

GRAINGER W W INC  
Form 10-Q  
November 01, 2018

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2018  
OR

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

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

Commission file number 1-5684

W.W. Grainger, Inc.  
(Exact name of registrant as specified in its charter)

Illinois 36-1150280  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

100 Grainger Parkway, Lake Forest, Illinois 60045-5201  
(Address of principal executive offices) (Zip Code)  
(847) 535-1000  
(Registrant's telephone number including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated

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filer," "smaller reporting company" and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes [ ] No [X]

There were 56,320,463 shares of the Company's Common Stock, par value \$0.50, outstanding as of September 30, 2018.

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## PART I – FINANCIAL INFORMATION

## Item 1: Financial Statements

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

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

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

(Unaudited)

|  | Three Months Ended |             | Nine Months Ended |             |
|--|--------------------|-------------|-------------------|-------------|
|  | September 30,      |             | September 30,     |             |
|  | 2018               | 2017        | 2018              | 2017        |
| Net sales  | \$2,831,429        | \$2,635,999 | \$8,458,042       | \$7,792,397 |
| Cost of goods sold   | 1,752,194          | 1,618,819   | 5,176,107         | 4,716,069   |
| Gross profit   | 1,079,235          | 1,017,180   | 3,281,935         | 3,076,328   |
| Selling, general and administrative expenses               | 890,113            | 739,442     | 2,413,997         | 2,277,009   |
| Operating earnings   | 189,122            | 277,738     | 867,938           | 799,319     |
| Other income (expense):                                    |                    |             |                   |             |
| Interest income  | 2,003              | 707         | 3,645             | 1,365       |
| Interest expense   | (22,353)           | (23,790)    | (69,942)          | (64,971)    |
| Losses from equity method investment                       | (3,731)            | (10,635)    | (18,271)          | (25,130)    |
| Other, net   | 5,976              | 5,978       | 18,001            | 17,284      |
| Total other expense, net                                   | (18,105)           | (27,740)    | (66,567)          | (71,452)    |
| Earnings before income taxes                               | 171,017            | 249,998     | 801,371           | 727,867     |
| Income taxes   | 55,972             | 79,182      | 197,798           | 267,239     |
| Net earnings   | 115,045            | 170,816     | 603,573           | 460,628     |
| Less: Net earnings attributable to noncontrolling interest | 10,668             | 8,810       | 30,680            | 25,957      |
| Net earnings attributable to W.W. Grainger, Inc.           | \$104,377          | \$162,006   | \$572,893         | \$434,671   |
| Earnings per share:  |                    |             |                   |             |
| Basic  | \$1.84             | \$2.80      | \$10.12           | \$7.43      |
| Diluted  | \$1.82             | \$2.79      | \$10.04           | \$7.39      |
| Weighted average number of shares outstanding:             |                    |             |                   |             |
| Basic  | 56,339,630         | 57,316,532  | 56,172,277        | 58,010,222  |
| Diluted  | 56,803,857         | 57,521,348  | 56,588,530        | 58,329,925  |
| Cash dividends paid per share                              | \$1.36             | \$1.28      | \$4.00            | \$3.78      |

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<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2018                                | 2017      | 2018                               | 2017      |
| Net earnings   | \$115,045                           | \$170,816 | \$603,573                          | \$460,628 |
| Other comprehensive (losses) earnings:   |                                     |           |                                    |           |
| Foreign currency translation adjustments   | 213                                 | 24,563    | (25,142 )                          | 100,409   |
| Postretirement benefit plan re-measurement, net of tax expense \$29,172<br>(see note 8)                                | —                                   | 46,543    | —                                  | 46,543    |
| Postretirement benefit plan reclassification, net of tax benefit of \$825,<br>\$962, \$2,475 and \$2,720, respectively | (2,440 )                            | (1,540 )  | (7,317 )                           | (4,338 )  |
| Other  | 1                                   | 1         | 23                                 | (11 )     |
| Total other comprehensive (losses) earnings  | (2,226 )                            | 69,567    | (32,436 )                          | 142,603   |
| Comprehensive earnings, net of tax   | 112,819                             | 240,383   | 571,137                            | 603,231   |
| Less: Comprehensive earnings (losses) attributable to noncontrolling<br>interest                                       |                                     |           |                                    |           |
| Net earnings   | 10,668                              | 8,810     | 30,680                             | 25,957    |
| Foreign currency translation adjustments   | (4,472 )                            | (8 )      | (2,248 )                           | 4,338     |
| Comprehensive earnings attributable to noncontrolling interest   | 6,196                               | 8,802     | 28,432                             | 30,295    |
| Comprehensive earnings attributable to W.W. Grainger, Inc.   | \$106,623                           | \$231,581 | \$542,705                          | \$572,936 |

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

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

|  | As of<br>(Unaudited)  |                      |
|--|-----------------------|----------------------|
|  | September 30,<br>2018 | December 31,<br>2017 |
| <b>ASSETS</b>  |                       |                      |
| <b>CURRENT ASSETS</b>  |                       |                      |
| Cash and cash equivalents  | \$516,850             | \$326,876            |
| Accounts receivable (less allowances for doubtful accounts of \$27,336 and \$29,267, respectively)     | 1,481,300             | 1,325,186            |
| Inventories, net   | 1,473,117             | 1,429,199            |
| Prepaid expenses and other assets  | 93,586                | 86,667               |
| Prepaid income taxes   | 18,491                | 38,061               |
| Total current assets   | 3,583,344             | 3,205,989            |
| <b>PROPERTY, BUILDINGS AND EQUIPMENT, NET</b>  | 1,348,914             | 1,391,967            |
| <b>DEFERRED INCOME TAXES</b>   | 20,726                | 22,362               |
| <b>GOODWILL</b>  | 429,818               | 543,903              |
| <b>INTANGIBLES, NET</b>  | 479,521               | 569,115              |
| <b>OTHER ASSETS</b>  | 69,860                | 70,918               |
| <b>TOTAL ASSETS</b>  | <b>\$5,932,183</b>    | <b>\$5,804,254</b>   |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                      |
| <b>CURRENT LIABILITIES</b>   |                       |                      |
| Short-term debt  | \$49,429              | \$55,603             |
| Current maturities of long-term debt   | 36,973                | 38,709               |
| Trade accounts payable   | 730,215               | 731,582              |
| Accrued compensation and benefits  | 215,727               | 254,560              |
| Accrued contributions to employees' profit sharing plans   | 93,509                | 92,682               |
| Accrued expenses   | 302,263               | 313,766              |
| Income taxes payable   | 39,216                | 19,759               |
| Total current liabilities  | 1,467,332             | 1,506,661            |
| <b>LONG-TERM DEBT (less current maturities)</b>  | 2,148,399             | 2,248,036            |
| <b>DEFERRED INCOME TAXES AND TAX UNCERTAINTIES</b>   | 115,644               | 111,710              |
| <b>EMPLOYMENT-RELATED AND OTHER NON-CURRENT LIABILITIES</b>  | 100,754               | 110,114              |
| <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; 109,659,219 shares issued             | 54,830                | 54,830               |
| Additional contributed capital   | 1,124,831             | 1,040,493            |
| Retained earnings  | 7,751,677             | 7,405,192            |
| Accumulated other comprehensive losses   | (164,862 )            | (134,674 )           |
| Treasury stock, at cost – 53,338,756 and 53,330,356 shares, respectively                               | (6,828,773 )          | (6,675,709 )         |
| Total W.W. Grainger, Inc. shareholders' equity   | 1,937,703             | 1,690,132            |
| Noncontrolling interest  | 162,351               | 137,601              |
| Total shareholders' equity   | 2,100,054             | 1,827,733            |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>  | <b>\$5,932,183</b>    | <b>\$5,804,254</b>   |

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





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

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of dollars)

(Unaudited)

|  | Nine Months Ended |               |
|--|-------------------|---------------|
|  | September 30,     |               |
|  | 2018              | 2017          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                   |                   |               |
| Net earnings   | \$603,573         | \$460,628     |
| Provision for losses on accounts receivable                    | 6,784             | 15,187        |
| Deferred income taxes and tax uncertainties                    | 10,004            | (15,261 )     |
| Depreciation and amortization                                  | 191,602           | 194,338       |
| Net gains from sales of assets and divestitures                | (22,270 )         | (7,163 )      |
| Impairment of goodwill, intangible and other assets            | 142,155           | 18,459        |
| Stock-based compensation                                       | 36,241            | 27,152        |
| Losses from equity method investment                           | 18,271            | 25,130        |
| Change in operating assets and liabilities:                    |                   |               |
| Accounts receivable  | (171,829 )        | (145,631 )    |
| Inventories  | (53,270 )         | 34,851        |
| Prepaid expenses and other assets                              | (12,920 )         | (4,206 )      |
| Trade accounts payable   | 4,419             | 56,717        |
| Other current liabilities                                      | (36,377 )         | 29,643        |
| Income taxes payable, net                                      | 38,666            | 18,015        |
| Accrued employment-related benefits cost                       | (18,408 )         | 4,306         |
| Other, net   | 6,363             | 8,713         |
| Net cash provided by operating activities                      | 743,004           | 720,878       |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                   |                   |               |
| Additions to property, buildings and equipment and intangibles | (168,896 )        | (191,183 )    |
| Proceeds from sales of assets and business divestitures        | 75,558            | 110,421       |
| Equity method investment                                       | (11,875 )         | (22,430 )     |
| Other, net   | —                 | 3,554         |
| Net cash used in investing activities                          | (105,213 )        | (99,638 )     |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                   |                   |               |
| Net increase (decrease) in commercial paper                    | 18                | (369,748 )    |
| Borrowings under lines of credit                               | 23,782            | 33,931        |
| Payments against lines of credit                               | (27,899 )         | (39,705 )     |
| Proceeds from issuance of long-term debt                       | 185               | 424,020       |
| Payments of long-term debt                                     | (89,408 )         | (15,812 )     |
| Proceeds from stock options exercised                          | 179,549           | 27,255        |
| Payments for employee taxes withheld from stock awards         | (11,381 )         | (17,546 )     |
| Purchase of treasury stock                                     | (282,746 )        | (435,983 )    |
| Cash dividends paid  | (232,289 )        | (225,504 )    |
| Other, net   | 2,747             | —             |
| Net cash used in financing activities                          | (437,442 )        | (619,092 )    |
| Exchange rate effect on cash and cash equivalents              | (10,375 )         | 8,281         |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>                 | <b>189,974</b>    | <b>10,429</b> |
| Cash and cash equivalents at beginning of year                 | 326,876           | 274,146       |
| Cash and cash equivalents at end of period                     | \$516,850         | \$284,575     |

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

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W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. BACKGROUND AND BASIS OF PRESENTATION

W.W. Grainger, Inc. is a broad line, business-to-business distributor of maintenance, repair and operating (MRO) supplies, and other related products and services. W.W. Grainger, Inc.'s operations are primarily in the United States (U.S.) and Canada, with a presence in Europe, Asia and Latin America. In this report, the words "Company" or "Grainger" mean W.W. Grainger, Inc. and its subsidiaries, except where the context makes it clear that the reference is only to W.W. Grainger, Inc. itself and not 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, 2017 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on February 26, 2018.

