

GRAINGER W W INC  
Form 10-Q  
May 02, 2007

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended **March 31, 2007**

**OR**

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number **1-5684**

**W.W. Grainger, Inc.**

(Exact name of registrant as specified in its charter)

**Illinois**  
(State or other jurisdiction of incorporation or organization)

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

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

**60045-5201**  
(Zip Code)

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

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

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

Yes  X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of

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the Exchange Act). (Check One):

Large accelerated filer            Accelerated filer      Non-accelerated filer

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 83,560,089 shares of the Company's Common Stock outstanding as of March 31, 2007.

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements (Unaudited)****W.W. Grainger, Inc. and Subsidiaries****CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

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

(Unaudited)

	Three Months Ended	
	March 31, 2007	2006
Net sales	\$ 1,546,658	\$ 1,419,117
Cost of merchandise sold	914,570	848,790
Gross profit	632,088	570,327
Warehousing, marketing and administrative expenses	469,503	435,910
Operating earnings	162,585	134,417
Other income and (expense):		
Interest income	4,022	5,359
Interest expense	(577)	(493)
Equity in income (loss) of unconsolidated entities - net	(342)	1,207
Unclassified - net	33	(123)
Total other income and (expense)	3,136	5,950
Earnings before income taxes	165,721	140,367
Income taxes	63,934	54,134
Net earnings	\$ 101,787	\$ 86,233
Earnings per share:		
Basic	\$ 1.21	\$ 0.96
Diluted	\$ 1.17	\$ 0.93
Weighted average number of shares outstanding:		
Basic	83,979,114	89,637,735
Diluted	86,758,949	92,484,701
Cash dividends paid per share	\$ 0.29	\$ 0.24

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	
	March 31, 2007	2006
Net earnings	\$ 101,787	\$ 86,233
Other comprehensive earnings (losses):		
Foreign currency translation adjustments, net of tax		
(expense) benefit of \$(528) and \$243, respectively	2,583	(1,857)
Comprehensive earnings	\$ 104,370	\$ 84,376

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

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

## CONDENSED CONSOLIDATED BALANCE SHEETS

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

(Unaudited)

ASSETS	March 31, 2007	Dec. 31, 2006
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 325,472	\$ 348,471
Marketable securities at cost, which approximates market value		12,827
Accounts receivable (less allowances for doubtful accounts of \$19,112 and \$18,801, respectively)	611,126	566,607
Inventories	815,891	827,254
Prepaid expenses and other assets	66,544	58,804
Deferred income taxes	50,198	48,123
Total current assets	1,869,231	1,862,086
<b>PROPERTY, BUILDINGS AND EQUIPMENT</b>	1,854,039	1,827,104
Less accumulated depreciation and amortization	1,051,666	1,034,169
Property, buildings and equipment net	802,373	792,935
<b>DEFERRED INCOME TAXES</b>	59,554	48,793
<b>INVESTMENT IN UNCONSOLIDATED ENTITY</b>	8,228	8,492
<b>GOODWILL</b>	212,237	210,671
<b>OTHER ASSETS AND INTANGIBLES NET</b>	121,433	123,111
<b>TOTAL ASSETS</b>	\$ 3,073,056	\$ 3,046,088



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

## CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)

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

(Unaudited)

LIABILITIES AND SHAREHOLDERS' EQUITY	March 31, 2007	Dec. 31, 2006
<b>CURRENT LIABILITIES</b>		
Current maturities of long-term debt	\$ 4,590	\$ 4,590
Trade accounts payable	378,432	334,820
Accrued compensation and benefits	113,208	140,141
Accrued contributions to employees profit sharing plans	33,225	113,014
Accrued expenses	94,689	106,681
Income taxes	50,394	7,077
Total current liabilities	674,538	706,323
 LONG-TERM DEBT (less current maturities)	 4,895	 4,895
 DEFERRED INCOME TAXES	 22,893	 6,235
 ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS	 157,275	 151,020
 <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 109,657,938 shares	54,829	54,829
Additional contributed capital	527,385	513,667
Retained earnings	3,085,744	3,007,606
Unearned restricted stock compensation	(39,408)	(35,213)
Accumulated other comprehensive earnings	6,014	3,431
Treasury stock, at cost		
26,097,849 and 25,590,311 shares, respectively	(1,421,109)	(1,366,705)
Total shareholders' equity	2,213,455	2,177,615
 <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	 <b>\$ 3,073,056</b>	 <b>\$ 3,046,088</b>

