax benefits from stock-based compensation                          | 11,873            | 24,415        |
| Purchase of treasury stock   | (613,198 )        | (1,177,241)   |
| Cash dividends paid  | (221,131 )        | (230,948 )    |
| Net cash (used in) provided by financing activities                        | (499,901 )        | 36,600        |
| Exchange rate effect on cash and cash equivalents                          | 10,759            | (20,982 )     |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>(4,155 )</b>   | <b>31,507</b> |
| Cash and cash equivalents at beginning of year                             | 290,136           | 226,644       |
| Cash and cash equivalents at end of period                                 | \$285,981         | \$258,151     |



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

7

---

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 (MRO) 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. 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. In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing. The amendment is meant to clarify the identification of performance obligations and the licensing implementation guidelines, while retaining the related principles of those areas. The effective dates of ASU 2016-08 and ASU 2016-10 are consistent with ASU 2014-09. The Company has elected not to early adopt these ASUs and is evaluating their impact to the consolidated financial statements.

In July 2015, the 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 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

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

than twelve months. The effective date for the standard is for fiscal years 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 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 2016-09, 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 within 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 has elected not to early adopt this ASU. The Company expects the new guidance to impact its tax expense and dilutive shares outstanding calculation, with a potentially dilutive impact on future earnings per share and increased period to period variability of net earnings.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments. The amendments in this update affect an entity to varying degrees depending on the credit quality of the assets held by the entity, their duration, and how the entity applies current GAAP. The effective date of the amendment to the standard is for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is evaluating the impact of this ASU.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments. The amendments in this update address eight specific cash flow issues with the objective of reducing the existing diversity in practice. The effective date of the amendment to the standard is for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is evaluating the impact of this ASU.

### 3. DIVIDEND

On October 26, 2016, the Company's Board of Directors declared a quarterly dividend of \$1.22 per share, payable on December 1, 2016, to shareholders of record on November 14, 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 \$355 million. The goodwill is not deductible for tax purposes. The purchase price allocation has been finalized and the impact to the consolidated financial statements was not material. Disclosure of pro forma results are not required.

## 5. GOODWILL

At September 30, 2016, Grainger had approximately \$1 billion of Goodwill and Intangible assets, or 17% of total assets. Grainger annually reviews goodwill and intangible assets with indefinite lives for impairment in the fourth quarter and when events or changes in circumstances indicate the carrying value of these assets might exceed their current fair values. Grainger tests for goodwill impairment at the reporting unit level and performs a qualitative assessment of factors such as a reporting unit's current performance and overall economic factors to determine if it is more likely than not that the goodwill might be impaired and whether it is necessary to perform the two-step quantitative goodwill

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

impairment test. In the two-step test, Grainger first compares the carrying value of assets of the reporting unit to its calculated fair value. If the carrying value of assets of the reporting unit exceeds its calculated fair value, the second step is performed, where the implied fair value of goodwill is compared to the carrying value of that goodwill, to determine the amount of impairment.

The fair value of reporting units is calculated primarily using the discounted cash flow (DCF) method and incorporating value indicators from a market approach to evaluate the reasonableness of the resulting fair values. The DCF method incorporates various assumptions including the amount and timing of future expected cash flows, including revenues, gross margins, operating expenses, capital expenditures and working capital based on operational budgets, long range strategic plans and other estimates. The terminal value growth rate is used to calculate the value of cash flows beyond the last projected period and reflects management's best estimates for perpetual growth for the reporting units. Estimates of market participant risk-adjusted weighted average cost of capital are used as a basis for determining the discount rates to apply to the reporting units' future expected cash flows and terminal value.

As previously reported, Grainger completed the annual impairment testing during the fourth quarter of 2015, including the quantitative test for Fabory, with \$106 million of goodwill at December 31, 2015. The fair value of the Fabory reporting unit's goodwill exceeded the carrying value by 15%, and the step two calculation was not required. For the Company's remaining reporting units, the estimated fair values substantially exceeded the carrying values. Grainger monitors the operating performance of Fabory and the quarterly assessment did not indicate the presence of any goodwill impairment triggering events as of September 30, 2016. If Fabory's future earnings and cash flows projections are not achieved or economic conditions in Europe deteriorate, future impairment of Fabory's intangible assets, including goodwill, could result.