The Condensed Consolidated Balance Sheet as of December 31, 2017 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 U.S. for complete financial statements.

The unaudited financial information reflects all adjustments (primarily consisting of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the statements contained in this report.

2. NEW ACCOUNTING STANDARDS

In March 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2017-07, Compensation Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost (ASU 2017-07). This ASU improves the presentation of net periodic pension cost and net periodic postretirement benefit cost. The effective date of this ASU was for fiscal years and interim periods beginning after December 15, 2017. The Company adopted this ASU as of January 1, 2018. This ASU was applied retrospectively for the presentation of the net periodic postretirement cost components in the Condensed Consolidated Statement of Earnings for the three and nine months ended September 30, 2017 and prospectively, after the effective date. The guidance limiting the capitalization of net periodic benefit cost in assets to the service cost component is applied prospectively. The impact of the ASU for the three and nine months ended September 30, 2017 was an increase of \$3.4 million and \$9.4 million, respectively, in Selling, general and administrative expenses (SG&A) offset by a reduction in Total other expense, net of \$3.4 million and \$9.4 million, respectively, related to the reclassification of interest cost, expected return on plan assets and amortization of unrecognized gains and prior service credits. See Note 8 to the Financial Statements.

In February 2018, the FASB issued ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. This ASU allows a reclassification from Accumulated other comprehensive earnings to Retained earnings for stranded tax effects resulting from the 2017 Tax Cuts and Jobs Act. The effective date of this ASU is for fiscal years and interim periods beginning after December 15, 2018, and early adoption is permitted. The Company has evaluated the provisions of this standard and is in the process of assessing the amount to reclassify from Accumulated other comprehensive losses to Retained earnings.

In August 2018, the FASB issued ASU 2018-14, Retirement Benefits - Defined Benefit Plans - Changes to the Disclosure Requirements for Defined Benefit Plans. This ASU removes disclosures that are no longer considered cost

beneficial, clarifies specific requirements of the disclosure and adds disclosure requirements identified as relevant to improve the effectiveness of the disclosures. The effective date of this ASU is for fiscal years and interim periods beginning after December 15, 2020 and early adoption is permitted. The Company is evaluating the impact of this ASU.

In September 2018, the FASB issued ASU 2018-15, Intangibles - Goodwill and Other Internal Use Software (Subtopic 350-40) Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract. This ASU aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The effective date of this ASU is for fiscal years and interim periods beginning after December

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

15, 2019, and early adoption is permitted. The Company has elected to early adopt prospectively and does not expect a material impact to the Company's Consolidated Financial Statements.

#### LEASE ACCOUNTING STANDARDS

In February 2016, the FASB issued ASU 2016-02, Leases as modified by subsequently issued ASUs 2018-01, 2018-10 and 2018-11. The core principle of the ASU improves transparency and comparability related to the accounting and reporting of leasing arrangements, including balance sheet recognition for assets and liabilities associated with rights and obligations created by leases with terms greater than twelve months, among other changes.

The effective date of these ASUs is for fiscal years and interim periods beginning after December 15, 2018 and early adoption is permitted. The Company has elected not to early adopt these ASUs. The Company plans to elect the modified retrospective application with practical expedient to adopt the new guidance effective January 1, 2019. Grainger will record the right of use assets and corresponding liabilities and does not expect a material impact to the Company's Consolidated Financial Statements.

#### 3. REVENUE

Company revenue is primarily comprised of MRO product sales and related activities, such as freight and services.

##### Recognition

The Company recognizes revenue when a sales arrangement with a customer exists (e.g., contract, purchase orders, others), transaction price is fixed or determinable and the Company has satisfied its performance obligation per the sales arrangement. The Company's sales arrangements generally have standard payment terms that do not exceed a year.

The majority of Company revenue originates from contracts with a single performance obligation to deliver products, whereby the Company's performance obligations are satisfied when control of the product is transferred to the customer per the arranged shipping terms. Some Company contracts contain a combination of product sales and services, which are distinct and accounted for as separate performance obligations. The Company's performance obligations for services are satisfied when the services are rendered within the arranged service period. Total service revenue is not material and accounted for approximately 1% of total Company revenue for the three and nine months ended September 30, 2018.

The Company records a contract asset when it has a right to payment from a customer that is conditioned on events other than the passage of time. The Company also records a contract liability when customers prepay but the Company has not yet satisfied its performance obligation. The Company did not have any material unsatisfied performance obligations, contract assets or liabilities as of September 30, 2018 and December 31, 2017.

##### Measurement

The Company's revenue is reported as Net sales and is measured at the determinable transaction price, net of any variable considerations (e.g., rights to return product, sales incentives, others) and any taxes collected from customers and subsequently remitted to governmental authorities. The Company considers shipping and handling as activities to fulfill its performance obligation. Billings for freight are accounted for as Net sales and shipping and handling costs are accounted for in Cost of goods sold.

The Company offers customers rights to return product and sales incentives, which primarily consist of volume rebates. The Company's rights of return and sales incentives generally do not exceed a year. The Company estimates sales returns and volume rebate accruals throughout the year based on various factors, including contract terms, historical experience and performance levels. Total accrued sales returns were approximately \$28 million as of both September 30, 2018 and December 31, 2017, respectively, and are reported as a reduction of Accounts receivable, net. Total accrued sales incentives were approximately \$63 million and \$55 million as of September 30, 2018 and December 31, 2017, respectively, and are reported as part of Accrued expenses.

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## Disaggregation of Revenues

Grainger serves a large number of customers in diverse industries, which are subject to different economic and market specific factors. The Company's presentation of revenue by industry most reasonably depicts how the nature, amount, timing and uncertainty of Company revenue and cash flows are affected by economic and market specific factors. The following table presents the Company's percentage of revenue by reportable segment and by major customer industry for the three and nine months ended September 30, 2018:

|                                  | Three Months Ended<br>September 30, 2018 |       |        |  |              |
|----------------------------------|--|-------|--------|--|--------------|
|                                  | U.S.                                     |       | Canada |  | Total<br>(2) |
|                                  |  |       |        |  |              |
| Government                       | 20 %                                     | 5 %   | 15 %   |  | %            |
| Heavy Manufacturing              | 19 %                                     | 20 %  | 18 %   |  | %            |
| Light Manufacturing              | 13 %                                     | 6 %   | 11 %   |  | %            |
| Transportation                   | 5 %                                      | 8 %   | 5 %    |  | %            |
| Commercial                       | 16 %                                     | 9 %   | 13 %   |  | %            |
| Retail/Wholesale                 | 8 %                                      | 4 %   | 7 %    |  | %            |
| Contractors                      | 9 %                                      | 11 %  | 8 %    |  | %            |
| Natural Resources                | 3 %                                      | 34 %  | 4 %    |  | %            |
| Other (1)                        | 7 %                                      | 3 %   | 19 %   |  | %            |
| Total net sales                  | 100 %                                    | 100 % | 100 %  |  | %            |
| Percent of Total Company Revenue | 73 %                                     | 5 %   | 100 %  |  | %            |

|                                  | Nine Months Ended<br>September 30, 2018 |       |        |  |              |
|----------------------------------|---|-------|--------|--|--------------|
|                                  | U.S.                                    |       | Canada |  | Total<br>(2) |
|                                  |   |       |        |  |              |
| Government                       | 19 %                                    | 6 %   | 14 %   |  | %            |
| Heavy Manufacturing              | 19 %                                    | 20 %  | 18 %   |  | %            |
| Light Manufacturing              | 13 %                                    | 6 %   | 11 %   |  | %            |
| Transportation                   | 5 %                                     | 7 %   | 5 %    |  | %            |
| Commercial                       | 16 %                                    | 10 %  | 13 %   |  | %            |
| Retail/Wholesale                 | 8 %                                     | 4 %   | 7 %    |  | %            |
| Contractors                      | 10 %                                    | 11 %  | 8 %    |  | %            |
| Natural Resources                | 3 %                                     | 33 %  | 4 %    |  | %            |
| Other (1)                        | 7 %                                     | 3 %   | 20 %   |  | %            |
| Total net sales                  | 100 %                                   | 100 % | 100 %  |  | %            |
| Percent of Total Company Revenue | 73 %                                    | 6 %   | 100 %  |  | %            |

(1) Other category primarily includes revenue from individual customers not aligned to major industry segment, including small businesses and consumers and intersegment net sales.

(2) Total Company includes other businesses, which include the Company's single channel businesses and operations in Europe, Asia and Latin America and account for approximately 22% and 21% of revenue for the three and nine months ended September 30, 2018, respectively.