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



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

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of dollars)

(Unaudited)

	Three Months Ended March 31,	
	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net earnings	\$ 101,787	\$ 86,233
Provision for losses on accounts receivable	1,981	1,629
Deferred income taxes	3,294	(956)
Depreciation and amortization:		
Property, buildings and equipment	23,888	23,128
Capitalized software and other intangibles	6,035	3,989
Stock-based compensation	7,207	6,525
Tax benefit of stock incentive plans	888	2,944
Net gains on sales of property, buildings and equipment	(1,300)	(36)
(Income) loss from unconsolidated entities	342	(1,207)
Change in operating assets and liabilities net of		
business acquisitions:		
(Increase) in accounts receivable	(46,013)	(52,205)
(Increase) decrease in inventories	12,342	(14,256)
(Increase) in prepaid expenses	(7,733)	(4,411)
Increase in trade accounts payable	44,004	36,424
(Decrease) in other current liabilities	(111,123)	(112,565)
Increase in current income taxes payable	44,171	45,620
Increase in accrued employment-related benefit costs	6,255	4,940
Other net	(3,612)	1,080
Net cash provided by operating activities	82,413	26,876
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Additions to property, buildings and		
equipment net of dispositions	(32,246)	(28,632)
Additions to capitalized software	(727)	(1,536)
Net cash paid for business acquisitions		(14,327)
Other net	12,389	(4,058)
Net cash used in investing activities	\$ (20,584)	\$ (48,553)

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

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

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(In thousands of dollars)

(Unaudited)

	Three Months Ended March 31,	
	2007	2006
CASH FLOWS FROM FINANCING ACTIVITIES:		
Stock options exercised	\$ 31,277	\$ 25,293
Excess tax benefits from stock-based compensation	6,784	2,774
Purchase of treasury stock	(98,698)	(35,851)
Cash dividends paid	(24,519)	(21,591)
Net cash used in financing activities	(85,156)	(29,375)
Exchange rate effect on cash and cash equivalents	328	41
NET (DECREASE) IN CASH AND CASH EQUIVALENTS	(22,999)	(51,011)
Cash and cash equivalents at beginning of year	348,471	544,894
Cash and cash equivalents at end of period	\$ 325,472	\$ 493,883

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 STATEMENT PRESENTATION**

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

The Condensed Consolidated Financial Statements of the Company and the related notes are unaudited and should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2006, 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, 2006 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 (consisting of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the statements contained herein.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

In July 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes." The Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized a decrease of approximately \$0.9 million in the liability for tax uncertainties, which resulted in an increase to the January 1, 2007 balance of Retained earnings.

The Company's liability for tax uncertainties was \$15.8 million, including \$0.6 million for interest and penalties, at January 1, 2007. The Company classifies this liability in Deferred income taxes. Included in this amount is \$4.3 million of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred tax accounting, other than interest and penalties, the disallowance of the shorter deductibility period would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authority to an earlier period.

During the three months ended March 31, 2007, the Company recognized an additional \$0.6 million of income tax expense for the current year positions, of which approximately \$0.2 million is for interest and penalties. The Company recognizes interest expense and penalties in the provision for income taxes.

The Company regularly undergoes examination of its federal income tax returns by the Internal Revenue Service (IRS). The Company and the IRS have settled tax years through 2004. Additionally, the Company is routinely involved in state and local income tax audits, and on occasion, foreign jurisdiction tax audits. The Company's tax years 2002-2006 remain subject to state, local and foreign audits. The Company expects to resolve these audits within the amounts paid and/or reserved for these liabilities.

