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2Q14 Earnings Podcast Script
July 17, 2014

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 2014 second quarter results. Please also reference our 2014 second quarter earnings release issued on July 17th, in addition to other information available on our Investor Relations website, to supplement this podcast.

Before we begin, please remember that certain statements and projections of future results made in the press release and in this podcast 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 results for the 2014 second quarter and updated our sales and earnings per share guidance for 2014. While there are several moving parts this quarter, we continue to be pleased with the U.S. segment, which represents 78 percent of sales and the majority of company earnings. In addition, our three most recent U.S. acquisitions are exceeding our sales and earnings expectations. Furthermore, the investments we continue to make in growth and infrastructure are helping us gain share with our large, more complex customers who appreciate our value proposition.

Before we discuss our results, I'd like to highlight a non-cash charge included in the second quarter:

- Fabory, our business in Europe, recorded a $10 million after-tax, or $0.15 per share, charge related to the replacement of its existing defined benefit pension plan with a defined contribution plan. As part of the transition, Fabory transferred the plan assets and its existing and future obligations under the defined benefit plan to a third party. The recognition of actuarial losses, combined with a write-off of the related asset and liability, resulted in this charge. The change will create better alignment with market trends in the Netherlands and help reduce future benefits costs to the company.

Excluding this non-cash charge from the 2014 second quarter, company operating earnings increased 1 percent, while net earnings declined 1 percent. Adjusted earnings per share were $3.09 for the quarter, a 2 percent increase versus $3.03 in 2013.

Now let's look at our reported results for the 2014 second quarter. Company sales for the quarter increased 5 percent versus the 2013 second quarter. There were 64 selling days in both quarters. Reported operating earnings decreased 3 percent and net earnings decreased 5 percent. Reported earnings per share were $2.94 for the quarter, a decline of 3 percent versus the 2013 second quarter. We also lowered the top end of our 2014 guidance range for sales and narrowed our expectations for earnings per share, which Bill will cover in detail at the end of the podcast. Our 2014 guidance issued on January 24, 2014, called for sales growth of 5 to 9 percent and earnings per share of $12.10 to $12.85. We now expect 2014 sales growth of 5 to 7 percent and earnings per share of $12.20 to $12.60. Please note, the earnings per share guidance excludes the $0.15 per share charge in the 2014 second quarter. Despite the lower sales outlook for the year, we expect 10 to 30 basis points of operating margin expansion for the year.

Let's now walk down the operating section of the income statement in more detail. Gross profit margins in the second quarter decreased 90 basis points to 43.1 percent versus 44.0 percent in 2013, due primarily to unfavorable mix from the acquired businesses, faster growth with lower gross margin customers in the United States and lower gross profit margins from the international businesses. Operating expenses for the company increased 6 percent, driven by the following:

- $20 million in incremental growth and infrastructure spending;
- $14 million related to the Fabory retirement plan transition costs noted earlier;
- Incremental expenses from the acquired businesses; and
- $7 million related to a write-off of capitalized software development costs primarily for Canada and Mexico.

In the second quarter, growth spending was lower than previously estimated primarily due to timing of supply chain investments. In the first quarter of 2014, we had forecasted $115 million in incremental growth-related investments for the year. We continue to invest in our growth drivers but now estimate incremental growth-related spending of $90 to $110 million for 2014. We view our commitment to investing in growth as an example of our leadership in the MRO industry that will help us gain market share over the long term.

Given that we are at the mid-year point, we thought it would be helpful to provide an update on our growth drivers:

- **eCommerce:** Our eCommerce sales continue to grow at twice the rate of our other channels. For the first half of 2014, eCommerce represented 35 percent of total company sales, up 200 basis points from full year 2013.

- **Inventory Management:** We added more than 7,400 Keepstock installations in the United States in the first half of the year and are targeting 12,000 installations for the full year. Outside of the United States, primarily in Canada, we added more than 1,200 KeepStock installations in the first six months of the year. Sales to customers with inventory management grow at twice the rate of sales to customers without this service.
- **Distribution Network:** We enhanced our North America distribution center network to accommodate growth and increase scale. We continued construction of a 500,000 square-foot distribution center in the Toronto area, expected to be operational by early 2015. We also purchased land to build a 1.3 million square-foot facility in New Jersey, which is scheduled to open in 2016. The new distribution center will add needed supply chain capacity to our highest volume region in the United States.
- **Single Channel Online Model:** Sales for MonotaRO, our online business in Japan, grew more than 30 percent in local currency. Revenue for Zoro grew more than 120 percent.
- **Sales Force Expansion:** We added approximately 70 new sales representatives in the United States in the first half of the year and expect to hire more by year-end.
- **M&A:** The three recently acquired businesses in the United States, Techni-Tool, E&R and Safety Solutions, are outperforming our sales and earnings projections and remain on track with our integration plans.