## Cost of Goods Sold

Cost of goods sold includes products and product-related costs, vendor consideration, shipping and handling costs and service costs.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 4. PROPERTY, BUILDINGS AND EQUIPMENT

Property, buildings and equipment consisting of the following (in thousands of dollars):

|   | As of                 |                      |
|---|-----------------------|----------------------|
|   | September<br>30, 2018 | December<br>31, 2017 |
| Land  | \$319,990             | \$348,739            |
| Building, structures and improvements           | 1,339,754             | 1,342,508            |
| Furniture, fixtures, machinery and equipment    | 1,781,459             | 1,753,413            |
| Property, buildings and equipment               | \$3,441,203           | \$3,444,660          |
| Less: Accumulated depreciation and amortization | 2,092,289             | 2,052,693            |
| Property, buildings and equipment, net          | \$1,348,914           | \$1,391,967          |

## 5. GOODWILL AND INTANGIBLE ASSETS

The balances and changes in the carrying amount of Goodwill by segment, including cumulative goodwill impairment charges are as follows (in thousands of dollars):

|  | United<br>States | Canada    | Other<br>businesses | Total                        |
|--|------------------|-----------|---------------------|------------------------------|
| Balance at January 1, 2017                                 | \$202,020        | \$122,140 | \$202,990           | \$527,150                    |
| Divestiture  | (3,316 )         | —         | —                   | (3,316 )                     |
| Impairment   | (7,169 )         | —         | —                   | (7,169 )                     |
| Translation  | —                | 8,282     | 18,956              | 27,238                       |
| Balance at December 31, 2017                               | 191,535          | 130,422   | 221,946             | 543,903                      |
| Divestiture  | —                | —         | —                   | —                            |
| Impairment   | —                | —         | (104,461 )          | (104,461 )                   |
| Translation  | —                | (3,304 )  | (6,320 )            | (9,624 )                     |
| Balance at September 30, 2018                              | \$191,535        | \$127,118 | \$111,165           | \$429,818                    |
| Cumulative goodwill impairment charges, December 31, 2017  |                  |           | \$24,207            | \$32,265 \$70,299 \$126,771  |
| Impairment   |                  |           | —                   | — 104,461 104,461            |
| Cumulative goodwill impairment charges, September 30, 2018 |                  |           | \$24,207            | \$32,265 \$174,760 \$231,232 |

W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The balances and changes in Intangible assets, net are as follows (in thousands of dollars):

|                                     | Weighted average life | September 30, 2018    |                          |                     | December 31, 2017     |                          |                     |
|-------------------------------------|-----------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                                     |                       | Gross carrying amount | Accumulated amortization | Net carrying amount | Gross carrying amount | Accumulated amortization | Net carrying amount |
| Customer lists and relationships    | 14.3 years            | \$413,216             | \$ 199,645               | \$213,571           | \$430,026             | \$ 195,842               | \$234,184           |
| Trademarks, trade names and other   | 14.5 years            | 24,073                | 14,945                   | 9,128               | 25,886                | 16,054                   | 9,832               |
| Non-amortized trade names and other |                       | 99,172                | —                        | 99,172              | 137,491               | —                        | 137,491             |
| Capitalized software                | 4.2 years             | 652,501               | 494,851                  | 157,650             | 632,431               | 444,823                  | 187,608             |
| Total intangible assets             | 8.2 years             | \$1,188,962           | \$ 709,441               | \$479,521           | \$1,225,834           | \$ 656,719               | \$569,115           |

The Company tests goodwill and intangible assets for impairment annually during the fourth quarter and more frequently if impairment indicators exist. Qualitative assessments of significant events or changes in circumstances are performed quarterly to determine the existence of impairment indicators and assess if it is more likely than not that the carrying value of these assets may not be recoverable and determine if quantitative impairment tests are necessary. Factors evaluated include declines in stock price, market capitalization and reporting units' historical and projected results, deteriorations of industry growth assumptions, declining economic indicators and other structural variables. For the quantitative impairment tests for goodwill, the Company compares reporting units' carrying values with their fair values and records an impairment charge for any excess of carrying value over fair value. Reporting unit fair values are estimated primarily using the income-based discounted cash flow (DCF) method. Value indicators from a market-based approach are used to evaluate overall reasonableness. The DCF method incorporates various assumptions including the amount and timing of reporting unit future expected cash flows, including revenues, gross margins, operating expenses, capital expenditures and working capital based on reporting units' budgets, long-range strategic plans and other estimates, plus a terminal value that estimates the perpetual growth for the reporting units. Estimates of market-participant risk-adjusted weighted average cost of capital are used to discount reporting units' future expected cash flows and terminal value to net present value.

For the quantitative tests for indefinite-lived intangible assets, which are primarily trade names, the Company compares the assets' carrying values with their fair values and records an impairment charge for any excess of carrying value over fair value. Trade name fair values are estimated using the relief from royalty method, which estimates the expected royalty savings attributable to the ownership of the trade name asset. The key assumptions when valuing trade names are revenue, royalty rate and discount rate.

For the quantitative tests for amortizable intangible assets, the Company first estimates the future undiscounted cash flows through the useful lives of the assets and compares them to the assets' carrying value. If carrying values exceed future undiscounted cash flows, then a second step is performed whereas the assets' fair value is estimated and an impairment charge is recorded for any excess of carrying value over fair value.

#### Third Quarter 2018 Qualitative Tests

During the quarter ended September 30, 2018, the Company performed qualitative goodwill and intangible asset assessments. With the exception of the Cromwell reporting unit, the Company did not identify any significant events or changes in circumstances that indicated the existence of impairment indicators, and as such quantitative impairment tests were not required. However, changes in assumptions, judgments and estimates regarding reporting unit performance and structural economic conditions may have a significant impact on the fair value of reporting units and intangible assets in the future. If future earnings and cash flow projections are not achieved or structural economic conditions are unfavorable, future impairments of goodwill or intangible assets could result.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## Cromwell Goodwill and Intangible Assets

The operating performance of the Cromwell reporting unit has deteriorated from the second quarter of 2018 and the Company lowered its short-term forecasts and long-term outlook projections. These factors, combined with sustained economic uncertainty in the U.K market and higher interest rates, led the Company to conclude that it was more likely than not that the carrying value of Cromwell's goodwill and intangible assets may not be recoverable. Accordingly, quantitative tests were performed during the quarter ended September 30, 2018.

In the quantitative test for goodwill performed in 2017, the fair value of the Cromwell reporting unit exceeded its carrying value by 15%. During the third quarter 2018 test, the Company considered the impact of the prolonged softness and uncertainty in the U.K. market due to Brexit and other unfavorable structural economic conditions, as well as Cromwell's underperformance compared to expectations, prior year quantitative test assumptions and future performance projections. The revised outlook and uncertainty beyond 2018 were factored into lower revenues, earnings and cash flow projections which, combined with an increase in the discount rate, resulted in the calculated fair value of the Cromwell reporting unit below its carrying value. Accordingly, during the quarter ended September 30, 2018, the Company recorded a full goodwill impairment charge of \$105 million with no tax benefit due to the nondeductibility of goodwill in the relevant taxing jurisdictions. The revised revenue and gross margin projections also resulted in the reduction of royalty rate and value attributable to the Cromwell trade name for which the Company recorded a \$34 million impairment charge during the same period. The cumulative indefinite-lived intangible impairment charge of \$34 million was recorded in other businesses as of September 30, 2018 and there were none as of December 31, 2017. The goodwill and intangible asset impairment charges were recorded in SG&A.

The Company also performed an impairment test on Cromwell's intangible assets subject to amortization and long-lived assets using the undiscounted cash flows method and no impairment charge was required during the quarter ended September 30, 2018.

## 6. RESTRUCTURING

The Company continues to execute on its previously announced restructuring actions to reduce costs in the U.S. and at the Company level (Unallocated expense) and to focus on profitability in Canada and other businesses. Restructuring costs, net, for the three and nine months ended September 30, 2018 and 2017 are as follows (in thousands of dollars):

|                  | Three Months Ended September 30, |  |                       |                    | 2017   |                       |                    |          |
|------------------|----------------------------------|--|-----------------------|--------------------|--|-----------------------|--------------------|----------|
|                  | 2018                             |  | 2017                  |                    | 2017   |                       | 2017               |          |
|                  | Cost of goods sold               | Selling, general and administrative expenses | Total                 | Cost of goods sold | Selling, general and administrative expenses | Total                 | Cost of goods sold | Total    |
|                  |                                  | Involuntary employee termination costs       | Other charges (gains) |                    | Involuntary employee termination costs       | Other charges (gains) |                    |          |
| U.S.             | \$48                             | \$3,453                                      | \$(1 )                | \$3,500            | \$(100)                                      | \$10,917              | \$(2,873)          | \$7,944  |
| Canada           | (189 )                           | 3,431  | (4,123 )              | (881 )             | —  | 1,882                 | 3,055              | 4,937    |
| Other businesses | —                                | —  | 1,115                 | 1,115              | 581  | 73                    | (864 )             | (210 )   |
| Total            | \$(141)                          | \$6,884                                      | \$(3,009)             | \$3,734            | \$481  | \$12,872              | \$(682 )           | \$12,671 |

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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

|                     | Nine Months Ended September 30,<br>2018 |  |                       |          | 2017               |  |                       |          |
|---------------------|---|--|-----------------------|----------|--------------------|--|-----------------------|----------|
|                     | Cost of goods sold                      | Selling, general and administrative expenses<br>Involuntary employee termination costs | Other charges (gains) | Total    | Cost of goods sold | Selling, general and administrative expenses<br>Involuntary employee termination costs | Other charges (gains) | Total    |
| U.S.                | \$348                                   | \$12,133   | \$(7,444)             | \$5,037  | \$(100)            | \$19,459   | \$(17,634)            | \$1,725  |
| Canada              | (611)                                   | 23,131   | (463)                 | 22,057   | 2,574              | 9,842  | 14,093                | 26,509   |
| Other businesses    | 1,083                                   | 1,564  | 2,015                 | 4,662    | 581                | 3,595  | 37,124                | 41,300   |
| Unallocated expense | —                                       | —  | (4,688)               | (4,688)  | —                  | —  | —                     | —        |
| Total               | \$820                                   | \$36,828   | \$(10,580)            | \$27,068 | \$3,055            | \$32,896   | \$33,583              | \$69,534 |

Other charges (gains) primarily include asset impairment charges in Canada and other exit-related costs, net of gains from the sales of branches in the U.S., Canada and corporate offices. Other charges (gains) in 2017 reflect charges related to the wind-down of the Colombia business, including \$16 million of accumulated foreign currency translation losses reclassified from Accumulated other comprehensive losses to SG&A in Other businesses.