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

(Unaudited)

**NEW ACCOUNTING STANDARD**

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS No. 159), The Fair Value Option for Financial Assets and Financial Liabilities. SFAS No. 159 provides companies with an option to report selected financial assets and liabilities at fair value. It also establishes presentation and disclosure requirements to facilitate comparisons between companies using different measurement attributes for similar types of assets and liabilities. The statement is effective for the first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact that adoption of SFAS No. 159 may have on its results of operations and financial position.

**3. DIVIDEND**

On April 25, 2007, the Board of Directors declared a quarterly dividend of 35 cents per share, payable June 1, 2007 to shareholders of record on May 14, 2007. This represents a 21% increase from the prior quarterly rate of 29 cents per share.

**4. WARRANTY RESERVES**

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

	Three Months Ended March 31,	
	2007	2006
	(In thousands of dollars)	
Beginning balance	\$ 4,651	\$ 3,763
Returns	(4,382)	(1,003)
Provision	3,468	1,319
Ending balance	\$ 3,737	\$ 4,079

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 5. EMPLOYEE BENEFITS

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

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

	Three Months Ended March 31,	
	2007	2006
	(In thousands of dollars)	
Service cost	\$ 2,714	\$ 2,434
Interest cost	2,243	1,900
Expected return on assets	(1,012)	(698)
Amortization of transition asset	(36)	(36)
Amortization of unrecognized losses	523	726
Amortization of prior service cost	(109)	(215)
Net periodic benefit costs	\$ 4,323	\$ 4,111

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 quarter, the Company contributed \$0.5 million to the trust.



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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 6. SEGMENT INFORMATION

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

## Three Months Ended March 31, 2007

## Grainger

	Branch-based	Acklands - Grainger Branch-based	Lab Safety	Total
Total net sales	\$ 1,296,382	\$ 142,050	\$ 109,100	\$ 1,547,532
Intersegment net sales	(233)		(641)	(874)
Net sales to external customers	\$ 1,296,149	\$ 142,050	\$ 108,459	\$ 1,546,658
Segment operating earnings	\$ 160,242	\$ 8,948	\$ 14,610	\$ 183,800

## Three Months Ended March 31, 2006

## Grainger

	Branch-based	Acklands - Grainger Branch-based	Lab Safety	Total
Total net sales	\$ 1,177,141	\$ 139,022	\$ 103,879	\$ 1,420,042
Intersegment net sales	(315)		(610)	(925)
Net sales to external customers	\$ 1,176,826	\$ 139,022	\$ 103,269	\$ 1,419,117
Segment operating earnings	\$ 132,852	\$ 3,878	\$ 15,227	\$ 151,957

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

	Grainger			
	Branch-based	Acklands - Grainger Branch-based	Lab Safety	Total
<u>Segment assets:</u>				
March 31, 2007	\$ 2,015,876	\$ 410,809	\$ 212,391	\$ 2,639,076
December 31, 2006	\$ 1,938,270	\$ 394,707	\$ 215,515	\$ 2,548,492

Following are reconciliations of segment information with the consolidated totals per the financial statements:

	Three Months Ended March 31,	
	2007	2006
	(In thousands of dollars)	
<u>Operating earnings:</u>		
Total operating earnings for reportable segments	\$ 183,800	\$ 151,957
Unallocated expenses and eliminations	(21,215)	(17,540)
Total consolidated operating earnings	\$ 162,585	\$ 134,417
	March 31,	
	2007	December 31, 2006
	(In thousands of dollars)	
<u>Assets:</u>		
Total assets for reportable segments	\$ 2,639,076	\$ 2,548,492
Unallocated assets	433,980	497,596
Total consolidated assets	\$ 3,073,056	\$ 3,046,088

Unallocated expenses and unallocated assets primarily relate to the Company headquarters support services, which are not part of any business segment. Unallocated expenses include payroll and benefits, depreciation and other costs associated with headquarters-related support services. Unallocated expenses increased primarily due to higher incentive compensation and profit sharing accruals. Unallocated assets include non-operating cash and cash equivalents, certain prepaid expenses and property, buildings and equipment net.