## 6. RESTRUCTURING RESERVES

The Company recorded employee termination benefits with the majority expected to be paid through 2017 related to the reorganization of the business. Severance costs of approximately \$7 million and \$32 million were recorded in the three and nine months ended September 30, 2016, respectively, and are included in Warehousing, marketing and administrative expenses. The severance reserve balance as of September 30, 2016 and December 31, 2015 was approximately \$29 million and \$24 million, respectively, and is included in Accrued compensation and benefits.

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

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

|                              | September 30, December 31, |            |
|------------------------------|----------------------------|------------|
|                              | 2016                       | 2015       |
| Outstanding lines of credit  | \$ 17,797                  | \$ 23,072  |
| Outstanding commercial paper | 369,887                    | 330,000    |
|                              | \$ 387,684                 | \$ 353,072 |

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

|                             | September 30, December 31, |              |
|-----------------------------|----------------------------|--------------|
|                             | 2016                       | 2015         |
| 4.60% senior notes due 2045 | \$ 1,000,000               | \$ 1,000,000 |
| 3.75% senior notes due 2046 | 400,000                    | —            |
| U.S. dollar term loan       | —                          | 114,614      |
| British pound term loan     | 197,220                    | 235,808      |
| Euro term loan              | 123,618                    | 114,030      |

Edgar Filing: GRAINGER W W INC - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| Japanese yen term loans                   | 59,212       | 49,875       |
| Canadian dollar revolving credit facility | 106,650      | 108,389      |
| Other                                     | 23,367       | 25,991       |
| Debt issuance costs and discounts         | (19,447 )    | (12,947 )    |
| Less current maturities                   | (16,488 )    | (247,346 )   |
|   | \$ 1,874,132 | \$ 1,388,414 |

10

---

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

On August 31, 2016, the Company entered into an agreement for a five year term loan of €110 million and a revolving credit facility of up to €20 million. The proceeds from the term loan were used to pay €102.5M of a term loan that matured in August 2016, which was entered into to partially fund the acquisition of Fabory in 2011. Under the agreement, no principal amount of the loan will be required to be paid until the loan becomes due on August 31, 2021 at which time the loan will be required to be paid in full. The Company, at its option, may prepay this term loan in whole or in part at the end of any interest period without penalty. The loan will bear interest at the Euro Interbank Offered Rate (EURIBOR) plus a margin of 45 basis points. If EURIBOR is less than zero, then EURIBOR will be deemed to be zero. The interest rate at September 30, 2016 was 0.45%. Costs of approximately €0.5 million associated with the issuance of the term loan, representing arrangement fees and other expenses, have been recorded as a contra-liability within Long-term debt and will be amortized to interest expense over the life of the term loan. The revolving credit facility must generally be paid at the conclusion of each interest period as defined in the facility agreement. This facility will bear interest at EURIBOR plus a margin of 35 basis points. The carrying value of the term loan approximates fair value due to the variable interest rates.

On May 16, 2016, the Company issued \$400 million of unsecured 3.75% Senior Notes (3.75% Notes) that mature on May 15, 2046. The 3.75% Notes require no principal payments until the maturity date and interest is payable semi-annually on May 15 and November 15, beginning on November 15, 2016. Prior to November 15, 2045, the Company may redeem the 3.75% 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 U.S. treasury security with a maturity comparable to the remaining term of the 3.75% Notes plus 20 basis points, together with accrued and unpaid interest, if any, to the redemption date. On or after November 15, 2045, the Company may redeem the 3.75% 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 and discounts of approximately \$7 million associated with the issuance of the 3.75% 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 3.75% Notes. The carrying value of the 3.75% Notes approximates the fair value as of September 30, 2016.

In January 2016, the Company exercised its option to prepay the U.S. dollar term loan and paid off the remaining balance of the loan.

On June 11, 2015, the Company issued \$1 billion of unsecured 4.60% Senior Notes (4.60% Notes) that mature on June 15, 2045. The 4.60% Notes require no principal payments until the maturity date and interest is payable semi-annually on June 15 and December 15, beginning on December 31, 2015. Prior to December 15, 2044, the Company may redeem the 4.60% 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 U.S. treasury security with a maturity comparable to the remaining term of the 4.60% 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 4.60% 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 and discounts of approximately \$11 million associated with the issuance of the 4.60% 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 4.60% Notes. The fair value of the 4.60% Notes was approximately \$1.2 billion and \$1 billion as of September 30, 2016 and December 31, 2015, respectively.

The estimated fair value of the Company’s 3.75% Notes and 4.60% 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.