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 June,
- Second, operating performance by segment,
- Third, cash generation and capital deployment and
- Finally, we'll wrap up with a discussion of our 2014 guidance and other key items.

Quarterly Sales

As mentioned earlier, company sales for the quarter increased 5 percent. Daily sales growth by month was as follows: 5 percent in April, 6 percent in May and 4 percent in June. Results for the quarter included 2 percentage points from acquisitions, net of dispositions, and a 1 percentage point reduction from foreign exchange. Excluding acquisitions and foreign exchange, organic sales increased 4 percent driven by 5 percentage points from volume partially offset by 1 percentage point from the timing of Good Friday. Good Friday fell in April 2014 versus March 2013. Good Friday is typically a day of slower customer activity in the United States with operations closed in Canada and much of Latin America.

Let's move on to sales by segment. We report two business segments, the United States and Canada. Our remaining operations are reported under Other Businesses.

Sales in the United States, which accounted for 78 percent of total company revenue in the quarter, increased 7 percent. Results for the quarter included 2 percentage points from acquisitions, net of dispositions. Excluding acquisitions, organic sales increased 5 percent driven by 6 percentage points from volume partially offset by a 1 percentage point decline from the timing of Good Friday.

Let’s review sales performance by customer end market in the United States:

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

Now let’s turn our attention to the Canadian business. Sales in Canada represented 10 percent of total company revenues. For the quarter, sales decreased 9 percent in U.S. dollars versus the prior year and were down 3 percent in local currency. The 3 percent sales decline consisted of 2 percentage points from the timing of Good Friday and a 1 percentage point decline from volume. Declines during the quarter in the Construction, Mining, Oil and Gas, Government, Light Manufacturing and Reseller customer end markets more than offset growth to customers in the Commercial, Forestry, Utilities, Transportation, Heavy Manufacturing and Retail end markets. Canada’s sales results continue to be affected by macroeconomic weakness and softness in natural resources.

Let’s conclude our discussion of sales for the quarter by looking at the Other Businesses, which represented 12 percent of total company sales. Sales for this group increased 14 percent for the 2014 second quarter versus the prior year. The sales growth consisted of 16 percentage points from volume and price, partially offset by a 2 percentage points decline from unfavorable foreign exchange. The sales increase was primarily due to growth from Zoro and the business in Japan, which more than offset a modest sales decline in Europe.

June Sales

Earlier in the quarter, we reported sales results for April and May and shared some information regarding performance in those months. Let's now take a look at June. There were 21 selling days in June of 2014 versus 20 days in the same month of 2013. Daily company sales increased 4 percent in June of 2014 versus June of 2013. The daily sales increase included 2 percentage points from acquisitions, net of dispositions, and a 1 percentage point reduction from foreign exchange. Excluding acquisitions and foreign exchange, organic daily sales increased 3 percent driven by 4 percentage points from volume partially offset by a 1 percentage point decline from lower sales of seasonal products.

In the United States, June daily sales increased 6 percent driven by 5 percentage points from volume, 2 percentage points from acquisitions, net of dispositions, partially offset by a 1 percentage point decline from lower sales of seasonal products. June customer end market performance in the United States was as follows:

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

Daily sales in Canada for June decreased 7 percent in U.S. dollars and were down 2 percent in local currency. The 2 percent decline consisted of a 2 percentage points decline from sales related to floods in Calgary in 2013, a 1 percentage point decline from lower sales of seasonal products and a 1 percentage point decline from the timing of the Canada Day holiday. Canada Day fell on Tuesday, July 1st, this year. Many businesses were either closed or had much lower activity on Monday, June 30th. In 2013, the holiday fell on Monday, July 1st, with little to no effect on June sales. The sales decrease was partially offset by a 1 percentage point increase from volume and a 1 percentage point increase from price. Excluding the headwinds noted above, daily sales increased 2 percent in local currency.

The 2 percent daily sales decrease in local currency in Canada was related to declines in the Construction, Mining, Government, Light Manufacturing and Retail customer end markets more than offsetting growth to customers in the Commercial, Heavy Manufacturing, Forestry, Utilities, Transportation and Oil and Gas end markets.

Daily sales for our Other Businesses increased 9 percent in June, consisting entirely of volume and price. The daily sales increase was primarily due to strong revenue growth from Zoro and the businesses in Japan and Mexico. Daily sales growth during June in Japan dropped to low double digits due to one less selling day in the month.

July Sales

Sales growth in the month of July is currently trending ahead of the growth rate reported for June, including a benefit from the favorable timing of the July 4th holiday. In addition, daily sales to date in Canada are growing in the low single digits in local currency.