The following summarizes the restructuring activity for the nine months ended September 30, 2018 (in thousands of dollars):

|                                     | Current asset write-downs | Property, buildings and equipment write-downs and disposals | Involuntary employee termination costs | Lease termination costs | Other costs | Total    |
|-------------------------------------|---------------------------|---|--|-------------------------|-------------|----------|
| Balances as of December 31, 2017    | \$ 13,101                 | \$ 741  | 50,289                                 | \$ 4,893                | \$ 12,764   | \$81,788 |
| Restructuring costs, net of (gains) | 4,201                     | (17,847)  | 36,828                                 | 3,456                   | 430         | 27,068   |
| Cash (paid) received, net           | (844)                     | 45,020  | (45,056)                               | (3,886)                 | (1,632)     | (6,398)  |
| Non-cash, translation and other     | (13,866)                  | (27,293)  | (1,276)                                | (1,729)                 | (6,393)     | (50,557) |
| Balances as of September 30, 2018   | \$ 2,592                  | \$ 621  | \$40,785                               | \$ 2,734                | \$5,169     | \$51,901 |

The cumulative amounts incurred to date since the inception of the program and expected through the end of 2019 (excluding results of sales of real estate) in connection with the Company's restructuring actions for active programs are as follows (in thousands of dollars):

|                     | Cumulative amount incurred to date | Additional amount expected |
|---------------------|------------------------------------|----------------------------|
| U.S.                | \$ 67,435                          | \$ 2,339                   |
| Canada              | 80,525                             | 6,749                      |
| Other businesses    | 65,378                             | 545                        |
| Unallocated expense | 14,852                             | —                          |
| Total               | \$ 228,190                         | \$ 9,633                   |



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 7. SHORT-TERM AND LONG-TERM DEBT

Short-term debt consisted of outstanding lines of credit. Long-term debt consisted of the following (in thousands of dollars):

|   | As of September 30, 2018 |              | As of December 31, 2017 |              |
|---|--------------------------|--------------|-------------------------|--------------|
|   | Carrying Value           | Fair Value   | Carrying Value          | Fair Value   |
| 4.60% senior notes due 2045               | \$ 1,000,000             | \$ 1,046,760 | \$ 1,000,000            | \$ 1,089,000 |
| 3.75% senior notes due 2046               | 400,000                  | 364,980      | 400,000                 | 384,200      |
| 4.20% senior notes due 2047               | 400,000                  | 392,540      | 400,000                 | 410,800      |
| British pound term loan                   | 177,180                  | 177,180      | 194,574                 | 194,574      |
| Euro term loan                            | 127,689                  | 127,689      | 131,956                 | 131,956      |
| Canadian dollar revolving credit facility | 54,247                   | 54,247       | 99,388                  | 99,388       |
| Capital lease obligations and other       | 48,867                   | 48,867       | 84,274                  | 84,274       |
| Subtotal                                  | 2,207,983                | 2,212,263    | 2,310,192               | 2,394,192    |
| Less current maturities                   | (36,973 )                | (36,973 )    | (38,709 )               | (38,709 )    |
| Debt issuance costs and discounts         | (22,611 )                | (22,611 )    | (23,447 )               | (23,447 )    |
| Long-term debt (less current maturities)  | \$ 2,148,399             | \$ 2,152,679 | \$ 2,248,036            | \$ 2,332,036 |

The estimated fair value of the Company's senior notes was based on available external pricing data and current market rates for similar debt instruments, among other factors, which are classified as level 2 inputs within the fair value hierarchy. The carrying value of other long-term debt approximates fair value due to their variable interest rates.

## 8. EMPLOYEE BENEFITS

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its U.S. employees hired prior to January 1, 2013. Effective January 1, 2018, the Company implemented plan design changes, which moved all post-65 Medicare eligible retirees to healthcare exchanges and provides them a subsidy, based on years of service, to purchase insurance.

The net periodic benefits for the Company's postretirement healthcare benefits plan, which are valued at the measurement date of January 1 for each year and recognized evenly throughout the year, consisted of the following (in thousands of dollars):

|  | Three Months Ended September 30, |           | Nine Months Ended September 30, |           |
|--|----------------------------------|-----------|---------------------------------|-----------|
|  | 2018                             | 2017      | 2018                            | 2017      |
| Selling, general and administrative expenses |                                  |           |                                 |           |
| Service cost                                 | \$ 1,629                         | \$ 1,856  | \$ 4,887                        | \$ 5,649  |
| Other income (expense)                       |                                  |           |                                 |           |
| Interest cost                                | 1,712                            | 2,026     | 5,136                           | 6,323     |
| Expected return on assets                    | (3,315 )                         | (2,957 )  | (9,945 )                        | (8,670 )  |
| Amortization of unrecognized gains           | (840 )                           | (609 )    | (2,520 )                        | (1,919 )  |
| Amortization of prior service credits        | (2,424 )                         | (1,893 )  | (7,272 )                        | (5,139 )  |
| Net periodic benefit                         | \$(3,238)                        | \$(1,577) | \$(9,714)                       | \$(3,756) |

The Company has established a Group Benefit Trust (Trust) to fund postretirement healthcare plan obligations and process benefit payments. The Company has no minimum funding requirement and did not make a contribution to the Trust during the nine months ended September 30, 2018.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 9. INCOME TAXES

The reconciliation of income tax expense with federal income taxes at statutory rate follows (in thousands of dollars):

|  | Three Months Ended |          | Nine Months Ended |           |
|--|--------------------|----------|-------------------|-----------|
|  | September 30,      |          | September 30,     |           |
|  | 2018               | 2017     | 2018              | 2017      |
| Federal income tax (21% in 2018 and 35% in 2017)       | \$35,914           | \$87,499 | \$168,288         | \$254,753 |
| States income taxes, net of federal income tax benefit | 4,817              | 5,996    | 22,572            | 17,458    |
| Clean energy credit                                    | (2,897 )           | (8,902 ) | (13,575 )         | (25,917 ) |
| Foreign rate difference                                | 1,895              | 2,152    | 8,880             | 6,265     |
| Impairment and other charges                           | 27,875             | —        | 27,875            | 19,188    |
| Stock compensation benefit                             | (8,289 )           | (575 )   | (18,899 )         | (8,314 )  |
| Other, net   | (3,343 )           | (6,988 ) | 2,657             | 3,806     |
| Income tax expense                                     | \$55,972           | \$79,182 | \$197,798         | \$267,239 |
| Effective tax rate                                     | 32.7 %             | 31.7 %   | 24.7 %            | 36.7 %    |

The Tax Cut and Jobs Act (the Tax Act) was enacted on December 22, 2017. The Company applied Staff Accounting Bulletin (SAB) 118 when accounting for the enactment-date effects of the Tax Act at December 31, 2017 and recorded estimates primarily related to the revaluation of deferred tax balances and the one-time transition tax. As of September 30, 2018, the Company had not completed the analysis for all of the tax effects of the Tax Act and had not recorded any additional adjustments to the amounts recorded at December 31, 2017. The Company expects to complete the Tax Act estimates in the fourth quarter of 2018 and does not expect a material impact to the Consolidated Financial Statements.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

## 10. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share under the two-class method (in thousands of dollars, except for share and per share amounts):

|  | Three Months Ended |            | Nine Months Ended |            |
|--|--------------------|------------|-------------------|------------|
|  | September 30,      |            | September 30,     |            |
|  | 2018               | 2017       | 2018              | 2017       |
| Net earnings attributable to W.W. Grainger, Inc. as reported   | \$104,377          | \$162,006  | \$572,893         | \$434,671  |
| Distributed earnings available to participating securities   | (640 )             | (603 )     | (1,596 )          | (1,576 )   |
| Undistributed earnings available to participating securities   | (243 )             | (806 )     | (3,108 )          | (1,966 )   |
| Numerator for basic earnings per share – Undistributed and distributed earnings available to common shareholders   | 103,494            | 160,597    | 568,189           | 431,129    |
| Undistributed earnings allocated to participating securities   | 243                | 806        | 3,108             | 1,966      |
| Undistributed earnings reallocated to participating securities   | (242 )             | (803 )     | (3,086 )          | (1,956 )   |
| Numerator for diluted earnings per share – Undistributed and distributed earnings available to common shareholders | \$103,495          | \$160,600  | \$568,211         | \$431,139  |
| Denominator for basic earnings per share – weighted average shares   | 56,339,630         | 57,316,532 | 56,172,277        | 58,010,222 |
| Effect of dilutive securities  | 464,227            | 204,816    | 416,253           | 319,703    |
| Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities              | 56,803,857         | 57,521,348 | 56,588,530        | 58,329,925 |
| Earnings per share two-class method  |                    |            |                   |            |
| Basic  | \$1.84             | \$2.80     | \$10.12           | \$7.43     |
| Diluted  | \$1.82             | \$2.79     | \$10.04           | \$7.39     |

## 11. DIVIDEND

On October 31, 2018, the Company's Board of Directors declared a quarterly dividend of \$1.36 per share, payable December 1, 2018, to shareholders of record on November 12, 2018.