#### 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, and as such the investments are accounted for under the equity method of accounting.

As of September 30, 2016 and December 31, 2015, the balance of the combined clean energy investments was \$6 million and \$9 million, respectively, and is included on the balance sheet under Other assets. During the three and nine months ended September 30, 2016, the Company recorded \$10 million and \$22 million, respectively, in equity

11

---

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

losses. The total tax benefit year-to-date of \$26 million including energy tax credits, is reflected in the Company's effective tax rate for the nine months ended September 30, 2016. The investments contributed \$4 million to net earnings for the nine months ended September 30, 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<br>September 30,<br>2016 |          | Nine Months<br>Ended<br>September 30,<br>2015 |          |
|---------------------------------------|--|----------|---|----------|
| Service cost                          | \$2,059  | \$2,532  | \$6,178                                       | \$7,596  |
| Interest cost                         | 2,464  | 2,412    | 7,391   | 7,236    |
| Expected return on assets             | (2,528 )                                       | (2,594 ) | (7,584 )                                      | (7,782 ) |
| Amortization of unrecognized losses   | 32   | 378      | 96  | 1,134    |
| Amortization of prior service credits | (1,672 )                                       | (1,700 ) | (5,016 )                                      | (5,100 ) |
| Net periodic benefit costs            | \$355  | \$1,028  | \$1,065                                       | \$3,084  |

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 as amended (IRC). 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 and nine months ended September 30, 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 single channel online businesses such as MonotaRO in Japan and Zoro 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. The Company is a broad-line distributor of maintenance, repair and operating (MRO) supplies, and other related products. Products are regularly added or deleted from the Company's inventory. Accordingly, it would be impractical to provide information by product category due to the way the business is managed. Following is a summary of segment results (in thousands of dollars):

## Three Months Ended September 30, 2016

|                                 | United States | Canada      | Other Businesses | Total       |
|---------------------------------|---------------|-------------|------------------|-------------|
| Total net sales                 | \$2,028,235   | \$179,281   | \$481,929        | \$2,689,445 |
| Intersegment net sales          | (92,160 )     | (23 )       | (974 )           | (93,157 )   |
| Net sales to external customers | \$1,936,075   | \$179,258   | \$480,955        | \$2,596,288 |
| Segment operating earnings      | \$342,524     | \$(15,118 ) | \$24,835         | \$352,241   |

## Three Months Ended September 30, 2015

|                                 | United States | Canada    | Other Businesses | Total       |
|---------------------------------|---------------|-----------|------------------|-------------|
| Total net sales                 | \$2,039,488   | \$213,132 | \$354,692        | \$2,607,312 |
| Intersegment net sales          | (73,393 )     | (21 )     | (998 )           | (74,412 )   |
| Net sales to external customers | \$1,966,095   | \$213,111 | \$353,694        | \$2,532,900 |
| Segment operating earnings      | \$359,414     | \$3,587   | \$14,260         | \$377,261   |

## Nine Months Ended September 30, 2016

|                                 | United States | Canada      | Other Businesses | Total       |
|---------------------------------|---------------|-------------|------------------|-------------|
| Total net sales                 | \$5,973,044   | \$552,470   | \$1,401,429      | \$7,926,943 |
| Intersegment net sales          | (257,101 )    | (109 )      | (3,239 )         | (260,449 )  |
| Net sales to external customers | \$5,715,943   | \$552,361   | \$1,398,190      | \$7,666,494 |
| Segment operating earnings      | \$1,023,318   | \$(55,207 ) | \$76,343         | \$1,044,454 |

## Nine Months Ended September 30, 2015

|                                 | United States | Canada    | Other Businesses | Total       |
|---------------------------------|---------------|-----------|------------------|-------------|
| Total net sales                 | \$6,041,576   | \$687,128 | \$971,389        | \$7,700,093 |
| Intersegment net sales          | (201,978 )    | (74 )     | (2,915 )         | (204,967 )  |
| Net sales to external customers | \$5,839,598   | \$687,054 | \$968,474        | \$7,495,126 |
| Segment operating earnings      | \$1,095,036   | \$22,474  | \$38,943         | \$1,156,453 |



