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4Q12 Earnings Release Podcast Script
January 24, 2013

Introduction

Hello, this is Laura Brown, Senior Vice President of Communications and Investor Relations. With me is Bill Chapman, Senior Director of Investor Relations. The purpose of this podcast is to provide you with additional information regarding Grainger's fourth quarter 2012 results. Please also reference our 2012 fourth quarter earnings release issued today, January 24th, in addition to other information available on our Investor Relations website, to supplement this web cast.

Before we begin, please remember that certain statements and projections of future results made in the press release and in this web cast constitute forward-looking information. These statements are based on current market conditions and competitive and regulatory expectations and involve risk and uncertainty. Please see our Form 10-K for a discussion of factors that relate to forward-looking statements.

Company Results Summary

Today we reported record results for the year 2012 and reiterated our earnings per share guidance for 2013. We'll discuss 2012 in more detail as well as comment on January's strong sales start. At the very end of December we experienced a dramatic slowdown in sales contributing to quarterly performance that was below our guidance. In addition, there were three items included in our quarterly results that were not part of our November 14th, 2012 earnings guidance.

- A $0.18 per share charge primarily related to streamlining operations in Europe, India and China to improve the long-term performance of these businesses;
- A $0.03 per share charge related to the closure of branches in the United States; and
- A $0.04 per share impairment charge related to our Alliance Energy Solutions business acquired in November 2009. The impairment was caused by lower than expected operating performance.

A schedule detailing these items can be found in the earnings release. These three items combined represented a $0.25 reduction to earnings per share, resulting in adjusted fourth quarter EPS of $2.42. As a reminder, the 2011 fourth quarter included a $0.16 per share charge from the closure of 27 branches in the U.S. business and a $0.07 per share gain from the sale of our 49 percent ownership in a joint venture in Korea. These two items in 2011 represented a $0.09 net reduction to earnings per share, resulting in adjusted EPS of $2.13. Excluding the items noted above, net earnings for the 2012 quarter increased 12 percent and earnings per share increased 14 percent versus the prior year.

So, why did we fall below the low end of our EPS guidance, or $2.55, issued on November 14th of last year? There were 2 primary factors:

1. First, the sudden and dramatic sales slowdown in the last third of December did not allow us to pull back on operating expenses sufficiently to mitigate the negative operating leverage. To put this in perspective, in the U.S. Business, we were anticipating 7 percent daily sales growth in the first two-thirds of December and 1 percent daily sales growth in the final third of the month. Actual results were much lower with 5 percent daily sales growth in the first two-thirds of the month and a 13 percent daily sales decline in the last third of the month driven by the timing of the holidays and concerns regarding the economy and the fiscal cliff.

2. Second, legal, M&A and health care costs related to long term disability came in above our forecast.

Company sales for the quarter increased 7 percent versus the 2011 fourth quarter. We had 64 selling days in the quarter, one more than the previous year. Given the timing of the holidays in December, the additional selling day added a minimal amount of sales dollars and created a headwind to sales on a daily basis, which increased 6 percent. On a reported basis, operating earnings increased 17 percent, while net earnings increased 5 percent. Items below the operating line, such as other income / expense and tax rate, contributed to earnings performance and are discussed later in the podcast. Reported earnings per share were $2.17 for the quarter, representing an increase of 6 percent versus the 2011 fourth quarter.

In a few moments we will more fully analyze our sales results for the quarter. Let's now walk down the operating section of the income statement. Gross profit margins were flat at 43.6 percent versus 2011 as forecasted in our 2012 third quarter podcast. We'll provide more detail when we review the business by segment. Company operating margin increased 90 basis points to 11.6 percent versus 10.7 percent a year ago. The earnings growth was driven by the 7 percent sales increase and operating expenses growing at a slower rate than sales. Operating expenses grew 4 percent, including $1 million in incremental growth-related spending over the 2011 fourth quarter, to fund the growth programs, including new Territory Sales Representatives, eCommerce, advertising and incremental expenses for the company's distribution center network. Incremental growth spending for the full year 2012 was $71 million versus 2011. A schedule summarizing incremental growth spending for 2011 and 2012 can be found in exhibit 3 of this podcast.

Let's now focus on performance drivers during the quarter. In doing so, we'll cover the following topics:

- First, sales by segment in the quarter and the month of December,
- Second, operating performance by segment,
- Third, cash generation and capital deployment,
- And finally, we'll wrap up with a discussion of our 2013 guidance and other key items.

