

GRAINGER W W INC  
Form 10-Q  
November 01, 2012

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, 2012  
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 69,494,573 shares of the Company’s Common Stock outstanding as of September 30, 2012.

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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 |             | Nine Months Ended |             |
|--|--------------------|-------------|-------------------|-------------|
|  | September 30,      |             | September 30,     |             |
|  | 2012               | 2011        | 2012              | 2011        |
| Net sales  | \$2,281,205        | \$2,114,647 | \$6,723,925       | \$6,001,281 |
| Cost of merchandise sold                                   | 1,287,245          | 1,201,648   | 3,777,290         | 3,396,274   |
| Gross profit   | 993,960            | 912,999     | 2,946,635         | 2,605,007   |
| Warehousing, marketing and administrative expenses         | 739,634            | 609,959     | 2,073,948         | 1,774,071   |
| Operating earnings   | 254,326            | 303,040     | 872,687           | 830,936     |
| Other income and (expense):                                |                    |             |                   |             |
| Interest income  | 707                | 553         | 1,904             | 1,560       |
| Interest expense   | (4,751)            | (2,579)     | (10,718)          | (6,437)     |
| Other non-operating income                                 | 830                | 231         | 1,698             | 893         |
| Other non-operating expense                                | (392)              | (786)       | (1,609)           | (1,503)     |
| Total other expense  | (3,606)            | (2,581)     | (8,725)           | (5,487)     |
| Earnings before income taxes                               | 250,720            | 300,459     | 863,962           | 825,449     |
| Income taxes   | 92,916             | 116,412     | 323,599           | 310,745     |
| Net earnings   | 157,804            | 184,047     | 540,363           | 514,704     |
| Less: Net earnings attributable to noncontrolling interest | 2,410              | 1,926       | 6,749             | 4,765       |
| Net earnings attributable to W.W. Grainger, Inc.           | \$155,394          | \$182,121   | \$533,614         | \$509,939   |
| Earnings per share:  |                    |             |                   |             |
| Basic  | \$2.19             | \$2.56      | \$7.50            | \$7.18      |
| Diluted  | \$2.15             | \$2.51      | \$7.35            | \$7.03      |
| Weighted average number of shares outstanding:             |                    |             |                   |             |
| Basic  | 69,625,081         | 69,846,233  | 69,896,864        | 69,621,649  |
| Diluted  | 70,960,547         | 71,280,405  | 71,306,416        | 71,105,343  |
| Cash dividends paid per share                              | \$0.80             | \$0.66      | \$2.26            | \$1.86      |

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,     |            |
|   | 2012               | 2011       | 2012              | 2011       |
| Net earnings  | \$ 157,804         | \$ 184,047 | \$ 540,363        | \$ 514,704 |
| Other comprehensive earnings (losses):  |                    |            |                   |            |
| Foreign currency translation adjustments, net of tax (expense) benefit of \$(2,029), \$5,303, \$(2,195) and \$3,094, respectively | 29,168             | (72,558 )  | 25,284            | (45,332 )  |
| Derivative instruments, net of tax benefit (expense) of \$1,889, \$(3,936), \$1,673 and \$(2,041), respectively                   | (3,607 )           | 6,207      | (4,941 )          | 3,218      |
| Comprehensive earnings, net of tax  | 183,365            | 117,696    | 560,706           | 472,590    |
| Comprehensive earnings attributable to noncontrolling interest  | 1,421              | 4,629      | 6,622             | 8,842      |
| Comprehensive earnings attributable to W.W. Grainger, Inc.  | \$ 181,944         | \$ 113,067 | \$ 554,084        | \$ 463,748 |

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)<br>Sep 30, 2012 | Dec 31, 2011 |
|---|-----------------------------|--------------|
| ASSETS  |                             |              |
| CURRENT ASSETS  |                             |              |
| Cash and cash equivalents   | \$420,803                   | \$335,491    |
| Accounts receivable (less allowances for doubtful<br>accounts of \$18,744 and \$18,801, respectively) | 1,022,185                   | 888,697      |
| Inventories – net   | 1,269,683                   | 1,268,647    |
| Prepaid expenses and other assets   | 96,989                      | 100,081      |
| Deferred income taxes   | 49,355                      | 47,410       |
| Prepaid income taxes  | 15,938                      | 54,574       |
| Total current assets  | 2,874,953                   | 2,694,900    |
| PROPERTY, BUILDINGS AND EQUIPMENT   | 2,680,876                   | 2,565,322    |
| Less: Accumulated depreciation and amortization   | 1,587,679                   | 1,505,027    |
| Property, buildings and equipment – net   | 1,093,197                   | 1,060,295    |
| DEFERRED INCOME TAXES   | 116,084                     | 100,830      |
| GOODWILL  | 526,634                     | 509,183      |
| OTHER ASSETS AND INTANGIBLES – NET  | 372,876                     | 350,854      |
| TOTAL ASSETS  | \$4,983,744                 | \$4,716,062  |

