GRAINGER W W INC
Form 10-Q
August 02, 2007
**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

**FORM 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2007**

**OR**

**o 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 X No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

| | | | | |
|---|---|---|---|---|
| Large accelerated filer | X | Accelerated filer | | Non-accelerated filer |

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

| | | |
|---|---|---|
| Yes | No | X |

There were 84,392,180 shares of the Company s Common Stock outstanding as of June 30, 2007.

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**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements (Unaudited)**

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

**CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS**

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

(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2007 | 2006 | June 30, 2007 | 2006 |
| Net sales | $ 1,601,011 | $ 1,482,880 | $ 3,147,669 | $ 2,901,997 |
| Cost of merchandise sold | 960,546 | 899,575 | 1,875,116 | 1,748,365 |
| Gross profit | 640,465 | 583,305 | 1,272,553 | 1,153,632 |
| Warehousing, marketing and administrative expenses | 473,890 | 438,761 | 943,393 | 874,671 |
| Operating earnings | 166,575 | 144,544 | 329,160 | 278,961 |
| Other income and (expense): | | | | |
| Interest income | 4,016 | 5,381 | 8,038 | 10,740 |
| Interest expense | (519) | (502) | (1,096) | (995) |
| Equity in income (losses) of unconsolidated entities net | 225 | 862 | (117) | 2,069 |
| Gain on sale of unconsolidated entity | | 2,291 | | 2,291 |
| Unclassified net | (45) | 293 | (12) | 170 |
| Total other income and (expense) | 3,677 | 8,325 | 6,813 | 14,275 |
| Earnings before income taxes | 170,252 | 152,869 | 335,973 | 293,236 |
| Income taxes | 65,461 | 59,130 | 129,395 | 113,264 |
| Net earnings | $ 104,791 | $ 93,739 | $ 206,578 | $ 179,972 |
| Earnings per share: | | | | |
| Basic | $ 1.25 | $ 1.05 | $ 2.46 | $ 2.01 |
| Diluted | $ 1.21 | $ 1.02 | $ 2.38 | $ 1.95 |
| Weighted average number of shares outstanding: | | | | |
| Basic | 84,130,074 | 89,342,642 | 84,057,230 | 89,490,188 |
| Diluted | 86,775,154 | 92,104,424 | 86,768,774 | 92,294,563 |
| Cash dividends paid per share | $ 0.35 | $ 0.29 | $ 0.64 | $ 0.53 |

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 | | Six Months Ended | |
|---|---|---|---|---|
| | June 30, 2007 | 2006 | June 30, 2007 | 2006 |
| Net earnings | $ 104,791 | $ 93,739 | $ 206,578 | $ 179,972 |
| Other comprehensive earnings: | | | | |
| Foreign currency translation adjustments, net of tax expense of $4,520, $2,474, $5,048, and $2,230, respectively | 25,652 | 12,611 | 28,235 | 10,754 |
| Comprehensive earnings | $ 130,443 | $ 106,350 | $ 234,813 | $ 190,726 |

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

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

**CONDENSED CONSOLIDATED BALANCE SHEETS**

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

(Unaudited)

| ASSETS | June 30, 2007 | Dec. 31, 2006 |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents | $ 389,390 | $ 348,471 |
| Marketable securities at cost, which approximates market value | | 12,827 |
| Accounts receivable (less allowances for doubtful accounts of $18,283 and $18,801, respectively) | 637,813 | 566,607 |
| Inventories | 845,227 | 827,254 |
| Prepaid expenses and other assets | 60,565 | 58,804 |
| Prepaid income taxes | 14,638 | |
| Deferred income taxes | 54,038 | 48,123 |
| Total current assets | 2,001,671 | 1,862,086 |
| PROPERTY, BUILDINGS AND EQUIPMENT | 1,899,969 | 1,827,104 |
| Less accumulated depreciation and amortization | 1,074,664 | 1,034,169 |
| Property, buildings and equipment net | 825,305 | 792,935 |
| DEFERRED INCOME TAXES | 60,222 | 48,793 |
| INVESTMENT IN UNCONSOLIDATED ENTITY | 8,097 | 8,492 |
| GOODWILL | 223,712 | 210,671 |
| OTHER ASSETS AND INTANGIBLES NET | 120,004 | 123,111 |
| TOTAL ASSETS | $ 3,239,011 | $ 3,046,088 |