Quarterly Sales

As mentioned earlier, company sales for the quarter increased 7 percent on a reported basis and 6 percent on a daily basis. Daily sales growth by month was as follows: 6 percent in October, 8 percent in November, and 2 percent in December. The 6 percent increase in daily sales in the quarter included 3 percentage points from price, 2 percentage points from volume, 1 percentage point from acquisitions and 1 percentage point from Hurricane Sandy-related sales, partially offset by a 1 percentage point decline attributable to the timing of the December holidays and extended customer shutdowns tied to concerns about the economy and the fiscal cliff as explained in the earnings release.

Let's move on to sales by segment. We report two segments, the United States and Canada. Our remaining operations, located primarily in Asia, Europe and Latin America, are reported under a grouping titled Other Businesses.

Sales in the United States, which account for 75 percent of total company revenue, increased 5 percent in the quarter, 4 percent on a daily basis. The 4 percent daily sales growth for the quarter was driven by 3 percentage points from price, 1 percentage point from volume and 1 percentage point from Hurricane Sandy-related sales, partially offset by a 1 percentage point decline from the timing of the December holidays. Daily sales increased 4 percent in October, 6 percent in November and declined 1 percent in December.

Let's review sales performance by customer end market in the United States. Here is the sales performance for each respective customer end market in the quarter:

- Light Manufacturing was up in the high single digits;
- Heavy Manufacturing and Commercial were up in the mid-single digits;
- Government and Retail was up in the low single digits;
- Reseller was flat;
- Contractor was down in the low single digits; and
- Natural Resources was down in the mid-single digits.

Now let's turn our attention to the Canadian business. Sales in Canada represent 13 percent of total company revenues. For the quarter, sales in Canada increased 14 percent in U.S. dollars and 11 percent in local currency. On a daily basis, sales increased 13 percent and consisted of 8 percentage points from volume, 4 percentage points from foreign exchange, 1 percentage point from price and 1 percentage point from sales of seasonal products, partially offset by a 1 percentage point decline from the timing of the December holidays. By month, daily sales in Canadian dollars increased 12 percent in October, 8 percent in November and 5 percent in December. Sales performance in Canada was driven by strong growth in the western provinces, led by the Commercial, Oil & Gas, Construction and Utilities end markets.

Let's conclude our discussion of sales for the quarter by looking at the Other Businesses. Again, this group includes our operations primarily in Asia, Europe and Latin America and currently represents about 12 percent of total company sales. Sales for this group increased 16 percent, 14 percent on a daily basis, which consisted of 13 percentage points from volume and 5 percentage points from acquisitions, partially offset by a 3 percentage point decline from unfavorable foreign exchange and a 1 percentage point decline attributable to the timing of the holidays.

December Sales

Earlier in the quarter, we reported sales results for October and November and shared some information regarding performance in those months. Let's now take a look at December, which was worse than expected because of the timing of the holidays and customer spending pull backs related to the fiscal cliff. As mentioned previously, in the first two-thirds of the month, sales growth was tracking in the mid-single digits but sales declined in the last third of the month versus the prior year. We attribute some of this to the timing of the Christmas and New Year's holidays. In addition, we observed that concerns surrounding the economy and the fiscal cliff resulted in businesses and institutions implementing spending moratoriums. Many customers we spoke with closed their facilities during the back part of December and furloughed employees for an extended period over the holidays.

There were 20 selling days in December of 2012 versus 21 days in the same month of 2011. Total company sales increased 2 percent on a daily basis in December of 2012 versus December of 2011. The daily sales growth in December included 4 percentage points from volume, 2 percentage points from price, 1 percentage point from acquisitions, partially offset by a 4 percentage point decline from the timing of the holidays and a 1 percentage point decline from lower sales of seasonal products.

In the United States, December daily sales declined 1 percent. This decline was primarily related to a 4 percentage points decline from the timing of the December holidays and concerns about the fiscal cliff and a 1 percentage point decline from lower sales of seasonal products, partially offset by a 2 percentage point increase in volume and a 2 percentage point increase from price. December customer end-market performance in the United States was as follows:

- Heavy and Light Manufacturing were up in the low-single digits;
- Government, Commercial, Retail and Reseller were down in the low single digits;
- Contractor was down in the mid-single digits; and
- Natural Resources was down in the high-single digits.