**W.W. Grainger, Inc. and Subsidiaries**

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

**Item 2.**

**Overview**

***General***

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

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

***Business Environment***

Several economic factors and industry trends shape Grainger's business environment. Grainger's sales tend to correlate positively with production growth, particularly manufacturing output, as well as growth in non-farm payrolls. According to the Federal Reserve, overall industrial production increased 2.3% from March 2006 to March 2007. Manufacturing output increased 2.6% from March of 2006 although manufacturing employment levels have declined approximately 0.8%. Non-farm employment levels grew 1.4% since March of 2006. Grainger's sales to the light and heavy manufacturing customer sectors showed improvement over the prior year. Current economic growth projections for 2007 industrial production and GDP are 2.2% and 2.3%, respectively.

For the first quarter of 2007, the Company had \$35.1 million of capital expenditures, of which \$12.9 million related to its market expansion program. The Company expects to continue its investments in the market expansion program and information technology enhancements are scheduled for 2008 and beyond.

**W.W. Grainger, Inc. and Subsidiaries****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL****CONDITION AND RESULTS OF OPERATIONS***Matters Affecting Comparability*

Grainger's operating results for the first quarter of 2007 include the operating results of the businesses acquired from Professional Inspection Equipment, Inc. and Construction Book Express, Inc. Those results have been included in the Lab Safety segment since the acquisition date of November 17, 2006.

Grainger's operating results for the first quarter of 2006 include the operating results of the business acquired from Rand Materials Handling Equipment Co. (Rand) from the acquisition date of January 31, 2006. Rand's results are included in the Lab Safety segment.

There were 64 sales days in the first quarter of both 2007 and 2006.

**Results of Operations – Three Months Ended March 31, 2007**

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

	Three Months Ended March 31, Items in Condensed Consolidated Statements of Earnings		
	As a Percent of Net Sales		
	2007	2006	Percent Increase
Net sales	100.0%	100.0%	9.0%
Cost of merchandise sold	59.1	59.8	7.7
Gross profit	40.9	40.2	10.8
Operating expenses	30.4	30.7	7.7
Operating earnings	10.5	9.5	21.0
Other income	0.2	0.4	(47.3)
Income taxes	4.1	3.8	18.1
Net earnings	6.6	6.1	18.0

Grainger's net sales of \$1,546.7 million in the first quarter of 2007 increased 9.0% compared with sales of \$1,419.1 million for the comparable 2006 quarter. First quarter 2007 sales benefited from the economy and ongoing strategic initiatives such as market expansion and product line expansion. Partially offsetting these improvements was the negative effect of the wind-down of low margin integrated supply contracts. An increase in net sales was realized in all three segments of the business.

The gross profit margin improved 0.7 percentage point to 40.9% for the first three months of 2007 from 40.2% in the comparable period of 2006. The primary driver of the gross profit margin improvement was positive inflation recovery. Operating expenses of \$469.5 million in 2007 grew 7.7% over the prior year, driven by payroll and benefits, primarily the result of increased headcount and higher incentive compensation,

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commission and profit sharing accruals. Operating earnings for the first quarter of 2007 totaled \$162.6 million, an increase of 21.0% over the first quarter of 2006 due to the increase in gross profit margin and operating expenses growing at a slower rate than sales.

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

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

## CONDITION AND RESULTS OF OPERATIONS

Net earnings for the first quarter of 2007 were \$101.8 million and increased by 18.0% from \$86.2 million in the first quarter of 2006. The growth in net earnings for the quarter resulted from the improvement in operating earnings, partially offset by lower interest income and a loss from unconsolidated entities in 2007 versus income in 2006. Diluted earnings per share of \$1.17 in the first quarter of 2007 were 25.8% higher than the \$0.93 for the first quarter of 2006.