## 12. SEGMENT INFORMATION

Grainger's two reportable segments are the U.S. and Canada. These reportable segments reflect the results of the Company's businesses in those geographies, except for Zoro Tools, Inc. (Zoro), which is in the U.S. Other businesses include the Company's single channel businesses (Zoro and MonotaRO in Japan) and small operations in Europe, Asia and Latin America. These businesses individually do not meet the criteria of a reportable segment.



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W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Following is a summary of segment results (in thousands of dollars):

|                                       | Three Months Ended September 30, 2018 |             |                     |             |
|---------------------------------------|---------------------------------------|-------------|---------------------|-------------|
|                                       | U.S.                                  | Canada      | Other<br>businesses | Total       |
| Total net sales                       | \$2,188,324                           | \$149,782   | \$609,317           | \$2,947,423 |
| Intersegment net sales                | (115,007 )                            | (22 )       | (965 )              | (115,994 )  |
| Net sales to external customers       | \$2,073,317                           | \$149,760   | \$608,352           | \$2,831,429 |
| Segment operating earnings            | \$326,273                             | \$(4,051 )  | \$(99,831 )         | \$222,391   |
|                                       | Three Months Ended September 30, 2017 |             |                     |             |
|                                       | U.S.                                  | Canada      | Other<br>businesses | Total       |
| Total net sales                       | \$2,015,968                           | \$188,216   | \$536,927           | \$2,741,111 |
| Intersegment net sales                | (103,667 )                            | (13 )       | (1,432 )            | (105,112 )  |
| Net sales to external customers       | \$1,912,301                           | \$188,203   | \$535,495           | \$2,635,999 |
| Segment operating earnings            | \$294,603                             | \$(14,972 ) | \$26,892            | \$306,523   |
|                                       | Nine Months Ended September 30, 2018  |             |                     |             |
|                                       | U.S.                                  | Canada      | Other<br>businesses | Total       |
| Total net sales                       | \$6,471,116                           | \$508,414   | \$1,819,562         | \$8,799,092 |
| Intersegment net sales                | (337,912 )                            | (55 )       | (3,083 )            | (341,050 )  |
| Net sales to external customers       | \$6,133,204                           | \$508,359   | \$1,816,479         | \$8,458,042 |
| Segment operating earnings            | \$1,032,491                           | \$(37,875 ) | \$(22,509 )         | \$972,107   |
|                                       | Nine Months Ended September 30, 2017  |             |                     |             |
|                                       | U.S.                                  | Canada      | Other<br>businesses | Total       |
| Total net sales                       | \$5,968,565                           | \$563,470   | \$1,560,894         | \$8,092,929 |
| Intersegment net sales                | (297,247 )                            | (15 )       | (3,270 )            | (300,532 )  |
| Net sales to external customers       | \$5,671,318                           | \$563,455   | \$1,557,624         | \$7,792,397 |
| Segment operating earnings            | \$913,705                             | \$(59,428 ) | \$44,177            | \$898,454   |
|                                       | Three Months Ended                    |             | Nine Months Ended   |             |
|                                       | September 30,                         |             | September 30,       |             |
|                                       | 2018                                  | 2017        | 2018                | 2017        |
| Operating earnings:                   |                                       |             |                     |             |
| Segment operating earnings            | \$222,391                             | \$306,523   | \$972,107           | \$898,454   |
| Unallocated expenses and eliminations | (33,269 )                             | (28,785 )   | (104,169 )          | (99,135 )   |
| Total consolidated operating earnings | \$189,122                             | \$277,738   | \$867,938           | \$799,319   |

Segment and total consolidated operating earnings for the three and nine months ended September 30, 2017 were restated for the implementation of ASU 2017-07. See Note 2 to the Financial Statements.

Unallocated expenses and eliminations primarily relate to the Company's headquarters support services and intercompany eliminations, which are not part of any reportable segment. Unallocated expenses are primarily comprised of employee compensation costs, depreciation and other administrative costs.



W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company is a broad-line distributor of MRO supplies, and other related products. Products are regularly added and deleted from the Company's inventory. Accordingly, it would be impractical to provide sales information by product category due to the way the business is managed.

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

|                                      | U.S.        | Canada        | Other<br>businesses | Total       |
|--------------------------------------|-------------|---------------|---------------------|-------------|
| Segment assets:                      |             |               |                     |             |
| September 30, 2018                   | \$2,515,137 | \$213,525     | \$672,854           | \$3,401,516 |
| December 31, 2017                    | \$2,309,734 | \$278,633     | \$605,452           | \$3,193,819 |
|                                      |             | As of         |                     |             |
| Total assets:                        |             | September 30, | December 31,        |             |
|                                      |             | 2018          | 2017                |             |
| Assets for reportable segments       |             | 3,401,516     | 3,193,819           |             |
| Other current and non-current assets |             | 2,251,555     | 2,428,074           |             |
| Unallocated assets                   |             | 279,112       | 182,361             |             |
| Total consolidated assets            |             | \$5,932,183   | \$5,804,254         |             |

Assets for reportable segments include net accounts receivable and first-in, first-out inventory which are reported to the Company's Chief Operating Decision Maker. Other current and non-current assets include all other assets of the reportable segments. Unallocated assets are primarily comprised of non-operating cash and cash equivalents, property, buildings and equipment, net, and certain prepaid expenses related to the Company's headquarters support services.

### 13. CONTINGENCIES AND LEGAL MATTERS

From time to time the Company is involved in various legal and administrative proceedings that are incidental to its business, including claims related to product liability, general negligence, contract disputes, cybersecurity incidents, privacy matters, environmental issues, wage and hour laws, intellectual property, employment practices, advertising laws, regulatory compliance, and other matters and actions brought by employees, customers, competitors, suppliers and governmental entities. As a government contractor selling to federal, state and local governmental entities, the Company is also subject to governmental and regulatory inquiries, audits and other proceedings, including those related to contract administration and pricing compliance. It is not expected that the ultimate resolution of any of these matters will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

W.W. Grainger, Inc. and Subsidiaries

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

Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

General

W.W. Grainger, Inc. (Grainger or the Company) is a broad line, business-to-business distributor of maintenance, repair and operating (MRO) supplies and other related products and services with operations primarily in the United States (U.S.) and Canada, with a presence in Europe, Asia and Latin America. More than 3 million customers worldwide rely on Grainger for products such as safety gloves, ladders, motors and janitorial supplies, along with services like inventory management and technical support. These customers represent a broad collection of industries (see Note 3 in the Condensed Consolidated Financial Statements (Financial Statements)). They place orders online, on mobile devices, through sales representatives, over the phone and at local branches. Approximately 5,200 suppliers provide Grainger with approximately 1.7 million products stocked in Grainger's distribution centers (DCs) and branches worldwide.

Grainger's two reportable segments are the U.S. and Canada (Acklands - Grainger Inc. and its subsidiaries). These reportable segments reflect the results of the Company's businesses in those geographies, except for Zoro Tools, Inc. (Zoro) which is in the U.S. Other businesses include the Company's single channel businesses (Zoro and MonotaRO in Japan) and operations in Europe, Asia and Latin America.

Business Environment

Given Grainger's large number of customers and the diverse industries it serves, several economic factors and market specific trends tend to shape Grainger's business environment. The overall economy and leading economic indicators provide general insight into projecting Grainger's growth. Grainger's sales in the U.S. and Canada tend to positively correlate with Business Investment, Business Inventory, Exports and Industrial Production. Sales in the U.S. also tend to positively correlate with Gross Domestic Product (GDP). Sales in Canada also tend to positively correlate with oil prices. The table below provides these estimated indicators for 2018:

|                       | U.S. 2018 |      | Canada 2018 |             |
|-----------------------|-----------|------|-------------|-------------|
|                       | Forecast  |      | Forecast    |             |
|                       | October   | July | September   | June        |
| Business Investment   | 7.0%      | 7.0% | 4.6%        | 5.8%        |
| Business Inventory    | 1.1%      | 2.0% | —           | —           |
| Exports               | 4.0%      | 5.1% | 2.8%        | 1.7%        |
| Industrial Production | 3.7%      | 3.5% | 3.1%        | 2.0%        |
| GDP                   | 2.9%      | 3.0% | 2.2%        | 2.2%        |
| Oil Prices            | —         | —    | \$69/barrel | \$66/barrel |

Source: Global Insight U.S. (October 2018 and July 2018), Global Insight Canada (September 2018 and June 2018)

In the U.S., Business Inventory and Exports are forecast to slow from the July forecast but all indicators are expected to remain strong during 2018, supported by expanding domestic and global markets, stable GDP and Exports, low capital costs and a stable regulatory climate. In Canada, Exports and Industrial Production are expected to improve, while Business Investment remains strong. Oil prices have signaled a recovery as the price per barrel has trended upward.

In the third quarter of 2018, the office of the United States Trade Representative enacted tariffs on a significant number of Chinese imports which may affect the Company's business environment, product availability, gross margins and results of operations. Grainger is currently validating tariff increases, working with suppliers to minimize the cost impact, identifying alternative suppliers and evaluating pricing actions while ensuring that the Company's pricing



is market based to mitigate tariff impact.

Outlook

Grainger's portfolio consists of its U.S. business, its Canada business and other businesses. Grainger's imperative to create unique value for customers is focused on: (i) continuing to grow its share of business with large and mid-size customers in the U.S. by executing its high-value sales and service model and building advantaged MRO solutions by leveraging its product and customer expertise; (ii) completing the business model reset in Canada; (iii) driving profitable growth in its international portfolio and (iv) continuing the strong growth of its single channel businesses by expanding their assortment and innovating around customer acquisition. Grainger is also focused on improving the end-to-end customer experience by making investments in its eCommerce and digital capabilities and executing continuous improvement initiatives within its supply chain and order-to-cash processes.

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## Matters Affecting Comparability

There were 63 sales days in the three months ended September 30, 2018 and 2017.