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

**CONDENSED CONSOLIDATED BALANCE SHEETS (Continued)**

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

(Unaudited)

| LIABILITIES AND SHAREHOLDERS' EQUITY | June 30, 2007 | Dec. 31, 2006 |
|---|---|---|
| CURRENT LIABILITIES | | |
| Short-term debt | $ 6,222 | $ |
| Current maturities of long-term debt | 4,590 | 4,590 |
| Trade accounts payable | 386,897 | 334,820 |
| Accrued compensation and benefits | 133,916 | 140,141 |
| Accrued contributions to employees profit sharing plans | 60,248 | 113,014 |
| Accrued expenses | 88,338 | 106,681 |
| Income taxes payable | 3,985 | 7,077 |
| Total current liabilities | 684,196 | 706,323 |
| LONG-TERM DEBT (less current maturities) | 4,895 | 4,895 |
| DEFERRED INCOME TAXES | 24,412 | 6,235 |
| ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS | 162,885 | 151,020 |
| SHAREHOLDERS' EQUITY | | |
| Cumulative Preferred Stock $5 par value 12,000,000 shares authorized; none issued nor outstanding | | |
| Common Stock $0.50 par value 300,000,000 shares authorized; issued 109,657,938 shares | 54,829 | 54,829 |
| Additional contributed capital | 569,934 | 513,667 |
| Retained earnings | 3,160,989 | 3,007,606 |
| Unearned restricted stock compensation | (60,969) | (35,213) |
| Accumulated other comprehensive earnings | 31,666 | 3,431 |
| Treasury stock, at cost 25,265,758 and 25,590,311 shares, respectively | (1,393,826) | (1,366,705) |
| Total shareholders' equity | 2,362,623 | 2,177,615 |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY | $ 3,239,011 | $ 3,046,088 |

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

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

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands of dollars)

(Unaudited)

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings | $ 206,578 | $ 179,972 |
| Provision for losses on accounts receivable | 3,220 | 1,508 |
| Deferred income taxes | (3,345) | (14,858) |
| Depreciation and amortization: | | |
| Property, buildings and equipment | 48,518 | 46,611 |
| Capitalized software and other intangibles | 12,209 | 8,213 |
| Stock-based compensation | 21,760 | 20,628 |
| Tax benefit of stock incentive plans | 2,193 | 4,599 |
| Net gains on sales of property, buildings and equipment | (4,112) | (6,268) |
| Gain on sale of unconsolidated entity | | (2,291) |
| (Income) losses from unconsolidated entities | 117 | (2,069) |
| Change in operating assets and liabilities net of business acquisitions: | | |
| (Increase) in accounts receivable | (68,420) | (88,571) |
| (Increase) decrease in inventories | (5,043) | 14,286 |
| (Increase) in prepaid income taxes | (14,638) | |
| (Increase) in prepaid expenses | (1,361) | (3,239) |
| Increase (decrease) in trade accounts payable | 50,456 | (3,138) |
| (Decrease) in other current liabilities | (72,064) | (78,750) |
| Increase (decrease) in current income taxes payable | (3,451) | 17,156 |
| Increase in accrued employment-related benefit costs | 11,865 | 8,971 |
| Other net | (4,148) | (2,237) |
| Net cash provided by operating activities | 180,334 | 100,523 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Additions to property, buildings and equipment net of dispositions | (73,141) | (52,494) |
| Additions to capitalized software | (2,567) | (3,368) |
| Cash paid for business acquisitions | (4,762) | (13,859) |
| Proceeds from sale of unconsolidated entity | | 27,413 |
| Other net | 12,364 | (1,718) |
| Net cash used in investing activities | (68,106) | (44,026) |

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

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(In thousands of dollars)

(Unaudited)

| | Six Months Ended June 30, 2007 | 2006 |
|---|---|---|
| CASH FLOWS FINANCING ACTIVITIES: | | |
| Increase in short-term debt | $ 6,222 | $ |
| Stock options exercised | 95,320 | 43,662 |
| Excess tax benefits from stock-based compensation | 24,203 | 5,533 |
| Purchase of treasury stock | (147,294) | (150,116) |
| Cash dividends paid | (54,065) | (47,715) |
| Net cash used in financing activities | (75,614) | (148,636) |
| Exchange rate effect on cash and cash equivalents | 4,305 | 786 |
| NET INCREASE (DECREASE) IN CASH AND CASH | | |
| EQUIVALENTS | 40,919 | (91,353) |
| Cash and cash equivalents at beginning of year | 348,471 | 544,894 |
| Cash and cash equivalents at end of period | $ 389,390 | $ 453,541 |

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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

## 1. BACKGROUND AND BASIS OF STATEMENT PRESENTATION

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

The Condensed Consolidated Financial Statements of the Company and the related notes are unaudited and should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2006, included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC).