*Segment Analysis*

The following comments at the segment level refer to external and intersegment net sales. Comments at the business unit level include external and inter- and intrasegment net sales. See Note 6 to the Condensed Consolidated Financial Statements.

*Grainger Branch-based*

In the first quarter of 2007, net sales of \$1,296.4 million increased by 10.1% compared to net sales of \$1,177.1 million in the first quarter of 2006. Sales in the United States were up 10.1%, with growth in all customer end markets, led by the government and commercial sectors. The Company's decision to wind down its low margin integrated supply contracts reduced sales growth by approximately 2 percentage points. Sales were positively affected by approximately 1 percentage point due to higher sales of seasonal products.

Market expansion contributed approximately 2 percentage points to the sales growth for the segment. Results for the market expansion program were as follows:

	2007 First Quarter Sales	Percent
	Increase	Complete
Phase 1 (Atlanta, Denver, Seattle)	14%	100%
Phase 2 (Four markets in Southern California)	6%	95%
Phase 3 (Houston, St. Louis, Tampa)	16%	95%
Phase 4 (Baltimore, Cincinnati, Kansas City, Miami, Philadelphia, Washington, D.C.)	11%	90%

The Company added approximately 25,000 new products in the most recently issued catalog as part of its ongoing product line expansion initiative. New products relating to this initiative contributed approximately 3 percentage points to the sales growth for the segment.

Sales in Mexico increased 19.5% in the first three months of 2007 versus 2006. In local currency, sales were up 24.2% driven by strong growth in the northeast and south central regions of the country as well as the addition of branches in Chihuahua and Santa Catarina in 2006.

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The segment gross profit margin increased 0.6 percentage point in the 2007 first quarter over the comparable quarter of 2006. The improvement in gross profit margin was primarily attributable to positive inflation recovery.

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**W.W. Grainger, Inc. and Subsidiaries**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Operating expenses in this segment were up 8.1% in the quarter. The operating expense growth was primarily driven by payroll and benefits, the result of increased headcount and higher incentive compensation, commission and profit sharing accruals.

Operating earnings were \$160.2 million for the first quarter of 2007 and increased 20.6% over \$132.9 million for the first quarter of 2006. The earnings improvement resulted from higher sales, improved gross profit margin and operating expenses growing at a slower rate than sales.

*Acklands - Grainger Branch-based*

Net sales for Acklands - Grainger in the first quarter of 2007 were 2.2% higher than the comparable quarter of 2006. In local currency, sales increased 3.7%, due to stronger sales in the oil and gas industries, partially offset by weakness in the mining, forestry and manufacturing industries.

The gross profit margin increased 2.7 percentage points in the 2007 first quarter over the comparable quarter of 2006. The improvement in gross profit margin was primarily due to price increases, higher supplier funding and vendor rebates, partially offset by higher freight costs.

Operating earnings of \$8.9 million in the first quarter of 2007 were up 130.7%, resulting from increased sales, higher gross profit margin and operating expenses growing slower than sales. This improvement in operating performance is consistent with the Company's expectations.

*Lab Safety*

Net sales for Lab Safety were \$109.1 million for the first quarter of 2007, an increase of \$5.2 million, or 5.0%, when compared with \$103.9 million for the same period in 2006. Sales from the acquisitions made during 2006 contributed approximately 6 percentage points to the growth.

The gross profit margin of 42.7% for the first quarter of 2007 decreased 0.9 percentage point from the first quarter of 2006. The gross profit margin was down as a result of customer and product mix and higher freight costs.

Operating expenses of \$32.0 million were \$2.0 million, or 6.5% higher in the quarter due primarily to higher media and information technology costs.

Operating earnings of \$14.6 million in the first quarter of 2007 were down 4.1% over 2006, resulting from lower gross profit margin and operating expenses which grew at a faster rate than sales.