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

|  | (Unaudited)<br>Sep 30, 2012 | Dec 31, 2011       |
|--|-----------------------------|--------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                             |                    |
| <b>CURRENT LIABILITIES</b>   |                             |                    |
| Short-term debt  | \$75,998                    | \$119,970          |
| Current maturities of long-term debt   | 6,392                       | 221,539            |
| Trade accounts payable   | 439,595                     | 477,648            |
| Accrued compensation and benefits  | 179,755                     | 207,010            |
| Accrued contributions to employees' profit sharing plans   | 127,758                     | 159,950            |
| Accrued expenses   | 243,412                     | 178,652            |
| Income taxes payable   | 10,291                      | 23,156             |
| Total current liabilities  | 1,083,201                   | 1,387,925          |
| LONG-TERM DEBT (less current maturities)   | 479,699                     | 175,055            |
| DEFERRED INCOME TAXES AND TAX UNCERTAINTIES  | 109,012                     | 100,218            |
| EMPLOYMENT-RELATED AND OTHER NON-CURRENT LIABILITIES   | 343,469                     | 328,585            |
| <b>SHAREHOLDERS' EQUITY</b>  |                             |                    |
| Cumulative Preferred Stock – \$5 par value – 12,000,000 shares authorized; none issued nor outstanding | —                           | —                  |
| Common Stock – \$0.50 par value – 300,000,000 shares authorized; issued 109,659,219 shares             | 54,830                      | 54,830             |
| Additional contributed capital   | 786,804                     | 700,826            |
| Retained earnings  | 5,178,930                   | 4,806,110          |
| Accumulated other comprehensive losses   | (8,268                      | ) (28,738 )        |
| Treasury stock, at cost – 40,164,646 and 39,696,367 shares, respectively                               | (3,145,068                  | ) (2,904,243 )     |
| Total W.W. Grainger, Inc. shareholders' equity   | 2,867,228                   | 2,628,785          |
| Noncontrolling interest  | 101,135                     | 95,494             |
| Total shareholders' equity   | 2,968,363                   | 2,724,279          |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$4,983,744</b>          | <b>\$4,716,062</b> |

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

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

|  | Nine Months Ended<br>September 30, |               |
|--|------------------------------------|---------------|
|  | 2012                               | 2011          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                               |                                    |               |
| Net earnings   | \$540,363                          | \$514,704     |
| Provision for losses on accounts receivable                                | 6,604                              | 5,019         |
| Deferred income taxes and tax uncertainties                                | (6,315)                            | (6,765)       |
| Depreciation and amortization  | 113,338                            | 103,573       |
| Stock-based compensation   | 42,815                             | 41,538        |
| Change in operating assets and liabilities – net of business acquisitions: |                                    |               |
| Accounts receivable  | (131,057)                          | (138,726)     |
| Inventories  | 12,116                             | (55,527)      |
| Prepaid expenses and other assets  | 46,648                             | 23,103        |
| Trade accounts payable   | (39,657)                           | 59,193        |
| Other current liabilities  | (3,861)                            | (17,814)      |
| Current income taxes payable   | (12,890)                           | 9,715         |
| Employment-related and other non-current liabilities                       | 11,478                             | 22,012        |
| Other – net  | (3,473)                            | (54)          |
| Net cash provided by operating activities                                  | 576,109                            | 559,971       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                               |                                    |               |
| Additions to property, buildings and equipment                             | (155,163)                          | (131,304)     |
| Proceeds from sale of property, buildings and equipment                    | 5,035                              | 7,464         |
| Net cash paid for business acquisitions                                    | (24,384)                           | (348,348)     |
| Other – net  | 440                                | 97            |
| Net cash used in investing activities                                      | (174,072)                          | (472,091)     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                               |                                    |               |
| Borrowings under lines of credit   | 93,506                             | 174,563       |
| Payments against lines of credit   | (137,616)                          | (158,911)     |
| Proceeds from issuance of long-term debt                                   | 300,000                            | 172,464       |
| Payments of long-term debt and commercial paper                            | (218,350)                          | (70,647)      |
| Proceeds from stock options exercised                                      | 54,266                             | 52,837        |
| Excess tax benefits from stock-based compensation                          | 44,177                             | 31,575        |
| Purchase of treasury stock   | (296,458)                          | (101,382)     |
| Cash dividends paid  | (161,998)                          | (132,719)     |
| Net cash used in financing activities                                      | (322,473)                          | (32,220)      |
| Exchange rate effect on cash and cash equivalents                          | 5,748                              | (8,451)       |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                             | <b>85,312</b>                      | <b>47,209</b> |
| Cash and cash equivalents at beginning of year                             | 335,491                            | 313,454       |
| Cash and cash equivalents at end of period                                 | \$420,803                          | \$360,663     |

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 (MRO), 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 an expanding 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, 2011 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, 2011 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 2012, the Financial Accounting Standards Board issued updated guidance on the periodic testing of indefinite-lived assets for impairment. This guidance allows companies to assess qualitative factors to determine if it is more-likely-than-not that an indefinite-lived intangible asset might be impaired. If it is determined that it is more likely than not that the fair value of such an asset exceeds its carrying value, no further testing is necessary. This guidance is applicable for fiscal years beginning after September 15, 2012, with early adoption permitted. The Company plans to early adopt this pronouncement and its adoption is not expected to have a material effect on the consolidated financial statements.

3. DIVIDEND

On October 31, 2012, the Company's Board of Directors declared a quarterly dividend of 80 cents per share, payable December 1, 2012, to shareholders of record on November 12, 2012.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 4. LONG-TERM DEBT

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

|                                 | Sep 30, 2012 | Dec 31, 2011 |
|---------------------------------|--------------|--------------|
| Bank term loan                  | \$300,000    | \$219,932    |
| Euro denominated bank term loan | 154,295      | 155,340      |
| Other                           | 31,796       | 21,322       |
| Less current maturities         | (6,392       | ) (221,539   |
|                                 | \$479,699    | \$175,055    |

In May 2012, the Company entered into a \$300 million, unsecured bank term loan, which matures in November 2016. The proceeds were used to refinance existing debt and for general corporate purposes. The Company may prepay the loan in whole or in part at its option.