The Condensed Consolidated Balance Sheet as of December 31, 2006 has been derived from the audited consolidated financial statements at that date, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America for complete financial statements.

The unaudited financial information reflects all adjustments (consisting of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the statements contained herein. Certain prior period amounts have been reclassified to conform to the current year s presentation.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

During the six months ended June 30, 2007, the Company recognized an additional $1.0 million of income tax expense for the current year positions, of which approximately $0.4 million is for interest and penalties. The Company recognizes interest expense and penalties in the provision for income taxes.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

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

NEW ACCOUNTING STANDARDS

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

In June 2007, the Emerging Issues Task Force (EITF) reached a consensus with respect to EITF Issue No. 06-11 (Issue No. 06-11), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. Under Issue 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and paid to employees for equity classified nonvested equity shares, nonvested equity share units, and outstanding equity share options should be recognized as an increase to additional paid-in capital (APIC). The amount recognized in APIC should be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards. A tax benefit recognized from a dividend on an award that is subsequently forfeited or is no longer expected to vest would be reclassified from APIC to the income statement, if sufficient excess tax benefits are available in the pool of excess tax benefits in APIC. Issue 06-11 is to be applied prospectively to the income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after December 15, 2007 with early application permitted. The Company does not expect adoption of Issue 06-11 to have a material effect on its results of operations or financial position.

**3. ACQUISITION**

On May 31, 2007, Lab Safety Supply, Inc. (Lab Safety), a wholly owned subsidiary of the Company, acquired substantially all of the assets and assumed certain liabilities of McFeely s Square Drive Screws (McFeely s). McFeely s is a business-to-business direct marketer of specialty fasteners, hardware and tools for the professional woodworking industry. McFeely s had more than $9 million in sales in 2006. The purchase price and costs of acquisition were $4.8 million in cash and $0.3 million in assumed liabilities. The estimated goodwill recognized in the transaction amounted to $1.3 million and is expected to be fully deductible for tax purposes. The results of McFeely s are included in the Company s consolidated results from the date of acquisition. Due to the immaterial nature of this transaction, disclosure of pro forma results were not considered necessary.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

**4. DIVIDEND**

On July 25, 2007, the Board of Directors declared a quarterly dividend of 35 cents per share, payable September 1, 2007 to shareholders of record on August 13, 2007.

**5. WARRANTY RESERVES**

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

The warranty reserve activity was as follows:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| | (In thousands of dollars) | |
| Beginning balance | $ 4,651 | $ 3,763 |
| Returns | (6,182) | (5,160) |
| Provision | 5,821 | 5,439 |
| Ending balance | $ 4,290 | $ 4,042 |

**6. SHORT-TERM DEBT**

The Company entered into a revolving short-term line of credit related to Grainger China LLC. The maximum loan amount of the line of credit is US$21.0 million or the equivalent Chinese Renminbi. Grainger China LLC utilizes the line of credit to meet its business expansion needs. As of June 30, 2007, $6.2 million of the line of credit was used to purchase its previously leased master branch facility in China.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

## 7. EMPLOYEE BENEFITS

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| | (In thousands of dollars) | | | |
| Service cost | $ 2,714 | $ 2,434 | $ 5,428 | $ 4,868 |
| Interest cost | 2,244 | 1,900 | 4,487 | 3,800 |
| Expected return on assets | (1,013) | (697) | (2,025) | (1,395) |
| Amortization of transition asset | (35) | (36) | (71) | (72) |
| Amortization of unrecognized losses | 524 | 726 | 1,047 | 1,452 |
| Amortization of prior service cost | (110) | (214) | (219) | (429) |
| Net periodic benefit costs | $ 4,324 | $ 4,113 | $ 8,647 | $ 8,224 |

The Company has established a Group Benefit Trust to fund the plan and process benefit payments. The funding of the trust is an estimated amount, which is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended. There are no minimum funding requirements and the Company intends to follow its practice of funding the maximum deductible contribution under the IRC. During the three and six months ended June 30, 2007, the Company contributed $0.6 million and $1.1 million, respectively, to the trust.