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 talk about performance by reportable segment.

In the United States, gross profit margins for the quarter declined 80 basis points due to mix from the acquired businesses and faster growth with lower gross margin customers. Operating expenses increased 3 percent including $19 million in incremental growth-related spending on areas such as new sales representatives, eCommerce and advertising. Operating earnings for the U.S. segment increased 8 percent in the quarter driven by the 7 percent sales growth and positive operating expense leverage, partially offset by lower gross profit margins.

Let's move on to our business in Canada. Operating earnings in Canada declined 48 percent in the 2014 second quarter and were down 45 percent in local currency. The earnings decline was primarily driven by lower sales, a lower gross profit margin and negative operating expense leverage. The gross profit margin in Canada declined 200 basis points versus the prior year primarily due to unfavorable foreign exchange from products sourced from the United States, inventory markdowns and higher freight costs. The increase in operating expenses was primarily driven by the IT write-down and non-reoccurring expenses. The company made the decision to move ahead with a single ERP instance versus multiple instances in North America. As a result, $4 million of capitalized software development costs related to a multiple instance approach were written-off and an incremental $1 million was spent on the implementation of the single instance in Canada.

Operating earnings for the Other Businesses were roughly breakeven in the 2014 second quarter versus $13 million in the 2013 second quarter. Lower performance versus the prior year was primarily driven by the $14 million cost incurred for the retirement plan transition in Europe and the write-off of approximately $2 million of capitalized software development in Mexico. Excluding these two items, the Other Businesses generated $15 million in operating earnings. Increased earnings from Zoro and Japan were tempered by the businesses in China and Latin America.

Other

Below the operating line, other income and expense was a net $2.3 million expense in the 2014 second quarter versus a net $2.6 million expense in the 2013 second quarter.

The tax rate in the quarter was 38.2 percent versus 36.5 percent in the 2013 quarter. The 2014 second quarter reflects a higher tax rate due to the effect of the retirement plan transition in Europe. Excluding the retirement plan transition, the effective tax rate for the 2014 second quarter was 37.7 percent. The 2013 second quarter tax rate reflected a benefit from a resolution of foreign tax matters in that period. Excluding that benefit, the effective tax rate for the 2013 second quarter was 37.3 percent. The company projects an effective tax rate for the year 2014 of approximately 37.5 to 37.8 percent, excluding the effect of the retirement plan transition.

Cash Flow

Lastly, let's take a look at cash flow for the quarter. Operating cash flow was $161 million versus $210 million in 2013. Cash generation from operations and cash on hand was lower in the 2014 quarter due to higher inventory purchases and higher tax payments versus the prior year. The company used the cash to invest in the business and return cash to shareholders through share repurchases and dividends. Capital expenditures for the quarter were $90 million, which included the purchase of land for a new distribution center in New Jersey, versus $40 million in 2013. We paid dividends of $76 million, reflecting the 16 percent increase in the quarterly dividend announced in April of 2014. In addition, we bought back 334,000 shares of stock for $85 million and ended the quarter with 9.9 million shares remaining on our share repurchase authorization. In total, we returned $161 million to shareholders in the quarter.

2014 Guidance

As reported in our 2014 second quarter earnings release, we lowered the top end of our 2014 sales guidance and narrowed earnings per share guidance. We now expect 5 to 7 percent sales growth and earnings per share of $12.20 to $12.60. Let's look more closely at our current expectations:

1. Let's begin with sales. The new guidance range implies roughly 5 to 9 percent daily sales growth for the remainder of the year. This outlook anticipates easier comparisons versus the prior year.

2. Now let's discuss gross profit margins. For the full year, on an organic basis, we expect gross margins to expand as much as 10 basis points. On a reported basis, we are forecasting gross margins to be down 20 basis points versus 2013 primarily due to lower gross margin from the mix of the acquired businesses.

3. Let's take a closer look at company operating margin expectations. For the full year, on an organic basis, we expect 15 to 35 basis points of operating margin expansion. On a reported basis, we are forecasting full year operating margin expansion of 10 to 30 basis points.

4. Looking ahead to the back half of the year, while we acquired the E&R business in August of 2013, we did not begin consolidating the results until the fourth quarter.

5. And, as we discussed earlier, we anticipate overall growth and infrastructure spending at a slower rate primarily based on timing of projects and a weaker economic outlook.

And lastly, we would like to leave you with one modeling tip. Please be sure to review the bottom of the income statement for the calculation of net earnings available to common shareholders.