Daily sales in Canada for December increased 9 percent in U.S. dollars, up 5 percent in local currency. The 9 percent daily sales growth consisted of 6 percentage points from volume, 4 percentage points from foreign exchange, 1 percentage point from price, 1 percentage point from sales of seasonal products, partially offset by a 3 percentage point decline due to the timing of the holidays. Similar to the quarter, sales growth in Canada was driven by strong performance in the Commercial, Oil & Gas, Construction and Utilities end markets.

Daily sales for our Other Businesses increased 14 percent in December, consisting of 16 percentage points from volume and 4 percentage points from acquisitions, partially offset by a negative 4 percentage points from the timing of the holidays and a negative 2 percentage points from unfavorable foreign exchange.

January Sales

Daily sales growth in the first 3 business days of January followed the same trend as the back third of December. Since that time, sales have rebounded nicely and are trending in the mid to high single digits. Keep in mind that we are up against a very strong comparison in January. Daily sales were up 17 percent in January of 2012 versus the prior year. We may be benefiting from some catch up from the sales decline in late December though that is difficult to determine for sure. January of 2013 will be the first month we include the incremental sales from Techni-Tool, the business we acquired on December 31st, which had 2011 sales of $88 million. Now I would like to turn the discussion over to Bill Chapman.

Operating Performance

Thanks Laura.

Since we have already analyzed company operating performance, let's jump right into performance by reporting segment. Operating earnings in the United States increased 17 percent versus the 2011 fourth quarter and the U.S. operating margin increased 160 basis points to 16.2 percent. Excluding $10 million and $18 million in charges during the 2012 and 2011 quarters, operating earnings increased 12 percent and the U.S. operating margin increased 110 basis points to 16.8 percent. This performance was driven by the 5 percent sales growth, higher gross profit margins and positive expense leverage. Gross profit margins for the quarter increased 50 basis points driven by price increases exceeding cost inflation, partially offset by unfavorable customer mix. Operating expenses grew at a slower rate than sales and included $1 million in incremental growth-related spending on areas such as new sales representatives, eCommerce and advertising.

Let's move on to our business in Canada. Operating earnings increased 2 percent versus the prior year, down 2 percent in local currency. The increase in operating earnings was driven by favorable foreign exchange and modest expense leverage, partially offset by lower gross profit margins. Gross margins in Canada decreased 150 basis points versus the prior year. The decline was primarily due to unfavorable customer and product sales mix. Lower gross margins and higher operating expenses contributed to a 130 basis point decline in operating margins to 10.7 percent.

Operating performance for our Other Businesses declined versus a year ago, posting a loss of $10.4 million for the quarter versus operating earnings of $5 million in 2011. During the quarter, we decided to implement the following structural changes to the businesses in Europe, India and China to improve long-term performance, resulting in $13.7 million in restructuring charges:

- In Europe, we closed six underperforming shops and reduced headcount to better align the business with the weak economy in Western Europe.
- In India and China, we are streamlining these businesses by narrowing the product offering and by reducing headcount.

Excluding these charges, the Other Businesses would have generated $3.3 million in operating earnings in the 2012 fourth quarter. This performance was primarily driven by the businesses in Japan and Mexico, partially offset by modest operating losses from the businesses in Brazil and Europe, before the restructuring charges.

Other

Below the operating line, the 2012 fourth quarter had $5 million in other expense versus $5 million in other income for the 2011 fourth quarter. This rounds to a $9 million negative swing, that was primarily due to an $8 million gain on the sale of our 49 percent ownership in MRO Korea that was recognized in the 2011 fourth quarter. In addition, interest expense net of interest income was $5 million in the 2012 fourth quarter versus $2 million in the 2011 quarter. The increase in interest expense was related to higher average borrowings, higher interest rates and capital leases for the acquired business in Europe.

For the quarter, the effective tax rate in 2012 was 37.6 percent versus 32.9 percent in 2011. The fourth quarter of 2011 included a benefit from the tax law change in Japan. For the year, the effective tax rate in 2012 was 37.5 percent versus 36.6 percent in 2011. In addition to the 2011 fourth quarter favorability, the company settled various tax reviews providing further benefit to the 2011 effective tax rate. Excluding these benefits in 2011, the effective tax rate was 38.1 percent. The effective tax rate in 2012 benefited primarily from a lower blended state tax rate. The company is currently projecting an effective tax rate of 37.3 to 37.7 percent for the year 2013.