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

## 8. SEGMENT INFORMATION

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

| | Three Months Ended June 30, 2007 | | | |
|---|---|---|---|---|
| | Grainger Branch-based | Acklands Grainger Branch-based | Lab Safety | Total |
| | (In thousands of dollars) | | | |
| Total net sales | $ 1,332,862 | $ 159,282 | $ 110,354 | $ 1,602,498 |
| Intersegment net sales | (491) | | (996) | (1,487) |
| Net sales to external customers | $ 1,332,371 | $ 159,282 | $ 109,358 | $ 1,601,011 |
| Segment operating earnings | $ 171,670 | $ 10,519 | $ 14,368 | $ 196,557 |

| | Three Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Grainger Branch-based | Acklands Grainger Branch-based | Lab Safety | Total |
| | (In thousands of dollars) | | | |
| Total net sales | $ 1,233,574 | $ 146,920 | $ 103,273 | $ 1,483,767 |
| Intersegment net sales | (345) | | (542) | (887) |
| Net sales to external customers | $ 1,233,229 | $ 146,920 | $ 102,731 | $ 1,482,880 |
| Segment operating earnings | $ 151,811 | $ 3,070 | $ 13,472 | $ 168,353 |

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

| | Six Months Ended June 30, 2007 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Grainger Branch-based | | Acklands | Grainger Branch-based | | Lab Safety | | Total |
| | (In thousands of dollars) | | | | | | | |
| Total net sales | $ | 2,629,244 | $ | 301,332 | $ | 219,454 | $ | 3,150,030 |
| Intersegment net sales | (724) | | | | (1,637) | | (2,361) | |
| Net sales to external customers | $ | 2,628,520 | $ | 301,332 | $ | 217,817 | $ | 3,147,669 |
| Segment operating earnings | $ | 331,912 | $ | 19,467 | $ | 28,978 | $ | 380,357 |

| | Six Months Ended June 30, 2006 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Grainger Branch-based | | Acklands | Grainger Branch-based | | Lab Safety | | Total |
| | (In thousands of dollars) | | | | | | | |
| Total net sales | $ | 2,410,715 | $ | 285,942 | $ | 207,152 | $ | 2,903,809 |
| Intersegment net sales | (660) | | | | (1,152) | | (1,812) | |
| Net sales to external customers | $ | 2,410,055 | $ | 285,942 | $ | 206,000 | $ | 2,901,997 |
| Segment operating earnings | $ | 284,663 | $ | 6,948 | $ | 28,699 | $ | 320,310 |

| | Grainger Branch-based | | Acklands | Grainger Branch-based | | Lab Safety | | Total |
|---|---|---|---|---|---|---|---|---|
| Segment assets: | (In thousands of dollars) | | | | | | | |
| June 30, 2007 | $ | 2,018,628 | $ | 461,810 | $ | 209,672 | $ | 2,690,110 |
| December 31, 2006 | $ | 1,938,270 | $ | 394,707 | $ | 215,515 | $ | 2,548,492 |

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

(Unaudited)

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Operating earnings: | | (In thousands of dollars) | | |
| Total operating earnings for reportable segments | $ 196,557 | $ 168,353 | $ 380,357 | $ 320,310 |
| Unallocated expenses and eliminations | (29,982) | (23,809) | (51,197) | (41,349) |
| Total consolidated operating earnings | $ 166,575 | $ 144,544 | $ 329,160 | $ 278,961 |

| | June 30, 2007 | December 31, 2006 |
|---|---|---|
| Assets: | (In thousands of dollars) | |
| Total assets for reportable segments | $ 2,690,110 | $ 2,548,492 |
| Unallocated assets | 548,901 | 497,596 |
| Total consolidated assets | $ 3,239,011 | $ 3,046,088 |

Unallocated expenses and unallocated assets primarily relate to the Company headquarters support services, which are not part of any business segment. Unallocated expenses include payroll and benefits, depreciation and other costs associated with headquarters-related support services. The unallocated expense increase was primarily driven by payroll and benefits. Unallocated assets include non-operating cash and cash equivalents, certain prepaid expenses and property, buildings and equipment net. The increase in unallocated assets was primarily driven by the increase in non-operating cash and cash equivalents.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**Item 2.**