*Income Taxes*

Grainger's effective tax rate was 38.6% for the first quarters of both 2007 and 2006. Excluding the effect of equity in unconsolidated entities, which is recorded net of tax, the effective income tax rate was 38.5% for the first quarter of 2007 and 38.9% for the first quarter of 2006. The full year 2006 rate was 36.4% and benefited from the resolution of uncertainties related to the audit of the 2004 tax year and from a reduction of deferred tax liabilities related to property, buildings and equipment.

**W.W. Grainger, Inc. and Subsidiaries**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**Financial Condition**

For the three months ended March 31, 2007, working capital of \$1,194.7 million increased by \$38.9 million when compared to \$1,155.8 million at December 31, 2006. The ratio of current assets to current liabilities was 2.8 at March 31, 2007, versus 2.6 at December 31, 2006.

Net cash provided by operating activities was \$82.4 million and \$26.9 million for the three months ended March 31, 2007 and 2006, respectively. Net cash flows from operating activities serve as the Company's primary source to fund its growth initiatives. Contributing to cash flows from operations were net earnings in the quarter of \$101.8 million and the change in non-cash items such as deferred income taxes and depreciation and amortization. Partially offsetting these amounts were Changes in operating assets and liabilities net of business acquisitions, which resulted in a net use of cash of \$58.1 million for the 2007 first quarter. The principal operating uses of cash were an increase in accounts receivables and a reduction of other current liabilities. The increase in receivables was due to a higher sales volume. Other current liabilities declined, primarily due to the timing of annual cash payments for prior year profit sharing and incentive compensation.

Net cash used in investing activities was \$20.6 million and \$48.6 million for the three months ended March 31, 2007 and 2006, respectively. In the first quarter of 2007, Grainger continued funding the Company's growth initiatives with its ongoing investment in the market expansion program. Cash expended for additions to property, buildings, equipment and capitalized software was \$35.8 million in the 2007 quarter versus \$30.4 million in the 2006 quarter. The 2006 first quarter included \$14.3 million for a business acquisition.

Net cash used in financing activities was \$85.2 million and \$29.4 million for the three months ended March 31, 2007 and 2006, respectively. Grainger's treasury stock purchases of \$98.7 million were \$62.8 million higher in the first three months of 2007 versus 2006 as Grainger repurchased 1.2 million shares compared with 0.5 million shares in the first three months of 2006. As of March 31, 2007, approximately 6.6 million shares of common stock remained available under Grainger's repurchase authorization. Dividends paid to shareholders were \$24.5 million and \$21.6 million for the first quarter of 2007 and 2006, respectively. Partially offsetting these financing cash outlays were proceeds and excess tax benefits realized from stock options exercised of \$38.1 million in 2007 versus \$28.1 million in 2006.

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 commercial paper sales and bank borrowings under lines of credit. Total debt as a percent of total capitalization was 0.4% at both March 31, 2007 and December 31, 2006.

**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 uncertain at the time the estimate is made and when different estimates than those management reasonably could have made have a material impact on the presentation of Grainger's financial condition, changes in financial condition or results of operations. For a description of Grainger's critical accounting policies see the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

**Forward-Looking Statements**

This document may contain forward-looking statements under the federal securities laws. The forward-looking statements relate to Grainger's expected future financial results and business plans, strategies and objectives and are not historical facts. They are often identified by qualifiers such as will, believes, intends, intended, expect, expects, expected, anticipate, estimated, assumption, may, tend, potential, complete, scheduled or similar expressions. There are risks and uncertainties the outcome of which could cause Grainger's results to differ materially from what is projected.

Factors that may affect forward-looking statements include the following: higher product costs or other expenses; a major loss of customers; increased competitive pricing pressure on Grainger's businesses; failure to develop or implement new technologies or other business strategies; the outcome of pending and future litigation and governmental proceedings; changes in laws and regulations; facilities disruptions or shutdowns; disruptions in transportation services; natural and other catastrophes; unanticipated weather conditions; and other difficulties in achieving or improving margins or financial performance.