Cash Flow

Lastly, let's take a look at cash flow for the quarter. Operating cash flow was $240 million versus $186 million in 2011. We used the cash generated during the quarter to invest in the business, fund an acquisition and return cash to shareholders through share repurchase and dividends. Capital expenditures for the quarter were $95 million versus $66 million in 2011. We paid dividends of $58 million in the quarter, reflecting the 21 percent increase in the quarterly dividend announced in April of 2012. In addition, we bought back 228,000 shares of stock for $44 million and ended the quarter with 5.3 million shares remaining on our share repurchase authorization. In total, we returned $102 million to shareholders in the quarter.

2013 Guidance

At our Analyst Meeting in November, we issued sales and earnings guidance for 2013. Today, we reiterated that earnings per share guidance of $10.85 to $12.00 reflecting confidence in our strategy and industry leading service. We also raised 2013 sales guidance to a new range of 3 to 9 percent growth to reflect the increase in sales from the December 31, 2012, acquisition of Techni-Tool, Inc. which had sales in 2011 of $88 million. Here are a few additional considerations as you refine your models:

1st Quarter 2013

1. The sales comparison in the 2013 first quarter is the most difficult of the year. We reported 16 percent sales growth in the 2012 first quarter.
2. We lose a selling day in the 2013 first quarter as we will have 63 selling days in 2013 versus 64 in 2012.
3. Good Friday falls in the 2013 first quarter. In 2012, the Easter holiday fell in the second quarter. Business typically slows around the Easter holiday, with Good Friday representing a very light day.
4. The company's annual customer trade shows held in the first quarter typically result in gross profit margins and operating expenses that are about 100 basis points above the run rate for the full year.

Full Year 2013

1. Sales comparisons get easier as we move through the year.
2. We anniversary the acquisition in Brazil in May of 2013.
3. Incremental growth spending in 2013 versus 2012 is still estimated to be $135 million, plus or minus $25 million depending on sales volume.
4. In aggregate, we are expecting 10 to 60 basis points of operating margin expansion versus 13.8 percent for 2012 after adjustments. Cost leverage should be a bit better than our original forecast, while gross margin expansion will be muted by the addition of Techni-Tool.

Conclusion

In conclusion, we remain confident in our strategy to gain share and extend our leadership position in the large and fragmented MRO market. Thank you for your interest in Grainger. Please mark your calendar for the release of January sales on Tuesday, February 12th. If you have any questions, please do not hesitate to contact Laura Brown at 847.535.0409 or me at 847.535.0881.

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Exhibit 1

2013 Guidance

	January 24, 2013	November 14, 2012
Sales ($B)	$ 9.3 - $9.8	$ 9.2 - $9.7
V% vs. prior yr.	3% - 9%	2% - 8%
Op Margin	13.9% - 14.4%	14.0% - 14.5%
bps vs. prior yr.	10 - 60	0 - 50
EPS	$10.85 - $12.00	$10.85 - $12.00

Notes: 1) As of January 24, 2013.
2) Excluding adjustments noted in the fourth quarter 2012 earnings release, 2012 full year operating margin was 13.8% and earnings per share were $10.43.

Exhibit 2

2013 Sales Guidance

	2013 E
Economy/Volume	0% - 5%
Price	2% - 3%
Organic Sales	2% - 8%
F/X, Sales Days	0%
Acquisitions	1%
Company Sales	3% - 9%

Note: As of January 24, 2013.

Exhibit 3

Incremental Growth Spending
($ in Millions)

	2012 Incremental vs. 2011	2011 Incremental vs. 2010
1Q	$27	$7
2Q	$24	$11
3Q	$19	$19
4Q	$1	$30
FY	$71	$66

Notes: 1) As of January 24, 2013.
2) The company expects 2013 incremental growth spending of $135 million, +/- $25 million.

Exhibit 4

Selling Days: 2013 vs. 2012

Month	2013	2012	Difference
January	22	21	1
February	20	21	-1
March	21	22	-1
1Q	63	64	-1
April	22	21	1
May	22	22	0
June	20	21	-1
2Q	64	64	0
July	22	21	1
August	22	23	-1
September	20	19	1
3Q	64	63	1
October	23	23	0
November	20	21	-1
December	21	20	1
4Q	64	64	0
Full Year	255	255	0