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3Q16 Earnings Podcast Script
October 18, 2016

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 2016 third quarter results.

This podcast supplements our 2016 third quarter earnings release issued today, October 18th, and other information available on our Investor Relations website. This material contains forward looking statements that are based on our current view of the competitive market and the overall environment. Future risks and uncertainties could cause our actual results to differ materially. Please see our SEC filings, including our most recent periodic reports filed on Form 10-K and Form 10-Q, which are available on our Investor Relations website, for a discussion of factors that may affect our forward-looking statements.

Company Results Summary

Today we reported results for the 2016 third quarter and updated our sales and earnings per share guidance for the full year to reflect our performance to date and the challenging industrial economy.

Before we begin our review of results, I'd like to remind you of the adjustments to reported results in the third quarters of 2016 and 2015. In general, we adjust the reported results to exclude any items that are unrelated to the ongoing operations of the business. We believe this gives investors a better view of our core operational performance. Tables reconciling reported to adjusted results and other non-GAAP measures accompany today's earnings release and the transcript of this podcast, both of which are available on our Investor Relations website.

The 2016 third quarter included restructuring charges in the U.S. and Canadian segments. In both countries, we are closing branches and reducing headcount to proactively address changes in customer buying behavior and better position the business for profitable growth. These actions had a net charge of $0.01 to earnings per share. In 2015, we took restructuring actions that resulted in net charges of $0.11 per share. <u>All figures from this point forward represent adjusted amounts unless specifically noted.</u>

With that as a backdrop, let's look at our results for the 2016 third quarter. Company sales for the quarter increased 3 percent versus the 2015 third quarter. Excluding acquisitions and foreign exchange, organic sales were flat. There were 64 selling days in both quarters. Operating earnings decreased 5 percent, and net earnings decreased 6 percent. Earnings per share were $3.06, up 1 percent versus the prior year.

Bill will cover our revised guidance in detail at the end of the podcast. We now expect 2016 sales growth of 1.5 to 2.5 percent and earnings per share of $11.40 to $11.70. Our 2016 guidance issued on July 19, 2016, was 1 to 4 percent sales growth and earnings per share of $11.20 to $12.20.

Let's now walk down the operating section of the income statement in more detail. Gross profit margins in the third quarter decreased 180 basis points to 40.1 percent versus 41.9 percent in 2015, due primarily to unfavorable customer mix and modest negative price-cost mix in the United States and price deflation versus product cost inflation in Canada. Operating expenses for the company were essentially flat. We attained positive expense leverage as operating expenses as a percent of sales were 27.3 percent, down 80 basis points versus the prior year. The third quarter benefited from operating expense favorability from the timing of certain professional expenses and other program-related expenses. Total company operating earnings were $332 million, a decrease of

5 percent versus the prior year. Company operating margin for the quarter was 12.8 percent, a decline of 110 basis points versus the 2015 quarter.

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 September,
- Second, operating performance by segment,
- Third, cash generation and capital deployment and
- Finally, we'll wrap up with a discussion of our 2016 guidance.

Quarterly Sales

Before we begin our sales discussion, please note that some of our businesses have a different number of selling days due to local holidays. Despite this, we use the number of selling days in the United States as the basis for our calculation of daily sales.

As mentioned earlier, company sales for the quarter increased 3 percent. Daily sales performance by month was as follows: up 3 percent in July, up 4 percent in August and flat in September. Excluding the Cromwell acquisition in the first two months of the quarter, sales performance by month was down 1 percent in July, up 1 percent in August and flat in September. Results for the quarter included 2 percentage points from the Cromwell acquisition, which we anniversaried on September 1, and 1 percentage point contribution from foreign exchange. Excluding acquisitions and foreign exchange, organic sales were flat consisting of a 1 percentage point contribution from sales of seasonal products offset by a 1 percentage point decline in price.

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 74 percent of total company revenue in the quarter, decreased 1 percent. Results for the quarter included a 1 percentage point decline from volume and a 1 percentage point decline from price, partially offset by 1 percentage point from intercompany sales, primarily to Zoro.