## Results of Operations – Three Months Ended September 30, 2018

The following table is included as an aid to understand the changes in Grainger's Condensed Consolidated Statements of Earnings (in millions of dollars):

|  | Three Months Ended September 30, |             |                                |    | As a Percent of |        |
|--|----------------------------------|-------------|--------------------------------|----|-----------------|--------|
|  | 2018<br>(A)                      | 2017<br>(A) | Percent<br>Increase/(Decrease) |    | 2018            | 2017   |
| Net sales  | \$2,831                          | \$2,636     | 7                              | %  | 100.0%          | 100.0% |
| Cost of goods sold                               | 1,752                            | 1,619       | 8                              | %  | 61.9            | 61.4   |
| Gross profit                                     | 1,079                            | 1,017       | 6                              | %  | 38.1            | 38.6   |
| Selling, general and administrative expenses     | 890                              | 739         | 20                             | %  | 31.4            | 28.1   |
| Operating earnings                               | 189                              | 278         | (32)                           | )% | 6.7             | 10.5   |
| Other expense, net                               | 18                               | 28          | (35)                           | )% | 0.6             | 1.1    |
| Income taxes                                     | 56                               | 79          | (29)                           | )% | 2.0             | 3.0    |
| Net earnings                                     | 115                              | 171         |                                |    |                 |        |
| Noncontrolling interest                          | 11                               | 9           | 21                             | %  | 0.4             | 0.3    |
| Net earnings attributable to W.W. Grainger, Inc. | \$104                            | \$162       | (36)                           | )% | 3.7             | 6.1    |

(A) May not sum due to rounding

Grainger's net sales of \$2,831 million for the third quarter of 2018 increased \$195 million, or 7% compared to the same period in 2017, and consisting of the following:

|                      | Percent Increase/(Decrease) |
|----------------------|-----------------------------|
| Volume               | 7                           |
| Price                | 1                           |
| Foreign exchange (1) |                             |
| Total                | 7%                          |

The increase in net sales was primarily driven by volume increases in the U.S. business due to market share gain, an improved demand environment and continued double digit growth in the single channel businesses, partially offset by lower sales in the Canada business. See Note 3 to the Financial Statements and refer to the Segment Analysis below for further details.

Gross profit of \$1,079 million for the third quarter of 2018 increased \$62 million, or 6% compared to the same quarter in 2017, primarily due to higher sales during the period. The gross profit margin of 38.1% during the third quarter of 2018 decreased 0.5 percentage point when compared to the same quarter in 2017. The lower gross profit margin includes a 0.5 percentage point decline from the implementation of the Financial Accounting Standards Board (FASB) new revenue recognition standard that primarily reclassifies certain costs related to KeepStock® services from Selling, general and administrative expenses (SG&A) to Cost of goods sold. Excluding this impact, gross profit margin would have been flat compared to the prior year.

The table below reconciles reported SG&A, operating earnings and net earnings attributable to W.W. Grainger, Inc. determined in accordance with U.S. generally accepted accounting principles (GAAP) to adjusted SG&A, operating earnings and net earnings attributable to W.W. Grainger, Inc., which are all considered non-GAAP measures. The

Company believes that these non-GAAP measures provide meaningful information to assist shareholders in understanding financial results and assessing prospects for future performance as they provide a better baseline for

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analyzing the ongoing performance of its businesses by excluding items that may not be indicative of core operating results. Because non-GAAP financial measures are not standardized, it may not be possible to compare these measures with other companies' non-GAAP measures having the same or similar names. All tables below are in thousands of dollars:

|   | Three Months Ended |           |       |
|---|--------------------|-----------|-------|
|   | September 30,      |           |       |
|   | 2018               | 2017      | %     |
| Selling, general and administrative expenses reported                                     | \$890,113          | \$739,442 | 20%   |
| Restructuring (U.S.)  | 3,452              | 13,251    |       |
| Branch gains (U.S.)   | —                  | (5,207)   | )     |
| Other charges (U.S.)  | —                  | (3,023)   | )     |
| Restructuring (Canada)  | (692)              | 4,937     | )     |
| Restructuring (Other businesses)  | 1,115              | (791)     | )     |
| Impairment charges (Other businesses)   | 138,750            | —         |       |
| Subtotal  | 142,625            | 9,167     |       |
| Selling, general and administrative expenses adjusted                                     | \$747,488          | \$730,275 | 2%    |
|   | 2018               | 2017      | %     |
| Operating earnings reported   | \$189,122          | \$277,738 | (32)% |
| Total restructuring and impairments charges, net of branch gains and other charges        | 142,484            | 9,648     |       |
| Operating earnings adjusted   | \$331,606          | \$287,386 | 15%   |
|   | 2018               | 2017      | %     |
| Net earnings attributable to W.W. Grainger, Inc. reported                                 | \$104,377          | \$162,006 | (36)% |
| Total restructuring and impairment charges, net of branch gains and other charges         | 142,484            | 9,648     |       |
| Tax effect of impairment  | (5,829)            | —         | )     |
| Tax effect (1)  | (626)              | (3,129)   | )     |
| Total restructuring and impairment charges, net of branch gains and other charges and tax | 136,029            | 6,519     |       |
| Net earnings attributable to W.W. Grainger, Inc. adjusted                                 | \$240,406          | \$168,525 | 43%   |

(1) The tax impact of adjustments is calculated based on the income tax rate in each applicable jurisdiction, subject to deductibility limitations and the Company's ability to realize the associated tax benefits.

SG&A of \$890 million for the third quarter of 2018 increased \$151 million, or 20% compared to the third quarter of 2017. During the quarter ended September 30, 2018, the Company recorded \$139 million of impairment charges related to goodwill and tradename intangible asset at the Cromwell business. See Note 5 to the Financial Statements. Excluding restructuring and impairment charges net of branch gains and other charges in both periods as noted in the table above, SG&A increased \$17 million, or 2% primarily due to higher variable costs in connection with higher sales, primarily payroll and variable compensation.

Operating earnings of \$189 million for the third quarter of 2018 decreased \$89 million, or 32% compared to the third quarter of 2017. Excluding restructuring and impairment charges net of branch gains and other charges in both periods as noted in the table above, operating earnings increased \$45 million or 15%, driven primarily by higher sales, higher gross profit dollars and improved SG&A leverage.

Other expense, net was \$18 million for the third quarter of 2018, a decrease of 35% compared to the third quarter of 2017. The decrease was primarily due to lower losses from the Company's clean energy investments.

Income taxes of \$56 million for the third quarter of 2018 decreased \$23 million, or 29% compared to the third quarter of 2017. Grainger's effective tax rates were 32.7% and 31.7% for the three months ended September 30, 2018 and

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2017, respectively. The higher effective tax rate in 2018 is primarily due to the impact of Cromwell impairment charges that lowered reported earnings and were not tax deductible, net of the benefit from the Tax Cut and Jobs Act (the Tax Act) and the excess tax benefits from stock-based awards.

Net earnings attributable to W.W. Grainger, Inc. of \$104 million for the third quarter of 2018 decreased \$58 million or 36% compared to the third quarter of 2017. Excluding restructuring and impairment charges net of branch gains and other charges from both periods in the table above, net earnings increased \$71 million, or 43%. The increase in net earnings primarily resulted from higher gross profit, lower SG&A and lower income taxes.

Diluted earnings per share of \$1.82 in the third quarter of 2018 was down 35% versus the \$2.79 for the third quarter of 2017, primarily due to lower net earnings. Excluding restructuring and impairment charges net of branch gains and other charges from both periods in the table above, diluted earnings per share of \$4.19 in the third quarter 2018 increased 44% from \$2.90 for the third quarter 2017.

Segment Analysis

The following comments at the U.S. and Canada segments and Other businesses level include external and intersegment net sales and operating earnings. See Note 12 to the Financial Statements.

United States

Net sales were \$2,188 million for the third quarter of 2018, an increase of \$172 million, or 9% compared to the same period in 2017, and consisting of the following:

Percent Increase/(Decrease)

Volume 8

Price 1

Total 9%

Sales to customers in the heavy manufacturing, government and retail end markets increased high single digits. Natural resources and contractors increased mid-single digits and light manufacturing end markets increased low-single digits. Overall, revenue increases were primarily driven by market share gains and improved demand in all industries. See Note 3 to the Financial Statements.

The gross profit margin for the third quarter of 2018 decreased 0.4 percentage point compared to the same period in 2017. The decline was primarily driven by a 0.6 percentage point decrease due to the implementation of the FASB's new revenue recognition standard. Excluding the impact of the implementation of the revenue recognition standard, gross profit margin would have shown a favorable 0.2 percentage point increase due to sales volume growth.

SG&A increased 6% in the third quarter of 2018 compared to the third quarter 2017. The increase was primarily driven by higher variable compensation due to stronger than anticipated performance, partially offset by the implementation of the FASB's new revenue recognition standard.

Operating earnings of \$326 million for the third quarter of 2018 increased \$31 million, or 11% from \$295 million for the third quarter of 2017. This increase was driven primarily by higher sales, higher gross profit dollars and improved SG&A leverage.

Canada

Net sales were \$150 million for the third quarter of 2018, a decrease of \$38 million, or 20% compared to the same period in 2017 and consisting of the following:

|                  | Percent (Decrease)/Increase |
|------------------|-----------------------------|
| Volume           | (27)                        |
| Foreign exchange | (3)                         |
| Price            | 10                          |
| Total            | (20)%                       |

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For the third quarter of 2018, volume was down 27 percentage points compared to the same period in 2017 due to branch closures and sales coverage optimization activities, partially offset by price increases and continued contract negotiations of 10 percentage points for the third quarter of 2018.

The gross profit margin decreased 0.3 percentage point in the third quarter of 2018 versus the third quarter of 2017, primarily related to prior year adjustments related to excess and obsolete inventory, vendor rebates not repeating in 2018 and the implementation of the FASB's new revenue recognition standard.