At the election of the Company, the term loan shall bear interest at the Base Rate plus the Applicable Margin or the LIBOR Rate plus the Applicable Margin as defined within the term loan agreement. At September 30, 2012, the Company had elected a one month LIBOR Interest Period. The weighted average interest rate during the period outstanding was 1.24%.

The scheduled loan principal payments are due as follows:

| Date | Payment Amount |         |
|------|----------------|---------|
| 2013 | \$7.5          | million |
| 2014 | \$18.7         | million |
| 2015 | \$26.3         | million |
| 2016 | \$247.5        | million |

## 5. DERIVATIVE INSTRUMENTS

The fair value of significant derivative instruments included in Employment-related and other non-current liabilities was as follows (in thousands of dollars):

| Derivatives Designated as Hedges | Sep 30, 2012 | Dec 31, 2011 |
|----------------------------------|--------------|--------------|
| Interest rate swap               | \$3,877      | \$1,574      |
| Foreign currency forwards        | \$9,134      | \$4,781      |

The Company uses derivative instruments to manage 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.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 6. EMPLOYEE BENEFITS

## Postretirement Benefits

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its United States employees 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 Ended September |           | Nine Months Ended September |           |
|---------------------------------------|------------------------------|-----------|-----------------------------|-----------|
|                                       | 30,<br>2012                  | 2011      | 30,<br>2012                 | 2011      |
| Service cost                          | \$5,014                      | \$3,941   | \$15,043                    | \$11,822  |
| Interest cost                         | 3,203                        | 3,338     | 9,608                       | 10,014    |
| Expected return on assets             | (1,553)                      | ) (1,448) | ) (4,659)                   | ) (4,343) |
| Amortization of transition asset      | (36)                         | ) (36)    | ) (107)                     | ) (107)   |
| Amortization of unrecognized losses   | 1,207                        | 817       | 3,621                       | 2,452     |
| Amortization of prior service credits | (123)                        | ) (123)   | ) (371)                     | ) (371)   |
| Net periodic benefit costs            | \$7,712                      | \$6,489   | \$23,135                    | \$19,467  |

The Company has established a Group Benefit Trust to fund the plan and process benefit payments. The funding of the trust is an estimated amount which is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended. There are no minimum funding requirements and the Company intends to follow its practice of funding the maximum deductible contribution under the IRC. During the three and nine months ended September 30, 2012, the Company contributed \$1.0 million and \$3.1 million, respectively, to the trust.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 7. 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., the Company's Canadian business. Other businesses include operations in Asia, Europe and Latin America. 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 September 30, 2012 |           |                     |             |
|---------------------------------|---------------------------------------|-----------|---------------------|-------------|
|                                 | United States                         | Canada    | Other<br>Businesses | Total       |
| Total net sales                 | \$1,776,749                           | \$272,943 | \$254,817           | \$2,304,509 |
| Intersegment net sales          | (23,049                               | ) (55     | ) (200              | ) (23,304   |
| Net sales to external customers | \$1,753,700                           | \$272,888 | \$254,617           | \$2,281,205 |
| Segment operating earnings      | \$247,054                             | \$34,247  | \$8,778             | \$290,079   |
|                                 | Three Months Ended September 30, 2011 |           |                     |             |
|                                 | United States                         | Canada    | Other<br>Businesses | Total       |
| Total net sales                 | \$1,715,120                           | \$248,398 | \$168,251           | \$2,131,769 |
| Intersegment net sales          | (16,853                               | ) (44     | ) (225              | ) (17,122   |
| Net sales to external customers | \$1,698,267                           | \$248,354 | \$168,026           | \$2,114,647 |
| Segment operating earnings      | \$302,858                             | \$25,016  | \$10,551            | \$338,425   |
|                                 | Nine Months Ended September 30, 2012  |           |                     |             |
|                                 | United States                         | Canada    | Other<br>Businesses | Total       |
| Total net sales                 | \$5,219,559                           | \$825,443 | \$742,904           | \$6,787,906 |
| Intersegment net sales          | (63,178                               | ) (261    | ) (542              | ) (63,981   |
| Net sales to external customers | \$5,156,381                           | \$825,182 | \$742,362           | \$6,723,925 |
| Segment operating earnings      | \$856,701                             | \$97,502  | \$30,737            | \$984,940   |

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

|                                 | Nine Months Ended September 30, 2011 |           |                     |             |
|---------------------------------|--------------------------------------|-----------|---------------------|-------------|
|                                 | United States                        | Canada    | Other<br>Businesses | Total       |
| Total net sales                 | \$4,878,582                          | \$747,683 | \$420,768           | \$6,047,033 |
| Intersegment net sales          | (45,096                              | ) (125    | ) (531              | ) (45,752   |
| Net sales to external customers | \$4,833,486                          | \$747,558 | \$420,237           | \$6,001,281 |
| Segment operating earnings      | \$829,866                            | \$78,194  | \$25,576            | \$933,636   |
|                                 |                                      |           |                     |             |
|                                 | United States                        | Canada    | Other<br>Businesses | Total       |
| Segment assets:                 |                                      |           |                     |             |
| September 30, 2012              | \$1,908,703                          | \$391,702 | \$367,194           | \$2,667,599 |
| December 31, 2011               | \$1,845,703                          | \$335,900 | \$331,896           | \$2,513,499 |