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

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

We believe that growth in the Government and Retail end markets was primarily a function of share gain as we outperformed our estimated growth of the market.

Now let's turn our attention to the Canadian business. Sales in Canada represented 7 percent of total company revenues. Sales for the quarter decreased 16 percent in U.S. dollars and local currency, consisting of a 15 percentage point decline in volume and a 1 percentage point decline in price. All end markets in Canada were down for the quarter. From a geographic standpoint, sales in Alberta were down 22 percent, compared to all other provinces which were down 12 percent in aggregate. In addition to a challenging economy, we are aggressively working through process standardization and change management related to the new IT system and expect improvement in the coming months.

Let's conclude our discussion of sales for the quarter by looking at the Other Businesses, which represented 19 percent of total company sales. Sales for the Other Businesses increased 36 percent, consisting of 16 percentage points from the Cromwell acquisition, 15 percentage points from volume and price and 5 percentage points from foreign exchange. The organic sales increase was primarily due to growth from the single channel online businesses of Zoro U.S. and MonotaRO.

September Sales

Earlier in the quarter, we reported sales results for July and August and shared some information regarding performance in those months. Let's now take a look at September. There were 21 selling days in September of 2016, the same as 2015. Company sales were essentially flat in September versus the prior year. The sales performance consisted of 1 percentage point from volume offset by a 1 percentage point decline in price.

In the United States, September daily sales were flat, driven by 1 percentage point from intercompany sales, primarily to Zoro, offset by a 1 percentage point decline from price. September customer end market performance in the United States was as follows:

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

The benefit often seen from federal government customers at the September fiscal year end appears to have been realized a month early, as we saw strong growth to that end market in August. In addition, the strong sales of seasonal products that benefited August did not continue into September.

Sales in Canada for September were down 14 percent in U.S. dollars and 15 percent in local currency. The 15 percent decrease was driven by a 15 percentage point decline in volume. All end markets except Light

Manufacturing were negative. From a geographic standpoint, sales in Alberta were down 22 percent, compared to all other provinces which were down 13 percent in aggregate. As mentioned in the quarter recap, we are aggressively working through process standardization and change management related to the new IT system.

Sales for our Other Businesses increased 17 percent in September, consisting of 14 percentage points from volume and price and 3 percentage points from foreign exchange. September was the first month where Cromwell sales were already included in the base results. The organic sales increase was primarily due to strong revenue growth from Zoro U.S., MonotaRO in Japan and the business in Mexico.

October Sales

Sales growth in the month of October to date is slightly below the sales performance in September. Multiple branches in the southeast and the distribution center in Jacksonville, FL, were closed earlier this month due to Hurricane Matthew. We believe there may be an effect on October sales, but it is too early to quantify that impact or any possible cleanup benefit.

Now I would like to turn the discussion over to Bill Chapman.

Operating Performance

Thanks Laura. Let's talk about performance by reportable segment since we have already analyzed company operating performance. As a reminder, all figures below represent results adjusted for restructuring charges that Laura discussed earlier.

In the United States, operating earnings decreased 6 percent in the quarter driven by lower sales and lower gross profit margins. Gross profit margins for the quarter declined 130 basis points primarily driven by negative customer selling mix and price deflation exceeding product cost deflation. Operating expenses were down 2 percent due to lower payroll and benefits costs. The operating margin for the U.S. segment was 17.2 percent versus 18.1 percent in the 2015 quarter.

Let's move on to our business in Canada, which had an operating loss of $11 million in the quarter versus operating earnings of $5 million in the 2015 third quarter, driven primarily by lower sales and lower gross profit. The gross profit margin in Canada declined 520 basis points versus the prior year, driven by product cost inflation and unfavorable foreign exchange from products sourced from the United States. Due to service gaps stemming from the systems transition, we have not passed on price increases to customers this year, and this is putting pressure on our gross profit margins. Operating expenses were down 9 percent versus the 2015 quarter driven by lower SAP costs and lower headcount. The new IT system continues to be a change management challenge for this business. However, we are making progress in areas such as direct to customer shipping, which has steadily increased each quarter this year. In the third quarter, 38 percent of shipments went direct to the customer, bypassing the branch network. We will provide more detail about the Canadian business at our Analyst Meeting in November.