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

|                    | United States | Canada    | Other Businesses | Total       |
|--------------------|---------------|-----------|------------------|-------------|
| Segment assets:    |               |           |                  |             |
| September 30, 2016 | \$2,272,869   | \$304,080 | \$ 522,879       | \$3,099,828 |
| 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 |           | Nine Months Ended |             |
|---|--------------------|-----------|-------------------|-------------|
|   | September 30,      |           | September 30,     |             |
|   | 2016               | 2015      | 2016              | 2015        |
| Operating earnings:                             |                    |           |                   |             |
| Total operating earnings for operating segments | \$352,241          | \$377,261 | 1,044,454         | \$1,156,453 |
| Unallocated expenses and eliminations           | (29,654 )          | (36,532 ) | (99,185 )         | (107,759 )  |
| Total consolidated operating earnings           | \$322,587          | \$340,729 | 945,269           | \$1,048,694 |

|                                      | September 30, | December 31, |
|--------------------------------------|---------------|--------------|
|                                      | 2016          | 2015         |
| Assets:                              |               |              |
| Total assets for operating segments  | \$3,099,828   | \$3,015,665  |
| Other current and non-current assets | 2,652,146     | 2,624,966    |
| Unallocated assets                   | 133,535       | 217,124      |
| Total consolidated assets            | \$5,885,509   | \$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 and \$55 million for the three and nine months ended September 30, 2016, respectively, 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 |            | Nine Months Ended |            |
|--|--------------------|------------|-------------------|------------|
|  | September 30,      |            | September 30,     |            |
|  | 2016               | 2015       | 2016              | 2015       |
| Net earnings attributable to W.W. Grainger, Inc. as reported   | \$185,873          | \$192,201  | \$545,262         | \$623,764  |
| Distributed earnings available to participating securities   | (547 )             | (676 )     | (1,749 )          | (2,187 )   |
| Undistributed earnings available to participating securities   | (1,085 )           | (1,138 )   | (3,179 )          | (4,012 )   |
| Numerator for basic earnings per share – Undistributed and distributed earnings available to common shareholders   | 184,241            | 190,387    | 540,334           | 617,565    |
| Undistributed earnings allocated to participating securities   | 1,085              | 1,138      | 3,179             | 4,012      |
| Undistributed earnings reallocated to participating securities   | (1,078 )           | (1,129 )   | (3,157 )          | (3,972 )   |
| Numerator for diluted earnings per share – Undistributed and distributed earnings available to common shareholders | \$184,248          | \$190,396  | \$540,356         | \$617,605  |
| Denominator for basic earnings per share – weighted average shares   | 60,016,550         | 64,720,037 | 60,854,548        | 66,188,236 |
| Effect of dilutive securities  | 399,601            | 569,107    | 413,571           | 661,530    |
| Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities              | 60,416,151         | 65,289,144 | 61,268,119        | 66,849,766 |
| Earnings per share two-class method  |                    |            |                   |            |
| Basic  | \$3.07             | \$2.94     | \$8.88            | \$9.33     |
| Diluted  | \$3.05             | \$2.92     | \$8.82            | \$9.24     |

## 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

As previously disclosed, 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 found that Davies was not an adequate class representative. The United States Court of Appeals for the Seventh Circuit denied Davies' petition for immediate review of the ruling. Davies subsequently moved the District Court for reconsideration of its ruling and his motion was denied on September 28, 2016. The parties filed cross-motions for summary judgment, which are pending.

The Company believes it has strong legal and factual defenses and intends to continue defending itself 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 (MRO) 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:

|                       | United States           |                            | Canada                  |                            |
|-----------------------|-------------------------|----------------------------|-------------------------|----------------------------|
|                       | 2016 Forecast<br>(July) | 2016 Forecast<br>(October) | 2016 Forecast<br>(July) | 2016 Forecast<br>(October) |
| Business Investment   | —%                      | (2.1)%                     | (3.9)%                  | (2.9)%                     |
| Business Inventory    | 1.3%                    | (0.1)%                     | —                       | —                          |
| Exports               | 0.9%                    | (0.1)%                     | 2.4%                    | 0.7%                       |
| Industrial Production | (1.6)%                  | (1.0)%                     | (2.0)%                  | (0.8)%                     |
| GDP                   | 1.9%                    | 1.4%                       | 1.3%                    | 1.2%                       |
| Oil Prices            | —                       | —                          | \$44/barrel             | \$43/barrel                |

Source: Global Insight (July & October 2016)

In the United States, Business Investment and Exports are two major indicators of MRO spending. Per the Global Insight October 2016 forecast, Business Investment is forecast to remain weak into 2017 primarily due to four factors: declines in oil and gas drilling, excess global capacity, a stronger U.S. dollar and slower growth in export markets. Capital spending should begin to have moderate growth in 2017 and 2018 as domestic demand strengthens and oil prices recover. Export growth is expected to remain relatively flat over the remainder of the year as the global economy stabilizes and the uncertainty of the Brexit vote fades. As a result of the strong U.S. dollar and slower growth abroad, U.S. economic growth, as measured by GDP, is forecast to be 1.4% for the year.