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

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |              |
|---|-------------------------------------|-----------|------------------------------------|--------------|
|   | 2012                                | 2011      | 2012                               | 2011         |
| Operating earnings:                             |                                     |           |                                    |              |
| Total operating earnings for operating segments | \$290,079                           | \$338,425 | \$984,940                          | \$933,636    |
| Unallocated expenses and eliminations           | (35,753                             | ) (35,385 | ) (112,253                         | ) (102,700   |
| Total consolidated operating earnings           | \$254,326                           | \$303,040 | \$872,687                          | \$830,936    |
|   |                                     |           |                                    |              |
|   |                                     |           | Sep 30, 2012                       | Dec 31, 2011 |
| Assets:   |                                     |           |                                    |              |
| Total assets for operating segments             |                                     |           | \$2,667,599                        | \$2,513,499  |
| Other current and non-current assets            |                                     |           | 1,875,169                          | 1,749,029    |
| Unallocated assets                              |                                     |           | 440,976                            | 453,534      |
| Total consolidated assets                       |                                     |           | \$4,983,744                        | \$4,716,062  |

Unallocated expenses and unallocated assets primarily relate to the Company headquarters' 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 expenses increased \$9.6 million for the nine months of 2012 compared to the nine months of 2011, primarily due to higher profit sharing expense and other corporate support services spending.

Assets for reportable segments include net accounts receivable and first-in, first-out inventory which are reported to the Company's Chief Operating Decision Maker. Unallocated assets include non-operating cash and cash equivalents, certain prepaid expenses and property, buildings and equipment-net.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 8. 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,     |            |
|  | 2012               | 2011       | 2012              | 2011       |
| Net earnings attributable to W.W. Grainger, Inc. as reported   | \$ 155,394         | \$ 182,121 | \$ 533,614        | \$ 509,939 |
| Distributed earnings available to participating securities   | (988 )             | (754 )     | (2,694 )          | (2,395 )   |
| Undistributed earnings available to participating securities   | (1,793 )           | (2,582 )   | (6,920 )          | (7,716 )   |
| Numerator for basic earnings per share – Undistributed and distributed earnings available to common shareholders   | 152,613            | 178,785    | 524,000           | 499,828    |
| Undistributed earnings allocated to participating securities   | 1,793              | 2,582      | 6,920             | 7,716      |
| Undistributed earnings reallocated to participating securities   | (1,760 )           | (2,531 )   | (6,786 )          | (7,558 )   |
| Numerator for diluted earnings per share – Undistributed and distributed earnings available to common shareholders | \$ 152,646         | \$ 178,836 | \$ 524,134        | \$ 499,986 |
| Denominator for basic earnings per share – weighted average shares   | 69,625,081         | 69,846,233 | 69,896,864        | 69,621,649 |
| Effect of dilutive securities  | 1,335,466          | 1,434,172  | 1,409,552         | 1,483,694  |
| Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities              | 70,960,547         | 71,280,405 | 71,306,416        | 71,105,343 |
| Earnings per share two-class method  |                    |            |                   |            |
| Basic  | \$2.19             | \$2.56     | \$7.50            | \$7.18     |
| Diluted  | \$2.15             | \$2.51     | \$7.35            | \$7.03     |

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 9. CONTINGENCIES AND LEGAL MATTERS

As previously reported in the Company's prior filings, in December 2007, the Company received a letter from the Commercial Litigation Branch of the Civil Division of the Department of Justice (DOJ). Since then, the Company has been in discussions with the DOJ regarding the Company's compliance with its disclosure obligations and the pricing provisions of the Company's contracts with the General Services Administration (GSA) and the United States Postal Service (USPS). As noted in the Company's Form 10Q for the second quarter of 2012, representatives of the Company and the DOJ had scheduled non-binding mediation for September 2012. Following this mediation with representatives of the DOJ, the Company reached a settlement in principle with the DOJ relating to the Company's disclosure obligations and pricing provisions of the GSA and USPS contracts. Under the terms of the proposed settlement, the Company agreed to pay \$70.0 million to resolve the parties' dispute (other than with respect to certain alleged claims regarding tax, freight and billing errors that the Company does not believe will require it to make any material additional payments and for which the Company estimates its liability to be approximately \$6.0 million). Accordingly, the Company recorded a \$76.0 million liability which is included in Accrued expenses at September 30, 2012. The proposed settlement, which does not contain any admission of wrongdoing by the Company, remains subject to approval by authorized officials of the DOJ and the negotiation of a definitive settlement agreement.

As previously reported, the Company has been conducting an inquiry into alleged falsification of expense reimbursement forms submitted by employees in certain sales offices of Grainger China LLC, a subsidiary of the Company. In the course of the investigation the Company learned that sales employees may have provided prepaid gift cards to certain customers. The Company's investigation included determining whether there were any violations of laws, including the U.S. Foreign Corrupt Practices Act. The Company retained outside counsel to assist in its investigation of this matter. On January 24, 2012, the Company contacted the DOJ and the Securities and Exchange Commission to voluntarily disclose that the Company was conducting an internal investigation, and agreed to fully cooperate and update the DOJ and SEC periodically on further developments. The results of the investigation, which have been submitted to the DOJ and the SEC, did not substantiate initial information suggesting significant use of gift cards for improper purposes. On August 14, 2012, the DOJ closed its inquiry into this matter.