**Overview**

***General***

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

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

***Business Environment***

Several economic factors and industry trends shape Grainger s business environment. Grainger s sales tend to correlate positively with production growth, particularly manufacturing output, as well as growth in non-farm payrolls. According to the Federal Reserve, overall industrial production increased 1.4% from June of 2006 to June of 2007. Manufacturing output increased 1.6% from June of 2006 to June of 2007, although manufacturing employment levels declined approximately 1.3%. Non-farm employment levels grew 1.5% from June of 2006 to June of 2007. Grainger s sales to the heavy and light manufacturing customer sector continue to show improvement over the prior year, though at a slower rate than the first quarter of 2007. Current economic growth projections for 2007 industrial production and GDP are 1.9% and 2.1%, respectively.

For the first six months of 2007, the Company had $81.7 million of capital expenditures, of which $33.8 million related to its market expansion program. The Company expects to continue its investments in the market expansion program through 2008.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

***Matters Affecting Comparability***

Grainger s operating results for the first six months of 2007 include the operating results of the acquisitions made by Lab Safety in 2007 and late 2006. Since the respective acquisition dates, those results have been included in the Lab Safety segment. See Note 3 to the Condensed Consolidated Financial Statements and Segment Analysis in the following Management s Discussion and Analysis.

**Results of Operations Three Months Ended June 30, 2007**

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

| | Three Months Ended June 30, Items in Condensed Consolidated Statements of Earnings | | |
|---|---|---|---|
| | As a Percent of Net Sales | | Percent Increase |
| | 2007 | 2006 | (Decrease) |
| Net sales | 100.0% | 100.0% | 8.0% |
| Cost of merchandise sold | 60.0 | 60.7 | 6.8 |
| Gross profit | 40.0 | 39.3 | 9.8 |
| Operating expenses | 29.6 | 29.6 | 8.0 |
| Operating earnings | 10.4 | 9.7 | 15.2 |
| Other income | 0.2 | 0.6 | (55.8) |
| Income taxes | 4.1 | 4.0 | 10.7 |
| Net earnings | 6.5 | 6.3 | 11.8 |

Grainger s net sales of $1,601.0 million in the second quarter of 2007 increased 8.0% compared with sales of $1,482.9 million for the comparable 2006 quarter. Second quarter 2007 sales benefited from ongoing strategic initiatives such as market expansion and product line expansion. Partially offsetting these improvements was the negative effect of the wind-down of low margin integrated supply contracts. An increase in net sales was realized in all three segments of the business.

The gross profit margin improved 0.7 percentage point to 40.0% for the second quarter of 2007 from 39.3% in the comparable period of 2006. The primary drivers of the gross profit margin improvement were positive product mix and an improvement in freight and handling costs, partially offset by unfavorable selling mix and inflation recovery.

Operating expenses of $473.9 million in the second quarter of 2007 increased 8.0%. This increase was driven primarily by non-payroll related operating expenses, partially offset by payroll and benefits which increased at a slower rate than sales.

Operating earnings for the second quarter of 2007 totaled $166.6 million, an increase of 15.2% over the second quarter of 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Net earnings for the second quarter of 2007 increased by 11.8% to $104.8 million from $93.7 million in 2006. The growth in net earnings for the quarter primarily resulted from the improvement in operating earnings, partially offset by lower interest income and no counterpart in the second quarter of 2007 to a gain realized in the second quarter of 2006 on the sale of Acklands Grainger s interest in the USI-AGI Prairies joint venture. Diluted earnings per share of $1.21 in the second quarter of 2007 were 18.6% higher than the $1.02 for the second quarter of 2006. This improvement was higher than the percentage increase for net earnings due to the effect of the Company s share repurchase program.

***Segment Analysis***

The following comments at the segment level refer to external and intersegment net sales. Comments at the business unit level include external and inter- and intrasegment net sales. See Note 8 to the Condensed Consolidated Financial Statements.

<u>*Grainger Branch-based*</u>

In the second quarter of 2007, net sales of $1,332.9 million increased 8.0% compared to net sales of $1,233.6 million in the second quarter of 2006.

Sales in the United States were up 8.0%, with growth in all customer end markets, led by the government and commercial sectors. The wind-down of the Company s low margin integrated supply contracts reduced sales growth by approximately 1 percentage point. The sales growth benefited from the Company s two strategic initiatives: market expansion and product line expansion.