Per the Global Insight October 2016 forecast, Canada economic growth in 2016 is forecast to continue to remain low. A rebound is forecast by the Bank of Canada to occur in the third quarter as oil production has resumed and rebuilding efforts in the affected region get underway, combined with growth driven by improving U.S. domestic demand and federal infrastructure spending announced by the government earlier this year. For the year, the Canadian economy, as measured by GDP, is forecast to grow 1.2% in 2016 compared to 1.1% in the prior year. Over the near term, a key factor contributing to the low level of economic growth will be nonresidential business investment (a component of Business Investment) which is forecast to be negative for the remainder of the year.

Outlook

On October 18, 2016, Grainger revised the 2016 sales growth guidance from a range of 1 to 4 percent to a range of 1.5 to 2.5 percent and the 2016 earnings per share guidance from a range of \$11.20 to \$12.20 to a range of \$11.40 to \$11.70. The guidance is revised to reflect modest sales growth anticipated in the fourth quarter and continued gross

profit pressure in the United States due to price deflation exceeding product cost deflation and product cost inflation in Canada.

**Matters Affecting Comparability**

There were 64 sales days in the third quarter of 2016 and 2015. Grainger completed the Cromwell Group (Holdings) Limited (Cromwell) acquisition on September 1, 2015 and operating results of Cromwell have been included in the results of the Company since the acquisition date.

17

---

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

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

## Results of Operations – Three Months Ended September 30, 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 September 30, |             |                     |    | As a Percent of |        |
|--|----------------------------------|-------------|---------------------|----|-----------------|--------|
|  | 2016<br>(A)                      | 2015<br>(A) | Percent             |    | Net Sales       |        |
|  |                                  |             | Increase/(Decrease) |    | 2016            | 2015   |
| Net sales  | \$2,596                          | \$2,533     | 3                   | %  | 100.0%          | 100.0% |
| Cost of merchandise sold                         | 1,557                            | 1,471       | 6                   | %  | 60.0            | 58.1   |
| Gross profit                                     | 1,040                            | 1,062       | (2)                 | )% | 40.0            | 41.9   |
| Operating expenses                               | 717                              | 721         | (1)                 | )% | 27.6            | 28.5   |
| Operating earnings                               | 323                              | 341         | (5)                 | )% | 12.4            | 13.5   |
| Other expense                                    | 29                               | 21          | 38                  | %  | 1.1             | 0.8    |
| Income taxes                                     | 100                              | 123         | (19)                | )% | 3.8             | 4.8    |
| Noncontrolling interest                          | 8                                | 4           | 70                  | %  | 0.3             | 0.2    |
| Net earnings attributable to W.W. Grainger, Inc. | \$186                            | \$192       | (3)                 | )% | 7.2             | 7.6    |

(A) May not sum due to rounding

Grainger's net sales of \$2,596 million for the third quarter of 2016 increased 3% compared with sales of \$2,533 million for the comparable 2015 quarter. On a daily basis, sales increased 3%. The 3% daily increase for the quarter consisted of the following:

|                      | Percent Increase/(Decrease) |
|----------------------|-----------------------------|
| Business acquisition | 2                           |
| Foreign exchange     | 1                           |
| Seasonal             | 1                           |
| Price                | (1)                         |
| Total                | 3%                          |

The increase in net sales was primarily driven by the acquisition of Cromwell on September 1, 2015 and single channel online businesses in Japan and the United States. Refer to the Segment Analysis below for further details.

In the three months ended September 30, 2016, eCommerce sales for Grainger were \$1,242 million, an increase of 16% over the prior year and represented 48% of total sales. The increase was primarily driven by an increase in sales via electronic data interchange (EDI) and electronic purchasing platforms in the United States and Japan. If the Company included KeepStock, the electronic inventory management offering, total eCommerce and KeepStock sales would represent 57% of total sales.