W.W. Grainger, Inc. and Subsidiaries

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

Item 2.

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 an expanding presence in Europe, Asia and Latin America. Grainger uses a multichannel business model to provide customers with a range of options for finding and purchasing products utilizing sales representatives, catalogs and direct marketing materials and eCommerce. Grainger serves approximately 2.0 million customers worldwide through a network of highly integrated branches, distribution centers, multiple websites and export services.

Business Environment

Several economic factors and industry trends tend to shape Grainger's business environment. The overall economy and leading economic indicators provide insight into anticipated Company performance for the near term and help in forming the development of projections. Historically, Grainger's sales trends have tended to correlate with industrial production and non-farm payrolls. According to the Federal Reserve, overall industrial production increased 2.8% from September 2011 to September 2012. This improvement has positively affected Grainger's sales growth for the nine months of 2012.

In October 2012, Consensus Forecasts-USA projected 2012 Industrial Production growth of 4.0% and GDP growth of 2.1% for the United States. In addition, Consensus Forecasts-USA projected 2012 GDP growth of 2.0% for Canada.

The light and heavy manufacturing customer end-markets have historically correlated with manufacturing employment levels and manufacturing output. According to the Federal Reserve, manufacturing output increased 1.4% from September 2011 to September 2012. The United States Department of Labor reported an increase of 1.5% in manufacturing employment levels. Grainger's heavy and light manufacturing customer end-markets outperformed these indicators as sales to both of these customer end-markets increased in the high single digits in the third quarter of 2012. For the nine months of 2012, sales to heavy and light manufacturing customers increased in the low double digits and high single digits, respectively.

Outlook

On October 16, 2012, Grainger revised the 2012 sales growth guidance to 11 to 12 percent. Grainger had previously provided guidance of sales growth of 12 to 14 percent. Earnings per share guidance remained unchanged at \$10.50 to \$10.80, which excludes the \$0.66 per share for the \$76.0 million pre-tax expense recorded for the expected resolution of government contract issues. See Note 9 to the Condensed Consolidated Financial Statements. Gross profit margins for the last quarter of the year are expected to remain relatively consistent with the 2012 third quarter gross profit margins.

W.W. Grainger, Inc. and Subsidiaries

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

Matters Affecting Comparability

There were 63 and 64 sales days in the third quarter of 2012 and 2011, respectively. Grainger completed several acquisitions throughout 2011 and 2012, all of which were immaterial individually and in the aggregate. Grainger's operating results have included the results of each business acquired since the respective acquisition dates. Operating expenses included a \$76.0 million estimated liability for the expected resolution of government contract issues, as described in Note 9 to the Condensed Consolidated Financial Statements.

Results of Operations – Three Months Ended September 30, 2012

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

|  | Three Months Ended September 30, |         | Percent Increase |    |
|--|----------------------------------|---------|------------------|----|
|  | As a Percent of Net Sales        |         |                  |    |
|  | 2012                             | 2011    |                  |    |
| Net sales  | 100.0                            | % 100.0 | % 7.9            | %  |
| Cost of merchandise sold                         | 56.4                             | 56.8    | 7.1              |    |
| Gross profit                                     | 43.6                             | 43.2    | 8.9              |    |
| Operating expenses                               | 32.4                             | 28.9    | 21.3             |    |
| Operating earnings                               | 11.2                             | 14.3    | (16.1            | )  |
| Other income (expense)                           | (0.2                             | ) (0.1  | ) 39.7           |    |
| Income taxes                                     | 4.1                              | 5.5     | (20.2            | )  |
| Noncontrolling interest                          | 0.1                              | 0.1     | 25.1             |    |
| Net earnings attributable to W.W. Grainger, Inc. | 6.8                              | % 8.6   | % (14.7          | )% |

Grainger's net sales of \$2,281.2 million for the third quarter of 2012 increased 8% compared with sales of \$2,114.6 million for the comparable 2011 quarter. On a daily basis, sales increased 10%. Approximately 4 percentage points of the daily sales growth came from an increase in volume. Approximately 3 percentage points came from business acquisitions and 4 percentage points from price, partially offset by a 1 percentage point decrease from foreign exchange. Sales to all customer end-markets except for reseller increased in the third quarter of 2012. The increase in net sales was led by growth in sales to heavy and light manufacturing customers followed by diversified commercial services customers. Refer to the Segment Analysis below for further details.

Gross profit of \$994.0 million for the third quarter of 2012 increased 9%. The gross profit margin during the third quarter of 2012 increased 0.4 percentage point when compared to the same period in 2011, primarily driven by price increases exceeding product cost increases, partially offset by customer mix.

Operating expenses of \$739.6 million for the third quarter of 2012 increased 21%. Operating expenses included the \$76.0 million estimated liability for the expected resolution of government contract issues. Excluding this expense, operating expenses increased 9%, primarily driven by the Fabory Group (Fabory) and the Brazilian (AnFreixo) acquisitions and incremental growth-related spending on new sales representatives, eCommerce and advertising.

Operating earnings for the third quarter of 2012 were \$254.3 million, a decrease of 16% compared to the third quarter of 2011. Excluding the \$76.0 million expense, operating earnings increased 9% primarily due to higher sales and higher gross profit margins.

Net earnings attributed to W.W. Grainger, Inc. for the third quarter of 2012 decreased by 15%, to \$155.4 million from \$182.1 million in the third quarter of 2011. Diluted earnings per share of \$2.15 in the third quarter of 2012 were 14% lower than the \$2.51 for the third quarter of 2011. The previously mentioned estimated liability had a \$0.66 earnings

per share impact on the third quarter of 2012. Excluding this impact, earnings per share increased 12% versus 2011.