SG&A decreased 31% in the third quarter of 2018 compared to the third quarter of 2017. Excluding restructuring costs in both periods (as noted in the table above and Note 6 to the Financial Statements), SG&A would have decreased 26%. This decrease was primarily due to cost reduction actions and lower variable expense due to lower sales volume.

Operating losses were \$4 million for the third quarter of 2018 compared to \$15 million in the third quarter of 2017. Excluding restructuring costs in both periods (as noted in the table above and Note 6 to the Financial Statements), operating losses would have been \$5 million compared to \$10 million in the prior period due to lower SG&A and lower sales volume.

Other businesses

Net sales were \$609 million for the third quarter of 2018, an increase of \$72 million, or 13% when compared to the same period in 2017 and consisting of the following:

|                      | Percent Increase |
|----------------------|------------------|
| Price/volume         | 14               |
| Foreign exchange (1) |                  |
| Total                | 13%              |

The net sales increase was primarily due to continued growth in the single channel businesses as a result of increased customer acquisition and improved sales growth in the international businesses.

Operating losses of \$100 million for the third quarter of 2018 were down \$127 million compared to operating earnings of \$27 million the third quarter of 2017. Other businesses included impairment charges relating to the Cromwell business in the U.K. See Note 5 to the Financial Statements. Excluding restructuring and impairment charges in both periods, operating earnings increased \$13 million or 50%, primarily due to strong performance from the single channel businesses.





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## Matters Affecting Comparability

There were 191 sales days in the nine months ended September 30, 2018 and 2017.

## Results of Operations – Nine Months Ended September 30, 2018

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

|  | Nine Months Ended September 30, |             |                                | As a Percent of   |                   |
|--|---------------------------------|-------------|--------------------------------|-------------------|-------------------|
|  | 2018<br>(A)                     | 2017<br>(A) | Percent<br>Increase/(Decrease) | Net Sales<br>2018 | Net Sales<br>2017 |
| Net sales  | \$8,458                         | \$7,792     |                                | 100.0%            | 100.0%            |
| Cost of goods sold                               | 5,176                           | 4,716       | 10                             | 61.2              | 60.5              |
| Gross profit                                     | 3,282                           | 3,076       | 7                              | 38.8              | 39.5              |
| Selling, general and administrative expenses     | 2,414                           | 2,277       | 6                              | 28.5              | 29.2              |
| Operating earnings                               | 868                             | 799         | 9                              | 10.3              | 10.3              |
| Other expense, net                               | 67                              | 71          | (7)                            | 0.8               | 1.0               |
| Income taxes                                     | 198                             | 267         | (26)                           | 2.3               | 3.4               |
| Net earnings                                     | 604                             | 461         |                                |                   |                   |
| Noncontrolling interest                          | 31                              | 26          | 18                             | 0.4               | 0.3               |
| Net earnings attributable to W.W. Grainger, Inc. | \$573                           | \$435       | 32                             | 6.8               | 5.6               |

(A) May not sum due to rounding

Grainger's net sales of \$8,458 million for the nine months ended September 30, 2018 increased \$666 million, or 9% compared to the same period in 2017, and consisting of the following:

|                  | Percent Increase/(Decrease) |
|------------------|-----------------------------|
| Volume           | 8                           |
| Foreign exchange | 1                           |
| Total            | 9%                          |

The increase in net sales was primarily driven by volume increases in the U.S. business due to market share gain and an improved demand environment and continued double digit growth in the single channel businesses, offset by lower sales in the Canada business. See Note 3 to the Financial Statements and refer to the Segment Analysis below for further details.

Gross profit of \$3,282 million for the nine months ended September 30, 2018 increased \$206 million, or 7% compared to the same period in 2017. The gross profit margin of 38.8% decreased 0.7 percentage point when compared to the same period in 2017. The lower gross profit margin includes a 0.5 percentage point decline from the implementation of the FASB's new revenue recognition standard. Excluding this impact, gross profit margin would have decreased 0.2 percentage point compared to the prior year, driven primarily by the strategic pricing actions in the U.S. business, partially offset by positive customer mix in the U.S. business and improved performance in the Canada business.

The table below reconciles reported SG&A, operating earnings and net earnings attributable to W.W. Grainger, Inc. determined in accordance with U.S. GAAP to adjusted SG&A, operating earnings and net earnings attributable to W.W. Grainger, Inc., which are all considered non-GAAP measures. The Company believes that these non-GAAP measures provide meaningful information to assist shareholders in understanding financial results and assessing prospects for future performance as they provide a better baseline for analyzing the ongoing performance of its

businesses by excluding items that may not be indicative of core operating results. Because non-GAAP financial measures are not standardized, it may not be possible to compare these measures with other companies' non-GAAP measures having the same or similar names. All tables below are in thousands of dollars:

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|   | Nine Months Ended |             |     |
|---|-------------------|-------------|-----|
|   | September 30,     |             |     |
|   | 2018              | 2017        | %   |
| Selling, general and administrative expenses reported                                     | \$2,413,997       | \$2,277,009 | 6%  |
| Restructuring (U.S.)  | 13,602            | 29,857      |     |
| Branch gains (U.S.)   | (8,913)           | (28,032)    |     |
| Other charges (U.S.)  | —                 | (3,023)     |     |
| Restructuring (Canada)  | 22,668            | 23,935      |     |
| Restructuring (Other businesses)  | 3,579             | 40,719      |     |
| Impairment charges (Other businesses)   | 138,750           | —           |     |
| Restructuring (Unallocated expense)   | (4,688)           | —           |     |
| Subtotal  | 164,998           | 63,456      |     |
| Selling, general and administrative expenses adjusted                                     | \$2,248,999       | \$2,213,553 | 2%  |
|   | 2018              | 2017        | %   |
| Operating earnings reported   | \$867,938         | \$799,319   | 9%  |
| Total restructuring and impairment charges, net of branch gains and other charges         | 165,818           | 66,511      |     |
| Operating earnings adjusted   | \$1,033,756       | \$865,830   | 19% |
|   | 2018              | 2017        | %   |
| Net earnings attributable to W.W. Grainger, Inc. reported                                 | \$572,893         | \$434,671   | 32% |
| Total restructuring and impairment charges, net of branch gains and other charges         | 165,818           | 66,511      |     |
| Tax effect of impairment  | (5,829)           | —           |     |
| Tax effect (1)  | (5,923)           | 65          |     |
| Total restructuring and impairment charges, net of branch gains and other charges and tax | 154,066           | 66,576      |     |
| Net earnings attributable to W.W. Grainger, Inc. adjusted                                 | \$726,959         | \$501,247   | 45% |

(1) The tax impact of adjustments is calculated based on the income tax rate in each applicable jurisdiction, subject to deductibility limitations and the Company's ability to realize the associated tax benefits.

SG&A of \$2,414 million for the nine months ended September 30, 2018 increased \$137 million, or 6% from \$2,277 million for the nine months ended September 30, 2017. During the quarter ended September 30, 2018, the Company recorded \$139 million of impairment charges related to goodwill and tradename intangible asset at the Cromwell business. Excluding restructuring and impairment charges net of branch gains and other charges in both periods as noted in the table above, SG&A increased \$35 million or 2%, driven primarily by higher variable costs in connection with higher sales.

Operating earnings for the nine months ended September 30, 2018 were \$868 million, an increase of \$69 million, or 9% compared to the same period in 2017. Excluding restructuring and impairment charges net of branch gains and other charges in both periods as noted in the table above, operating earnings increased \$168 million or 19%, driven primarily by higher sales and improved SG&A leverage.

Other expense, net was \$67 million for the nine months ended September 30, 2018, a decrease of \$4 million, or 7% compared to the nine months ended September 30, 2017. The decrease in expense was primarily due to lower losses from the Company's clean energy investments.

Income taxes of \$198 million for the nine months ended September 30, 2018 decreased \$69 million, or 26% compared with \$267 million for the comparable 2017 period. Grainger's effective tax rates were 24.7% and 36.7% for the nine months ended September 30, 2018 and 2017, respectively. The lower effective tax rate in 2018 is primarily due to the



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impact of the U.S. Tax Act and excess tax benefits from stock-based awards, partially offset by the impact of non-deductible goodwill impairment. The 2017 effective tax rate was impacted by the wind-down of the Colombia business and the inability to realize the associated tax benefit. The Company is currently projecting an effective tax rate of 23% to 26% for the year 2018. Future excess tax benefits from stock based awards are not estimated in the full year projection.

Net earnings attributable to W.W. Grainger, Inc. for the nine months ended September 30, 2018 increased \$138 million or 32% to \$573 million from \$435 million for the nine months ended September 30, 2017. The increase in net earnings primarily resulted from higher operating earnings and lower income taxes. Excluding restructuring and impairment charges net of branch gains and other charges from both periods mentioned above, net earnings increased \$226 million or 45%.

Diluted earnings per share of \$10.04 in the nine months ended September 30, 2018 was up 36% versus the \$7.39 for the same period in 2017, due to higher earnings and lower average shares outstanding. Excluding restructuring and impairment charges, net of branch gains and other charges from both periods in the table above, diluted earnings per share would have been \$12.74 compared to \$8.52 in 2017, an increase of 50%.

#### Segment Analysis

The following comments at the segment and other businesses level include external and intersegment net sales and operating earnings. See Note 12 to the Financial Statements.

#### United States

Net sales were \$6,471 million for the nine months ended September 30, 2018, an increase of \$502 million, or 8%, compared to the same period in 2017, and consisting of the following:

|                | Percent Increase/(Decrease) |
|----------------|-----------------------------|
| Volume         | 9                           |
| Divestiture(1) |                             |
| Total          | 8%                          |

Sales to customers in the government end market increased in the low teens. Retail/wholesale, commercial, contractors and natural resources increased in the high single digits and light manufacturing end markets increased in the mid-single digits. Overall, revenue increases were primarily driven by market share gains and improved demand in all industries, partially offset by the Company's pricing actions and the July 2017 divestiture of a specialty business in the U.S. business. See Note 3 to the Financial Statements.