Gross profit of \$1,040 million for the third quarter of 2016 decreased 2%. The gross profit margin of 40.0% during the third quarter of 2016 decreased 1.9 percentage points when compared to the same period in 2015, due primarily to unfavorable customer mix and negative price-cost mix in the United States and price deflation versus product cost inflation in Canada.

Operating expenses of \$717 million for the third quarter of 2016 decreased 1% from \$721 million for the comparable 2015 quarter.

Operating earnings for the third quarter of 2016 were \$323 million, a decrease of 5% compared to the third quarter of 2015. The decline was driven by lower gross profit partially offset by lower operating expenses.

18

---

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

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

Net earnings attributable to W.W. Grainger, Inc. for the third quarter of 2016 decreased 3% to \$186 million from \$192 million in the third quarter of 2015.

Diluted earnings per share of \$3.05 in the third quarter of 2016 were up 4% versus the \$2.92 for the third quarter of 2015, due to lower average shares outstanding, partially offset by lower earnings.

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 provides useful information to investors as an important indicator of operations because it excludes items that may not be indicative of core operating results and uses it internally to monitor performance of the business. 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. Non-GAAP financial measures should be viewed in addition to, and not as an alternative for, our reported results prepared in accordance with GAAP. Restructuring charges include employee termination benefits, facility closure costs and asset write downs.

|                                     | Three<br>Months<br>Ended<br>September<br>30, |        |    |
|-------------------------------------|--|--------|----|
|                                     | 2016   | 2015   | %  |
| Diluted earnings per share reported | \$3.05                                       | \$2.92 | 4% |
| Pre-tax adjustments:                |  |        |    |
| Restructuring (United States)       | 0.09   | 0.14   |    |
| Restructuring (Canada)              | 0.07   | 0.02   |    |
| Restructuring (Other Businesses)    | —  | 0.01   |    |
| Total pre-tax adjustments           | 0.16   | 0.17   |    |
| Tax effect (1)                      | (0.05)                                       | (0.06) |    |
| Discrete tax items                  | (0.10)                                       | —      |    |
| Total, net of tax                   | 0.01   | 0.11   |    |
| Diluted earnings per share adjusted | \$3.06                                       | \$3.03 | 1% |

(1) The tax impact of adjustments is calculated based on the income tax rate in each applicable jurisdiction.

## 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 single channel online businesses such as MonotaRO in Japan and Zoro in the United States, 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 \$2,028 million for the third quarter of 2016, a decrease of 1% when compared with net sales of \$2,040 million for the same period in 2015. On a daily basis, sales decreased 1%. The 1% daily decrease for the quarter

consisted of the following:

|                              | Percent Increase/(Decrease) |
|------------------------------|-----------------------------|
| Intercompany sales to Zoro 1 |                             |
| Price                        | (1)                         |
| Volume                       | (1)                         |
| Total                        | (1)%                        |

19

---

W.W. Grainger, Inc. and Subsidiaries

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

Light manufacturing was up low single digits and government and retail customers were up mid-single digits. The growth with government and retail customers was primarily a function of share gain as the Company outperformed the estimated growth in the market. Sales to commercial customers were flat and contractor and heavy manufacturing were down mid-single digits. Reseller customers were down low double digits and natural resource customers were down in the mid-teens. 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 September 30, 2016, eCommerce sales for the United States business were \$960 million, an increase of 13% over the prior year and represented 47% of total sales. The increase was primarily driven by an increase in sales via EDI and electronic purchasing platforms. If the Company included KeepStock, the electronic inventory management offering, total eCommerce and KeepStock sales would represent 58% of total sales.

The gross profit margin for the third quarter of 2016 decreased 1.3 percentage points compared to the same period in 2015, primarily driven by unfavorable customer selling mix and price deflation exceeding cost deflation. Excluding sales to Zoro, the gross profit margin decreased 1.0 percentage point versus prior year.

Operating expenses of \$493 million in the third quarter of 2016 were down \$14 million, or 3% versus the third quarter of 2015 primarily due to lower payroll and benefits. Operating expenses in 2016 included \$5.4 million of net restructuring charges composed of \$6.6 million of charges, partially offset by \$1.2 million of gains from the sale of real estate. Excluding the restructuring impact, operating expenses decreased 2%.

Operating earnings of \$343 million for the third quarter of 2016 decreased 5% from \$359 million for the third quarter of 2015 driven by lower sales and lower gross profit margins, partially offset by lower operating expenses. Excluding the restructuring impact mentioned above, operating earnings decreased 6%.