Important Dates

Finally, please mark your calendar for the following important dates:

- On August 6th at 9:15 a.m. ET., Laura Brown, Senior Vice President, Corporate Communication and Investor Relations will present at the CFA Society of Minnesota Conference in Minneapolis, MN. The presentation will be webcast on the Investor Relations section of our website.
- On August 13th we plan to release July sales.
- On September 16th at 12:45 p.m. ET, we will present at the 2nd Annual Morgan Stanley Laguna Conference in Dana Point, CA. The presentation will also be webcast on the Investor Relations section of our website.
- On October 16th we are scheduled to report third quarter results.
- And finally, we will host our Annual Analyst Meeting on November 12th, which will be held at our headquarters in Lake Forest, IL.

If you have any questions, please do not hesitate to contact Laura Brown at 847.535.0409, Casey Darby at 847.535.0099 or me at 847.535.0881. Thank you for your interest in Grainger.

Exhibit 1

2014 Second Quarter Adjusted EPS

	Three Months Ended June 30, 2014	2013	% Change
Diluted Earnings Per Share as reported:	$2.94	$3.03	-3%
Retirement plan transition in Europe	0.15		
Diluted Earnings Per Share as adjusted:	$3.09	$3.03	2%

Exhibit 2

Sales Guidance

	July 17, 2014	April 16, 2014	January 24, 2014	November 13, 2013
Economy/Volume	5% - 7%	5% - 8%	4% - 8%	4% - 8%
Price	0%	0% - 1%	1%	1%
Organic Sales	5% - 7%	5% - 9%	5% - 9%	5% - 9%
F/X	-1%	-1%	-1%	0%
Acquisitions	1%	1%	1%	1%
Company Sales	5% - 7%	5% - 9%	5% - 9%	6% - 10%

Note: As of July 17, 2014.

Exhibit 3
2014 EPS Guidance (1)
Total Company

	July 17, 2014	January 24, 2014	November 13, 2013
Sales ($B)	$9.9 - $10.1	$9.9 - $10.3	$10.1 - $10.4
V% vs. prior yr.	5% - 7%	5% - 9%	6% - 10%
Op. Margin	14.2% - 14.4%	14.2% - 14.6%	14.3% - 14.6%
bps vs. prior yr.	10 - 30	10 - 40	0 - 30
EPS	$12.20 – $12.60(2)	$12.10 - $12.85	$12.25 - $13.00

Note: (1) As of July 17, 2014.
(2) Earnings per share guidance excludes $0.15 per share charge from the 2014 second quarter.

Exhibit 4
2014 EPS Guidance (1)
Organic

	July 17, 2014	January 24, 2014	November 13, 2013
Sales ($B)	$9.8 - $10.0	$9.7 - $10.3	$10.1 - $10.4
V% vs. prior yr.	5% - 7%	5% - 9%	5% - 9%
Op. Margin	14.4% - 14.6%	14.6% - 14.9%	14.5% - 14.8%
bps vs. prior yr.	15 - 35	15 - 45	15 - 45
EPS	$12.25 – $12.65(2)	$12.15 - $12.95	$12.25 - $12.98

Notes: (1) As of July 17, 2014.
(2) Excludes E&R and Safety Solutions acquisitions and foreign exchange.
(3) Earnings per share guidance excludes $0.15 per share charge from the 2014 second quarter.

Exhibit 5
Incremental Growth Spending
($ in Millions)

	2014 Incremental vs. 2013	2013 Incremental vs. 2012	2012 Incremental vs. 2011	2011 Incremental vs. 2010
1Q	$31	$22	$27	$7
2Q	$20	37	24	11
3Q	$27E	40	19	19
4Q	$22E	31	1	30
FY	$100E (2)	$132	$71	$67

Notes:(1) As of July 17, 2014.
(2) The company expects 2014 incremental growth spending of $90-110 million. The $100 million estimate represents the mid-point of the range.

Exhibit 6
Acquisition / Divestiture Schedule

Acquired / Divested	Date	Revenue
Techni-Tool (Acquired)	December 31, 2012	2011 Sales of $88 Million
E&R Industrial, Inc. (Acquired)(1)	August 23, 2013	2012 Sales of $180 Million
Safety Solutions, Inc. (Acquired)	December 2, 2013	2012 Sales of $63 Million
Specialty Brands (Divested)	December 31, 2013	2013 Sales of $96 Million

Note: (1) E&R results were first consolidated in the fourth quarter of 2013.

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Exhibit 7
Selling Days: 2014 vs. 2013

Month	2014	2013	Difference
January	22	22	0
February	20	20	0
March	21	21	0
1Q	**63**	**63**	**0**
April	22	22	0
May	21	22	-1
June	21	20	1
2Q	**64**	**64**	**0**
July	22	22	0
August	21	22	-1
September	21	20	1
3Q	**64**	**64**	**0**
October	23	23	0
November	19	20	-1
December	22	21	1
4Q	**64**	**64**	**0**
Full Year	**255**	**255**	