Operating earnings for the Other Businesses were $25 million in the 2016 third quarter versus $15 million in the prior year, representing an earnings increase of 68 percent. Results included strong performance from Zoro U.S. and Japan and the earnings contribution from Cromwell.

Other

Below the operating line, other income and expense was a net $29 million expense in the 2016 third quarter versus a net $21 million expense in the 2015 third quarter. The increase was driven by higher interest expense from the company's $400 million debt offering in May of 2016. Operating losses from the clean energy investments were higher as a result of higher demand from a warm summer, resulting in a higher overall benefit to the company, net of tax credits.

Income Tax

For the quarter, the reported effective tax rate in 2016 was 34.0 percent versus 38.4 percent in 2015. The year-over-year decrease in the tax rate was primarily due to a higher benefit from the company's clean energy investments partially offset by a larger proportion of earnings from higher tax rate jurisdictions. The 2016 third quarter also included a benefit from the conclusion of the federal income tax audit for the years 2009 through 2012 and other discrete items. Excluding the discrete items, the company's effective tax rate was 36.1 percent. We currently project an effective tax rate, excluding discrete items, of 36.1 to 37.1 percent for the full year 2016 versus 36.8 to 37.8 percent provided on July 19, 2016. This decrease is driven by the expectation of a higher benefit from the clean energy investments, partially offset by a larger proportion of earnings from higher tax rate jurisdictions.

Cash Flow

Lastly, let's take a look at cash flow for the quarter. Operating cash flow was $344 million versus $366 million in 2015, primarily the result of lower net income. We used the cash generated during the quarter and proceeds from the May 2016 debt offering to invest in the business and return cash to shareholders through share repurchase and dividends. We returned a total of $275 million to shareholders in the quarter including $74 million in dividends, reflecting the 4 percent increase in the quarterly dividend announced in April of 2016. In addition, we bought back 887,000 shares of stock for $201 million in the third quarter. Capital expenditures were $108 million in the quarter versus $82 million in the third quarter of 2015.

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2016 Guidance

As reported in our 2016 third quarter earnings release, we updated our 2016 guidance. For the full year 2016, we now expect 1.5 to 2.5 percent sales growth and earnings per share of $11.40 to $11.70. Let's look more closely at our current expectations:

1. We'll begin with sales:
    a. For the full year, our guidance is lowered to reflect year-to-date performance and the expectation of continued modest sales growth in the fourth quarter. As a reminder, we will have 63 selling days in the 2016 fourth quarter, one fewer than the 64 selling days in the 2015 fourth quarter.

2. Moving on to gross profit margins:
    a. For the full year, we expect gross profit margins to be down 170 to 180 basis points. We continue to see gross profit pressure due to unfavorable price-cost spread for the businesses in the United States and Canada, along with faster growth with the lower margin single channel businesses. We expect gross margin pressure to continue into the fourth quarter.

3. Let's take a closer look at operating margin expectations:
    a. For the full year, we now anticipate operating margin of 12.3 to 12.5 percent, down 100 to 120 basis points. For the fourth quarter, we expect operating expenses to increase as a percentage of sales versus the 2016 third quarter, reflecting:
        i. The loss of a selling day;
        ii. Three months of depreciation for the new distribution center in New Jersey versus two months in the 2016 third quarter;
        iii. The hiring of 30 new inside sales representatives in the fourth quarter to call on medium-sized customers given the

success of the first 275 inside sales reps added in the 2016 second quarter.

iv. The operating expense favorability in the 2016 third quarter related to the timing of program-related expenses and professional services that are not expected to repeat in the 2016 fourth quarter.

4. Finally, earnings per share:
    a. As noted earlier, we now expect 2016 EPS of $11.40 to $11.70.
    b. For the full year, we now expect a $0.10 benefit to earnings per share in 2016 from the two clean energy investments, compared to the prior projection of a $0.07 benefit on July 19, 2016. Through the first nine months of the year we have realized a $0.06 per share benefit from the investments. Please see Exhibit 4 for more detail.