Canada

Net sales were \$179 million for the third quarter of 2016, a decrease of \$34 million, or 16%, when compared with \$213 million for the same period in 2015. In local currency, sales decreased 16%. On a daily sales basis, sales decreased 16% for the quarter and consisted of the following:

Percent Decrease

Price (1)  
Volume(15)  
Total (16)%

Sales performance in Canada continues to be affected by a weak economic environment, resulting in lower sales to most customer end markets. The Alberta region, which represents about one-third of the sales in the Canadian business, decreased 22% versus prior year, on a daily basis, as it was negatively impacted by oil prices. Sales growth for the remaining regions in aggregate was down 12% in local currency.

In the three months ended September 30, 2016, eCommerce sales in Canada were \$24 million, a decrease of 8% over the prior year and represented 13% of total sales. The decrease was primarily driven by lower sales volume. If the Company included KeepStock, the electronic inventory management offering, total eCommerce and KeepStock sales would represent 24% of total sales.

The gross profit margin decreased 5.5 percentage points in the third quarter of 2016 versus the third quarter of 2015 due to product cost inflation and unfavorable foreign exchange from products sourced in the United States. Due to

service gaps stemming from the systems transition, the Company has not passed on price increases to customers this year and this is putting pressure on the Company's gross profit margin.

Operating expenses decreased 5% in the third quarter of 2016 versus the third quarter of 2015, due to lower SAP project costs and payroll costs. Reported results included \$4.4 million of restructuring charges, composed of \$3.8 million in operating expense-related charges and \$0.6 million of inventory-related charges.



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

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

Operating losses were \$15 million for the third quarter of 2016 versus operating earnings of \$4 million in the third quarter of 2015, driven primarily by the sales decline and a lower gross profit margin, partially offset by lower operating expenses.

## Other Businesses

Net sales for other businesses were \$482 million for the third quarter of 2016, an increase of \$127 million when compared with net sales of \$355 million for the same period in 2015, primarily due to the September 1, 2015 acquisition of Cromwell. On a daily sales basis, sales were up 36%. The drivers of the increase in daily sales for the quarter consisted of the following:

|                      | Percent Increase |
|----------------------|------------------|
| Business acquisition | 16               |
| Price/volume         | 15               |
| Foreign exchange     | 5                |
| Total                | 36%              |

Operating earnings of \$25 million for the third quarter of 2016 were up \$11 million compared to the third quarter of 2015. The earnings performance for the quarter versus prior year was primarily driven by strong operating results from MonotaRO in Japan, Zoro in the United States and the business in Mexico. Cromwell's business also contributed to the earnings growth in the quarter.

## Other Income and Expense

Other income and expense was \$29 million of expense in the third quarter of 2016 compared to \$21 million of expense in the third quarter of 2015. The increase was driven by higher interest expense from the Company's \$400 million of debt issued in May 2016 and higher losses from the Company's clean energy investment.

## Income Taxes

For the quarter, the effective tax rate in 2016 was 34.0% versus 38.4% in 2015. The year-over-year decrease in the tax rate was primarily due to a higher benefit from the Company's clean energy investments partially offset by a larger proportion of earnings from higher tax rate jurisdictions. The 2016 third quarter included a \$6 million benefit from discrete tax items. Excluding this discrete tax benefit, the Company's effective tax rate was 36.1%.

## Matters Affecting Comparability

There were 192 sales days in the nine months ended September 30, 2016 compared to 191 sales days in 2015.

## Results of Operations – Nine Months Ended September 30, 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):

W.W. Grainger, Inc. and Subsidiaries

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

|                          | Nine Months Ended September 30, |             |                                |    | As a Percent of |        |
|--------------------------|---------------------------------|-------------|--------------------------------|----|-----------------|--------|
|                          | 2016<br>(A)                     | 2015<br>(A) | Percent<br>Increase/(Decrease) |    | 2016            | 2015   |
| Net sales                | \$7,666                         | \$7,495     | 2                              | %  | 100.0%          | 100.0% |
| Cost of merchandise sold | 4,542                           | 4,266       | 276                            | %  | 59.2            | 56.9   |
| Gross profit             | 3,125                           | 3,229       | (104)                          | )% | 40.8            | 43.1   |
| Operating expenses       | 2,180                           | 2,180       | —                              | %  | 28.4            | 29.1   |
| Operating earnings       | 945                             | 1,049       | (104)                          | )% | 12.3            |        |