The gross profit margin decreased 0.9 percentage point compared to the same period in 2017. This decrease is primarily driven by a 0.6 percentage point decline from the adoption of the FASB's new revenue recognition standard and pricing actions.

SG&A for the nine months ended September 30, 2018 increased 2% compared to the same period in 2017. This increase was primarily driven by higher variable compensation due to stronger than anticipated performance, partially offset by the implementation of the FASB's new revenue recognition standard.

Operating earnings of \$1,032 million for the nine months ended September 30, 2018 increased \$118 million, or 13% from \$914 million for the nine months ended September 30, 2017. This increase was driven primarily by higher sales, higher gross profit dollars and improved SG&A leverage.



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## Canada

Net sales were \$508 million for the nine months ended September 30, 2018, a decrease of \$55 million, or 10% compared to the same period in 2017 consisting of the following:

|                    | Percent (Decrease)/Increase |
|--------------------|-----------------------------|
| Volume             | (20)                        |
| Foreign exchange 1 |                             |
| Price              | 9                           |
| Total              | (10)%                       |

For the nine months ended September 30, 2018, volume was down 20 percentage points compared to the same period in 2017 due to branch closures and sales coverage optimization activities, partially offset by price increases and continued contract negotiations of 9 percentage points for the nine months ended September 30, 2018.

The gross profit margin increased 2.7 percentage points in the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017, primarily due to price increases that began in late 2017 and improved customer mix.

SG&A decreased \$25 million, or 11% in the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017. This decrease was primarily due to cost reduction actions and lower variable expense due to lower sales volume.

Operating losses were \$38 million for the nine months ended September 30, 2018 compared to losses of \$59 million in the nine months ended September 30, 2017. Excluding restructuring costs in both periods (as noted in the table above and Note 6 to the Financial Statements), operating losses would have been \$16 million compared to \$33 million in the prior period primarily due to lower SG&A and lower sales volume.

## Other businesses

Net sales for other businesses were \$1,820 million for the nine months ended September 30, 2018 an increase of \$259 million, or 17% compared to the same period in 2017, and consisting of the following:

|                    | Percent Increase |
|--------------------|------------------|
| Price/volume       | 14               |
| Foreign exchange 3 |                  |
| Total              | 17%              |

The net sales increase was primarily due to growth in the single channel businesses as a result of increased customer acquisition and incremental sales in other international businesses. Foreign currencies strengthened in the countries where the Company operates. These currencies primarily include the Euro, Pound and Yen.

Operating losses of \$23 million for the nine months ended September 30, 2018 decreased \$67 million from operating earnings of \$44 million in the comparable period from the prior year. Other businesses included impairment charges relating to the Cromwell business in the U.K. See Note 5 to the Financial Statements. Excluding restructuring and impairment charges in both periods, operating earnings increased \$36 million or 41%, primarily due to strong performance from the single channel businesses.

## Financial Condition

## Cash Flow



Net cash provided by operating activities was \$743 million and \$721 million for the nine months ended September 30, 2018 and 2017, respectively. The increase in cash provided by operating activities is primarily the result of higher net earnings, partially offset by working capital investments to support growth. See Working Capital below for details.

Net cash used in investing activities was \$105 million and \$100 million for the nine months ended September 30, 2018 and 2017, respectively. This increase in net cash used in investing activities was primarily driven by lower additions

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to property, buildings and equipment partially offset by lower proceeds from the sales of assets when compared to the prior year.

Net cash used in financing activities was \$437 million and \$619 million in the nine months ended September 30, 2018 and 2017, respectively. The decrease in net cash used in financing activities was primarily driven by higher proceeds from stock options exercised and lower stock repurchases in 2018 compared to 2017.

#### Working Capital

Internally generated funds are the primary source of working capital and funds used for growth initiatives and capital expenditures. Grainger's working capital is not impacted by significant seasonality trends throughout the year.

Working capital consists of current assets (less non-operating cash) and current liabilities (less short-term debt and current maturities of long-term debt). Working capital at September 30, 2018, was \$1,913 million, an increase of \$244 million when compared to \$1,669 million at December 31, 2017. The increase was primarily driven by an increase in accounts receivable and inventory. At these dates, the ratio of current assets to current liabilities was 2.4 and 2.2, respectively.

#### Debt

Grainger maintains a debt ratio and liquidity position that provides flexibility in funding working capital needs and long-term cash requirements. In addition to internally generated funds, Grainger has various sources of financing available, including bank borrowings under lines of credit. Total debt, which is defined as total interest-bearing debt (short-term, current maturities and long-term) as a percent of total capitalization was 51.6% at September 30, 2018, and 56.2% at December 31, 2017.

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Critical Accounting 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 about future events that affect the amounts reported in the financial statements and accompanying notes.

Accounting estimates are considered critical when they require management to make subjective and complex judgments, estimates and assumptions about matters that have a material impact on the presentation of Grainger's financial statements and accompanying notes. For a description of Grainger's critical accounting estimates, see Grainger's Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Management has discussed the development and selection of these critical accounting estimates with the Audit Committee of the Board of Directors and with the Company's independent registered public accounting firm.

Forward-Looking Statements

From time to time in this Quarterly Report on Form 10-Q, as well as in other written reports, communications and verbal statements, Grainger makes forward-looking statements that are not historical in nature but concern forecasts of future results, business plans, analyses, prospects, strategies, objectives and other matters that may be deemed to be "forward-looking statements" under the federal securities laws. Such forward-looking statements are identified by words such as "anticipate," "estimate," "believe," "expect," "could," "forecast," "may," "intend," "plan," "predict," "project" and similar expressions.

Grainger cannot guarantee that any forward-looking statement will be realized and achievement of future results is subject to risks and uncertainties, many of which are beyond the Company's control, which could cause Grainger's results to differ materially from those that are presented.

Important factors that could cause actual results to differ materially from those presented or implied in the forward-looking statements include, without limitation: higher product costs or other expenses; a major loss of customers; loss or disruption of sources of supply; increased competitive pricing pressures; failure to develop or implement new technologies or business strategies; the implementation, timing and results of the Company's strategic pricing actions and other responses to market pressures; the outcome of pending and future litigation or governmental or regulatory proceedings, including with respect to wage and hour, anti-bribery and corruption, environmental, advertising, privacy and cybersecurity matters; investigations, inquiries, audits and changes in laws and regulations; disruption of information technology or data security systems; general industry or market conditions; general global economic conditions; currency exchange rate fluctuations; market volatility; commodity price volatility; labor shortages; facilities disruptions or shutdowns; higher fuel costs or disruptions in transportation services; natural and other catastrophes; unanticipated weather conditions; loss of key members of management; the Company's ability to operate, integrate and leverage acquired businesses; changes in credit ratings; changes in effective tax rates; and other factors identified under Item 1A: Risk Factors in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, as updated in the Company's Quarterly Reports on Form 10-Q.

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

W.W. Grainger, Inc. and Subsidiaries

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about market risk, see “Item 7A: Quantitative and Qualitative Disclosures About Market Risk” in Grainger's Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

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 Grainger's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. 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 in (i) ensuring that information required to be disclosed by Grainger in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There have been no changes in Grainger's internal control over financial reporting for the quarter ended September 30, 2018, that have materially affected, or are reasonably likely to materially affect, Grainger’s internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

For a description of the Company’s legal proceedings, see Note 13 - Contingencies and Legal Matters - to the Condensed Consolidated Financial Statements included under Item 1 - Financial Statements, of Part I of this report.

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

Issuer Purchases of Equity Securities – Third Quarter

| Period | Total Number of Shares Purchased (A) | Average Price Paid per Share (B) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (C) | Maximum Number of Shares That May Yet be Purchased Under the Plans or Programs |
|--------|--------------------------------------|----------------------------------|--|--|
|        |                                      |                                  |  |  |

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|          |         |          |         |           |
|----------|---------|----------|---------|-----------|
| July 1 - |         |          |         |           |
| July 31  | 33,029  | \$323.40 | 33,029  | 2,060,529 |
| Aug 1 -  |         |          |         |           |
| Aug 31   | 103,188 | \$355.48 | 103,188 | 1,957,341 |
| Sept 1 - |         |          |         |           |
| Sept 30  | 107,529 | \$354.10 | 107,529 | 1,849,812 |
| Total    | 243,746 |          | 243,746 |           |

(A) There were no shares withheld to satisfy tax withholding obligations.

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

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors on April 6, 2015, up to 15 million shares with no expiration date. Activity is reported on a trade date basis.

W.W. Grainger, Inc. and Subsidiaries

Item 6. Exhibits

A list of exhibits filed with this report on Form 10-Q is provided in the Exhibit Index on page 34 of this report.

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SIGNATURES

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

W.W. GRAINGER, INC.

Date: November 1, 2018

By: /s/ Thomas B. Okray  
Thomas B. Okray, Senior Vice President  
and Chief Financial Officer  
(Principal Financial Officer)

Date: November 1, 2018

By: /s/ Eric R. Tapia  
Eric R. Tapia, Vice President  
and Controller  
(Principal Accounting Officer)

EXHIBIT INDEX

| EXHIBIT NO. | DESCRIPTION  |
|-------------|--|
| <u>10.1</u> | W.W. Grainger, Inc. 2015 Incentive Plan as Amended and Restated Effective October 31, 2018.  |
| <u>31.1</u> | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>31.2</u> | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| <u>32</u>   | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS     | XBRL Instance Document.  |
| 101.SCH     | XBRL Taxonomy Extension Schema Document.   |
| 101.CAL     | XBRL Taxonomy Extension Calculation Linkbase Document.   |
| 101.DEF     | XBRL Taxonomy Extension Definition Linkbase Document.  |
| 101.LAB     | XBRL Taxonomy Extension Label Linkbase Document.   |
| 101.PRE     | XBRL Taxonomy Extension Presentation Linkbase Document.  |