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W.W. Grainger, Inc. and Subsidiaries

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

Segment Analysis

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

The following comments at the segment and business unit level include external and intersegment net sales and operating earnings. See Note 7 to the Condensed Consolidated Financial Statements.

United States

Net sales were \$1,776.7 million for the third quarter of 2012, an increase of \$61.6 million, or 4%, when compared with net sales of \$1,715.1 million for the same period in 2011. On a daily basis, sales increased 5%. For the quarter, approximately 1 percentage point of the daily sales growth came from an increase in volume and approximately 4 percentage points was due to price. The increase in net sales was led by high single digit sales growth to heavy and light manufacturing customers and mid-single digit sales growth to diversified commercial services customers and the Government. Sales to the contractor, reseller and natural resources customer segments decreased in the low single digits.

The gross profit margin increased 0.5 percentage point in the third quarter of 2012 over the comparable quarter of 2011, primarily driven by price increases exceeding product cost increases, partially offset by customer mix.

Operating expenses were up 20% in the third quarter of 2012 versus the third quarter of 2011. Operating expenses included a \$76.0 million estimated liability for the expected resolution of government contract issues. Excluding this expense, operating expenses increased 3%, primarily driven by an incremental \$19 million in growth-related spending on new sales representatives, eCommerce and advertising.

Operating earnings of \$247.1 million for the third quarter of 2012 decreased 18% from \$302.9 million for the third quarter of 2011. Excluding the \$76.0 million expense, operating earnings increased 7% primarily due to higher sales and higher gross profit margins.

Canada

Net sales were \$272.9 million for the third quarter of 2012, an increase of \$24.5 million, or 10%, when compared with \$248.4 million for the same period in 2011. On a daily basis, sales increased 12%. In local currency, net sales were up 11%, or 13% daily, driven by 11 percentage points from volume and 2 percentage points from price. The increase in net sales was driven by strong growth in the western provinces, led by commercial services, oil and gas, contractor and utilities customer end-markets.

The gross profit margin increased 1.4 percentage points in the third quarter of 2012 versus the third quarter of 2011. The improvement in gross profit margin was driven by higher supplier rebates and advertising credits due to timing and increased purchases.

Operating expenses were up 6% in the third quarter of 2012 versus the third quarter of 2011. In local currency, operating expenses increased 7%, primarily due to higher volume-related payroll and advertising, partially offset by lower bonus expense and occupancy costs.

Operating earnings of \$34.2 million for the third quarter of 2012 were up \$9.2 million, or 37%, over the third quarter of 2011. In local currency, operating earnings increased 38% in the third quarter of 2012 over the same period in

2011. The increase in earnings was due to strong sales growth, an improved gross profit margin and expense leverage.

W.W. Grainger, Inc. and Subsidiaries

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

Other Businesses

Net sales for other businesses, which include operations in Asia, Europe and Latin America, increased 51% for the third quarter of 2012 when compared to the same period in 2011. On a daily basis, sales increased 54%. The sales increase was due primarily to incremental sales from Fabory, acquired in August 2011, AnFreixo, acquired in April 2012 and strong growth from the businesses in Japan and Mexico. Excluding acquisitions, sales for the other businesses increased 20%. Operating earnings were \$8.8 million in the third quarter of 2012, compared to \$10.6 million in the third quarter of 2011. In the third quarter of 2012, strong performance improvements in Japan and Mexico were partially offset by losses from the acquired businesses in Europe and Brazil, along with losses in some start-up businesses in developing markets.

Other Income and Expense

Other income and expense was a net expense of \$3.6 million in the third quarter of 2012, an increase of \$1.0 million compared to \$2.6 million of expense in the third quarter of 2011. The increase was primarily attributable to higher net interest expenses. Both average debt outstanding and average interest rates were higher in 2012 versus 2011. In addition, interest expense related to capital leases for the acquired business in Europe contributed to the increase in 2012.

Income Taxes

Grainger's effective income tax rates were 37.1% and 38.7% for the three months ended September 30, 2012 and 2011, respectively. The effective tax rate decreased primarily due to higher earnings in foreign jurisdictions with lower tax rates and a lower blended state tax rate.

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

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

## Matters Affecting Comparability

There were 191 and 192 sales days in the nine months of 2012 and 2011, respectively. Grainger completed several acquisitions throughout 2011 and 2012, all of which were immaterial individually and in the aggregate. Grainger's operating results have included the results of each business acquired since the respective acquisition dates. Operating expenses included a \$76.0 million estimated liability for the expected resolution of government contract issues, as described in Note 9 to the Condensed Consolidated Financial Statements.