<u>Important Dates</u>

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

- We will host our Annual Analyst Meeting on the morning of Friday, November 11th, which will be held at our headquarters in Lake Forest, IL.
- We also plan to release October sales on November 11th.
- On Tuesday, November 15th, we will participate in the Barclays Select Series: Industrial Distribution Forum in New York, NY.

If you have any questions, please do not hesitate to contact Laura Brown at 847.535.0409, Michael Ferreter at 847.535.1439 or me Bill Chapman, at 847.535.0881. Thank you for your interest in Grainger.

Exhibit 1
2016 Reported and Adjusted Reconciliations

The company supplemented the reporting of financial information determined under U.S. generally accepted accounting principles (GAAP) with certain non-GAAP financial measures, which the company refers to as "adjusted" measures, including adjusted operating earnings, adjusted segment operating earnings, adjusted net earnings and adjusted diluted earnings per share. Adjusted measures exclude items that may not be indicative of core operating results. The company believes that these non-GAAP measures provide meaningful information to assist shareholders in understanding financial results and assessing prospects for future performance. Management believes adjusted operating earnings, adjusted net earnings and adjusted diluted earnings per share are important indicators of operations because they exclude items that may not be indicative of our core operating results, and provide a better baseline for analyzing trends in our underlying businesses. Because non-GAAP financial measures are not standardized, it may not be possible to compare these financial measures with other companies' non-GAAP financial measures having the same or similar names. These adjusted financial measures should not be considered in isolation or as a substitute for reported results. These non-GAAP financial measures reflect an additional way of viewing aspects of operations that, when viewed with GAAP results, provide a more complete understanding of the business. The company strongly encourages investors and shareholders to review company financial statements and publicly-filed reports in their entirety and not to rely on any single financial measure.

The reconciliations provided below reconcile the non-GAAP financial measures adjusted net earnings, adjusted diluted earnings per share, adjusted operating earnings and adjusted segment operating earnings with GAAP financial measures:

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	2015	%	2016	2015	%
Operating earnings reported	$ 322,587	$ 340,729	(5)%	$ 945,269	$ 1,048,694	(10)%
Restructuring (United States)	5,437	9,374		12,492	9,374	
Inventory reserve adjustment (Canada)	—	—		9,847	—	
Restructuring (Canada)	4,367	1,145		15,499	1,145	
Restructuring (Unallocated expense)	—	(37)		8,947	(37)	
Restructuring (Other Businesses)	—	497		—	4,583	
Subtotal	9,804	10,979		46,785	15,065	
Operating earnings adjusted	$ 332,391	$ 351,708	(5)%	$ 992,054	$ 1,063,759	(7)%

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	2015	%	2016	2015	%
Segment operating earnings adjusted						
United States	347,961	368,788		1,035,810	1,104,410	
Canada	(10,751)	4,732		(29,861)	23,619	
Other Businesses	24,835	14,757		76,343	43,526	
Unallocated expense	(29,654)	(36,569)		(90,238)	(107,796)	
Segment operating earnings adjusted	$ 332,391	$ 351,708	(5)%	$ 992,054	$ 1,063,759	(7)%
Company operating margin adjusted	12.8%	13.9%		12.9 %	14.2%	
ROIC* for Company				26.5 %	31.6%	
ROIC* for United States				43.6 %	50.6%	
ROIC* for Canada				(6.8)%	4.9%	

*The GAAP financial statements are the source for all amounts used in the Return on Invested Capital (ROIC) calculation. ROIC is calculated using operating earnings divided by net working assets (a 4-point average for the year). Net working assets are working assets minus working liabilities defined as follows: working assets equal total assets less cash equivalents (4-point average of $95.2 million, deferred taxes, and investments in unconsolidated entities, plus the LIFO reserve (4-point average of $388.0 million). Working liabilities are the sum of trade payables, accrued compensation and benefits, accrued contributions to employees' profit sharing plans, and accrued expenses.