Trends and projections could also be affected by general industry and market conditions, gross domestic product growth rates, general economic conditions, including industrial production, interest rate and currency rate fluctuations, global and other conflicts, job creation and employment levels in manufacturing, non-farm and other sectors, and other factors.

**W.W. Grainger, Inc. and Subsidiaries**

**PART I FINANCIAL INFORMATION**

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

For quantitative and qualitative disclosures about market risk, see Item 7A: Quantitative and Qualitative Disclosures About Market Risk in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

**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 first quarter, that have materially affected, or are reasonably likely to materially affect, Grainger's internal control over financial reporting.

**W.W. Grainger, Inc. and Subsidiaries****PART II OTHER INFORMATION**

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

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**  
**Issuer Purchases of Equity Securities First Quarter**

Period	Total Number of Shares Purchased (A)	Average Price Paid per Share (B)	Total Number of Shares Purchased as Part of Publicly Announced
Jan. 1 Jan. 31	39,632	\$70.49	36,600
Feb. 1 Feb. 28	336,200	\$78.14	336,200
Mar. 1 Mar. 31	812,335	\$75.66	800,500
Total	1,188,167	\$76.21	1,173,300

- (A) The total number of shares purchased includes Grainger's retention of 14,867 shares to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.
- (B) Average price paid per share includes any commissions paid and includes only those amounts related to purchases as part of publicly announced plans or programs. Activity is reported on a trade date basis.
- (C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors. On October 16, 2006, Grainger announced that its Board of Directors granted authority to repurchase up to 10 million shares. The program has no specified expiration date. No share repurchase plan or program expired or was terminated during the period covered by this report.

**Item 4. Submission of Matters to a Vote of Security Holders**

An annual meeting of shareholders of Grainger was held on April 25, 2007. At that meeting:

Management's nominees were elected directors for the ensuing year. Of the 74,974,693 shares present in person or represented by proxy at the meeting, the number of shares voted for, and the number of shares as to which authority to vote in the election was withheld, were as follows with respect to each of the nominees:



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

Name	Shares Voted for Election	Shares as to Which Voting Authority Withheld
B. P. Anderson	74,000,323	974,370
W. H. Gantz	73,471,344	1,503,349
V. A. Hailey	73,999,097	975,596
W. K. Hall	73,859,883	1,114,810
R. L. Keyser	73,405,009	1,569,684
S. L. Levenick	73,970,345	1,004,348
J. W. McCarter, Jr.	73,423,460	1,551,233
N. S. Novich	73,961,293	1,013,400
M. J. Roberts	73,952,400	1,022,293
G. L. Rogers	73,960,127	1,014,566
J. T. Ryan	73,616,577	1,358,116
J. D. Slavik	73,477,091	1,497,602
H. B. Smith	73,383,822	1,590,871

A proposal to ratify the appointment of Ernst & Young LLP as independent auditors of Grainger for the year ending December 31, 2007 was approved. Of the 74,974,693 shares present or represented by proxy at the meeting, 74,406,895 shares were voted for the proposal, 144,559 shares were voted against the proposal and 423,239 shares abstained from voting with respect to the proposal.

**Item 6. Exhibits**

- (a) Exhibits (numbered in accordance with Item 601 of Regulation S-K)
  - (11) Computations of Earnings per Share
  - (31) Rule 13a-14(a)/15d-14(a) Certifications
    - (a) Chief Executive Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
    - (b) Chief Financial Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - (32) Section 1350 Certifications
    - (a) Chief Executive Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
    - (b) Chief Financial Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

W.W. Grainger, Inc.  
(Registrant)

Date: May 1, 2007

By:

/s/ P. O. Loux  
P. O. Loux, Senior Vice President, Finance and Chief Financial  
Officer

Date: May 1, 2007

By:

/s/ R. L. Jadin  
R. L. Jadin, Vice President  
and Controller