## Results of Operations – Nine Months Ended September 30, 2012

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

|  | Nine Months Ended September 30, 2012 |         |                  |  |   |
|--|--------------------------------------|---------|------------------|--|---|
|  | As a Percent of Net Sales            |         | Percent Increase |  |   |
|  | 2012                                 | 2011    |                  |  |   |
| Net sales  | 100.0                                | % 100.0 | % 12.0           |  | % |
| Cost of merchandise sold                         | 56.2                                 | 56.6    | 11.2             |  |   |
| Gross profit                                     | 43.8                                 | 43.4    | 13.1             |  |   |
| Operating expenses                               | 30.8                                 | 29.6    | 16.9             |  |   |
| Operating earnings                               | 13.0                                 | 13.8    | 5.0              |  |   |
| Other income (expense)                           | (0.2                                 | ) (0.1  | ) 59.0           |  |   |
| Income taxes                                     | 4.8                                  | 5.2     | 4.1              |  |   |
| Noncontrolling interest                          | 0.1                                  | 0.1     | 41.6             |  |   |
| Net earnings attributable to W.W. Grainger, Inc. | 7.9                                  | % 8.4   | % 4.6            |  | % |

Grainger's net sales of \$6,723.9 million for the nine months of 2012 increased 12% compared with sales of \$6,001.3 million for the comparable 2011 period. On a daily basis, sales increased 13%. Approximately 7 percentage points of the sales growth came from an increase in volume. Approximately 4 percentage points came from business acquisitions and 3 percentage points from price, partially offset by a 1 percentage point decrease from foreign exchange. Sales to all customer end-markets increased in the nine months of 2012. The increase in net sales was led by growth in sales to heavy and light manufacturing customers, followed by natural resources and diversified commercial services customers. Refer to the Segment Analysis below for further details.

Gross profit of \$2,946.6 million for the nine months of 2012 increased 13%. The gross profit margin during the nine months of 2012 increased 0.4 percentage point when compared to the same period in 2011, primarily driven by price increases exceeding product cost increases, partially offset by customer mix.

Operating expenses of \$2,073.9 million for the nine months of 2012 increased 17%. Operating expenses included a \$76.0 million estimated liability for the expected resolution of government contract issues. Excluding this expense, operating expenses increased 13%, primarily driven by the Fabory and the AnFreixo acquisitions and incremental growth-related spending on new sales representatives, eCommerce and advertising.

Operating earnings for the nine months of 2012 were \$872.7 million, an increase of 5% compared to the nine months of 2011. Excluding the \$76.0 million expense, operating earnings increased 14%, primarily due to higher sales and gross profit margins, partially offset by operating expenses increasing at a slightly higher rate than sales.

Net earnings attributed to W.W. Grainger, Inc. for the nine months of 2012 increased by 5%, to \$533.6 million from \$509.9 million in the nine months of 2011. Diluted earnings per share of \$7.35 in the nine months of 2012 were 5%

higher than the \$7.03 for the nine months of 2011. The nine months of 2012 included a \$0.66 earnings per share expense from the previously mentioned estimated liability. The nine months of 2011 included a \$0.12 per share benefit from the settlement of tax examinations. Excluding these items from both years, earnings per share for the nine months of 2012 increased 16% versus 2011.



W.W. Grainger, Inc. and Subsidiaries

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

Segment Analysis

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

The following comments at the segment and business unit level include external and intersegment net sales and operating earnings. See Note 7 to the Condensed Consolidated Financial Statements.

United States

Net sales were \$5,219.6 million for the nine months of 2012, an increase of \$341 million, or 7%, when compared with net sales of \$4,878.6 million for the same period in 2011. On a daily basis, sales increased 8%. Approximately 4 percentage points of the sales growth came from an increase in volume and approximately 4 percentage points were due to price. Sales to all customer end-markets except contractor and reseller increased in the nine months of 2012. The increase in net sales was led by low double digit growth to heavy manufacturing customers and high single digit growth to light manufacturing customers. Sales to the contractor and reseller segments were down in the low single digits.

The gross profit margin increased 0.3 percentage point in the nine months of 2012 over the comparable period of 2011, primarily driven by price increases exceeding product cost increases, partially offset by customer mix.

Operating expenses were up 10% in the nine months of 2012 versus the nine months of 2011. Operating expenses included a \$76.0 million estimated liability for the expected resolution of government contract issues. Excluding this expense, operating expenses increased 5%, primarily driven by an incremental \$70 million in growth-related spending on new sales representatives, eCommerce and advertising.

Operating earnings of \$856.7 million for the nine months of 2012 increased 3% from \$829.9 million for the nine months of 2011. Excluding the \$76.0 million expense, operating earnings increased 12% due to higher sales, higher gross profit margins and expense leverage.

Canada

Net sales were \$825.4 million for the nine months of 2012, an increase of \$77.7 million, or 10%, when compared with \$747.7 million for the same period in 2011. Sales were up 11% on a daily basis. In local currency, net sales were up 13%, or 14% daily, driven by 12 percentage points from volume and 2 percentage points from price. The increase in net sales was led by growth in commercial services, oil and gas, contractor and utilities customer end-markets.

The gross profit margin increased 0.7 percentage point in the nine months of 2012 versus the nine months of 2011, primarily driven by price increases exceeding product cost increases and higher supplier rebates and advertising credits due to timing and volume purchases.

Operating expenses were up 8% in the nine months of 2012 versus the nine months of 2011. In local currency, operating expenses increased 11%, primarily due to higher volume-related payroll and increased sales related travel costs, partially offset by lower professional services and occupancy costs.

Operating earnings of \$97.5 million for the nine months of 2012 were up \$19.3 million, or 25%, over the nine months of 2011. In local currency, operating earnings increased 28% in the nine months of 2012 over the same period in 2011. The increase in earnings was due to strong sales growth, an improved gross profit margin and expense leverage.