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	Three Months Ended September 30,			Nine Months Ended September 30,		
	2016	2015	%	2016	2015	%
Net earnings reported	$ 185,873	$ 192,201	(3)%	$ 545,262	$ 623,764	(13)%
Restructuring (United States)	3,409	5,870		7,831	5,870	
Inventory reserve adjustment (Canada)	—	—		7,240	—	
Restructuring (Canada)	3,210	846		11,395	846	
Restructuring (Unallocated expense)	—	(23)		5,609	(23)	
Restructuring (Other Businesses)	—	423		—	3,927	
Discrete tax items	(6,087)	—		(13,162)	—	
Subtotal	532	7,116		18,913	10,620	
Net earnings adjusted	$ 186,405	$ 199,317	(6)%	$ 564,175	$ 634,384	(11)%
Diluted earnings per share reported	$ 3.05	$ 2.92	4 %	$ 8.82	$ 9.24	(5)%
Pretax adjustments:						
Restructuring (United States)	0.09	0.14		0.20	0.14	
Inventory reserve adjustment (Canada)	—	—		0.16	—	
Restructuring (Canada)	0.07	0.02		0.25	0.02	
Restructuring (Unallocated expense)	—	—		0.15	—	
Restructuring (Other Businesses)	—	0.01		—	0.07	
Total pretax adjustments	0.16	0.17		0.76	0.23	
Tax effect (1)	(0.05)	(0.06)		(0.24)	(0.07)	
Discrete tax items	(0.10)	—		(0.21)	—	
Total, net of tax	0.01	0.11		0.31	0.16	
Diluted earnings per share adjusted	$ 3.06	$ 3.03	1 %	$ 9.13	$ 9.40	(3)%

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

Exhibit 2
2016 Sales Guidance

	October 18, 2016	July 19, 2016
Economy/Volume	0.5% – 1.5%	0% - 3%
Price	(2)%	(2)%
Organic Sales	(1.5)% - (0.5)%	(2)% - 1%
Acquisitions	3%	3%
F/X	0%	0%
Company Sales	1.5% - 2.5%	1% - 4%

Note: As of October 18, 2016.

Exhibit 3
2016 EPS Guidance

	October 18, 2016	July 19, 2016
Sales ($B)	$10.1 - $10.2	$10.1 - $10.4
V% vs. prior yr.	1.5% - 2.5%	1% - 4%
Op. Margin	12.3% - 12.5%	12.2% - 12.9%
bps vs. prior yr.	(120) – (100)	(130) - (60)
EPS	$11.40 - $11.70	$11.20 - $12.20

Note: As of October 18, 2016. Excludes special items that the company believes are not indicative of ongoing operations and have been removed to make the results more comparable to prior periods. See the tables reconciling reported to adjusted results included in the earnings release and this transcript.

Exhibit 4
2016E Financials for Grainger's Clean Energy Investments

	October 18, 2016	July 19, 2016
Other Income and Expense	($28 million)	($22 million)
Tax Benefit	$10 million	$8 million
Clean Energy Tax Credits	$24 million	$18 million
Net Earnings	$6 million	$4 million
Earnings Per Share (rounded)	$0.10	$0.07

Exhibit 5
Selling Days: 2016 vs. 2015

Month	2016	2015	Difference
January	20	21	-1
February	21	20	1
March	23	22	1
1Q	**64**	**63**	**1**
April	21	22	-1
May	21	20	1
June	22	22	0
2Q	**64**	**64**	**0**
July	20	22	-2
August	23	21	2
September	21	21	0
3Q	**64**	**64**	**0**
October	21	22	-1
November	21	20	1
December	21	22	-1
4Q	**63**	**64**	**-1**
Full Year	**255**	**255**	

Safe Harbor Statement

All statements in this communication, other than those relating to historical facts, are "forward-looking statements" based on our current view of the competitive market and the overall environment. Factors that could cause our actual results to differ materially from those statements include, among other risks and uncertainties, a major loss of customers or suppliers, competitive pressures, legal proceedings, changes in laws and regulations, general economic, industry or market conditions, technological or operational disruptions, natural and other catastrophes and other factors that can be found in our filings with the Securities and Exchange Commission, including our most recent Forms 10-K and 10-Q, which are available on our Investor Relations website. We disclaim any obligation to update or revise any forward-looking statement, except as required by law.