Other Businesses

Net sales for other businesses, which include operations in Asia, Europe and Latin America, increased 77% for the nine months of 2012 when compared to the same period in 2011. The sales increase was due primarily to incremental sales from Fabory, acquired in August 2011, AnFreixo, acquired in April 2012, and strong growth from the businesses in Japan and Mexico. Excluding acquisitions, sales for the other businesses increased 24%. Operating earnings were \$30.7 million in the nine months of 2012, compared to \$25.6 million in the nine months of 2011. The increase was primarily driven by strong earnings growth in Japan and Mexico.

W.W. Grainger, Inc. and Subsidiaries

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

Other Income and Expense

Other income and expense was a net expense of \$8.7 million in the nine months of 2012, an increase of \$3.2 million compared to \$5.5 million of expense in the nine months of 2011. The increase was primarily attributable to higher net interest expense. Both average debt outstanding and average rates were higher in 2012 versus 2011. In addition, interest expense related to capital leases for the acquired business in Europe contributed to the increase.

Income Taxes

Grainger's effective income tax rates were 37.5% and 37.6% for the nine months of 2012 and 2011, respectively. The 2011 effective tax rate benefited from a tax adjustment recorded in the second quarter of 2011. Excluding that benefit, the 2011 effective tax rate would have been 38.7%. The decrease in 2012 was primarily due to higher earnings in foreign jurisdictions with lower tax rates and a lower blended state tax rate.

Financial Condition

Cash Flow

Cash from operating activities continues to serve as Grainger's primary source of liquidity. Net cash provided by operating activities was \$576.1 million and \$560.0 million for the nine months ended September 30, 2012 and 2011, respectively. The primary contribution to cash flows from operating activities was net earnings in the nine months ended September 30, 2012 of \$540.4 million compared to \$514.7 million in 2011. Partially offsetting these amounts were changes in operating assets and liabilities, which resulted in a net use of cash of \$117.2 million in the nine months of 2012 compared to \$98.0 million in the nine months of 2011.

Net cash used in investing activities was \$174.1 million and \$472.1 million for the nine months ended September 30, 2012 and 2011, respectively. The decrease in net cash used in investing activities for the nine months ended September 30, 2012 compared to 2011 was primarily due to cash expended in 2011 for the business acquisition in Europe.

Net cash used in financing activities was \$322.5 million and \$32.2 million for the nine months ended September 30, 2012 and 2011, respectively. The \$290.3 million increase in cash used in financing activities for the nine months ended September 30, 2012 was due primarily to higher treasury stock purchases and dividend payments for the nine months ended September 30, 2012 versus 2011.

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 September 30, 2012, was \$1,574.3 million, an increase of \$135.9 million when compared to \$1,438.4 million at December 31, 2011. The working capital assets to working capital liabilities ratio increased to 2.6 at September 30, 2012 from 2.4 at December 31, 2011. The increase related to higher accounts receivable, lower compensation and benefits, and lower profit sharing accruals due to the timing of annual payments, partially offset by higher accrued expenses. The increase in accrued expenses was primarily due to the estimated liability recorded to resolve government contract issues.

Debt

Grainger maintains a debt ratio and liquidity position that provides 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 and commercial paper. Total debt as a percent of total capitalization was 15.9% at September 30, 2012, flat compared to December 31, 2011. In May 2012, the Company entered into a \$300 million, unsecured bank term loan. The proceeds were used to refinance existing debt and for general corporate purposes.

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, 2011.

Forward-Looking Statements

This Form 10-Q contains statements that are not historical in nature but concern future results and business plans, strategies and objectives and other matters that may be deemed to be "forward-looking statements" under the federal securities laws. Grainger has generally identified such forward-looking statements by using words such as "anticipated, believes, continues, could, earnings per share guidance, estimate, estimated, expected, expected resolution of government contract issues, guidance, had potentially, intended, intends, help in forming, historically correlated, may, not expected to have a material adverse effect, possible, projected, projections, proposed, provide insight, range, reasonably likely, sales growth guidance, scheduled, settlement in principle, should, subject to, tend, tended, tended to correlate, tend to shape, trends, unanticipated, uncertainties, and will" or similar expressions.

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

Factors that could cause actual results to differ materially from those presented or implied in a forward-looking statement include, without limitation: higher product costs or other expenses; a major loss of customers; 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; 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 and unanticipated weather conditions.

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

W.W. Grainger, Inc. and Subsidiaries

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, 2011.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

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

PART II – OTHER INFORMATION

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

Item 1. Legal Proceedings

Information on specific and significant legal proceedings is set forth in Note 9 to the Condensed Consolidated Financial Statements included under Item 1.

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

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

## Issuer Purchases of Equity Securities – Third Quarter

| Period           | Total Number of 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 |
|------------------|--------------------------------------|----------------------------------|--|--|
| July 1 – July 31 | 40,696                               | \$204.76                         | 40,696   | 5,971,813 shares   |
| Aug. 1 – Aug. 31 | 307,730                              | \$203.49                         | 307,730  | 5,664,083 shares   |
| Sep. 1 – Sep. 30 | 72,574                               | \$204.47                         | 72,574   | 5,591,509 shares   |
| Total            | 421,000                              | \$203.78                         | 421,000  |  |

(A) There were no shares withheld to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.

(B) Average price paid per share includes any commissions paid and includes only those amounts related to purchases as part of publicly announced plans or programs.

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors on July 28, 2010. The program has no specified expiration date. Activity is reported on a trade date basis.

## Item 6. Exhibits

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

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

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

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

(32 ) Section 1350 Certifications

Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

W.W. Grainger, Inc.  
(Registrant)

Date: November 1, 2012

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

Date: November 1, 2012

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