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

| | 2007 Second Quarter Sales Increase | Percent Complete |
|---|---|---|
| Phase 1 (Atlanta, Denver, Seattle) | 12% | 100% |
| Phase 2 (Four markets in Southern California) | 5% | 95% |
| Phase 3 (Houston, St. Louis, Tampa) | 11% | 95% |
| Phase 4 (Baltimore, Cincinnati, Kansas City, Miami, Philadelphia, Washington D.C.) | 12% | 95% |
| Phase 5 (Dallas, Detroit, New York City, Phoenix) | 10% | 55% |

Product line expansion contributed approximately 3 percentage points to the sales growth for the segment. Over the past two years, the Company has added approximately 60,000 new products in the plumbing, fastener, material handling and security product lines as part of its ongoing product line expansion initiative.

Sales in Mexico increased 26.1% in the second quarter of 2007 versus 2006. In local currency, sales were up 22.6% driven primarily by the ongoing branch expansion program and an improved economy.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

The segment gross profit margin increased 0.6 percentage point in the 2007 quarter over the comparable quarter of 2006 primarily driven by positive product mix and an improvement in freight and handling costs, partially offset by unfavorable selling mix and inflation recovery.

Operating expenses in this segment were up 8.2% in the quarter. This increase was driven primarily by non-payroll related operating expenses, partially offset by payroll and benefits which increased at a slower rate than sales. The non-payroll related operating expense increase in 2007 was partially the result of lower gains on fixed asset disposals compared to the same period in 2006.

For the segment, operating earnings of $171.7 million for the second quarter of 2007 increased 13.1% over the $151.8 million for the second quarter of 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin, partially offset by operating expenses which grew at a slightly faster rate than sales.

*Acklands Grainger Branch-based*

Net sales at Acklands Grainger were $159.3 million in the second quarter of 2007, an increase of $12.4 million, or 8.4%, when compared with $146.9 million for the same period in 2006. In local currency, sales increased 6.0% due to stronger sales in the construction, mining, and oil and gas industries, partially offset by weakness in the forestry and manufacturing industries.

The gross profit margin increased 1.9 percentage points in the 2007 quarter over the second quarter of 2006. The improvement in the gross profit margin was primarily due to positive inflation recovery.

Operating expenses decreased 0.6% primarily driven by lower payroll costs, including lower severance costs of $0.9 million.

Operating earnings of $10.5 million in the second quarter of 2007 were up $7.4 million or 243%. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and reduced operating expenses.

*Lab Safety*

Net sales at Lab Safety were $110.4 million for the second quarter of 2007, an increase of $7.1 million, or 6.9%, when compared with $103.3 million for the same period in 2006. Sales from acquisitions made during 2007 and late 2006 contributed approximately 6 percentage points to the growth.

The gross profit margin decreased 0.5 percentage point for the second quarter of 2007 from the second quarter of 2006. Gross profit margin was down as a result of unfavorable selling and product mix, partially offset by lower freight costs.

Operating expenses were up 5.0% in the quarter. This increase was driven primarily by non-payroll related operating expenses, partially offset by payroll and benefits which increased at a slower rate than sales.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Operating earnings of $14.4 million in the second quarter of 2007 increased 6.6% over the same period in 2006. This earnings improvement was less than the sales growth rate due to a lower gross profit margin, partially offset by operating expenses which grew at a slower rate than sales.

***Other Income and Expense***

Other income and expense was income of $3.7 million in the second quarter of 2007 compared with $8.3 million in the second quarter of 2006. The decrease in other income and expense was primarily attributable to lower interest income in 2007 and no counterpart in the second quarter of 2007 to a gain realized in the 2006 second quarter on the sale of Acklands Grainger s interest in the USI-AGI Prairies joint venture.

***Income Taxes***

Grainger s effective tax rate was 38.4% and 38.7% for the second quarter of 2007 and 2006, respectively. Excluding the effect of equity in income of unconsolidated entities, which is recorded net of tax, the effective income tax rate was 38.5% for the second quarter of 2007 and 38.9% for the second quarter of 2006. The full year 2006 rate was 36.4% and benefited from the resolution of uncertainties related to the audit of the 2004 tax year and from a reduction of deferred tax liabilities related to property, buildings and equipment.

**Results of Operations Six Months Ended June 30, 2007**

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

| | Six Months Ended June 30, Items in Condensed Consolidated Statements of Earnings As a Percent of Net Sales | | Percent Increase |
|---|---|---|---|
| | 2007 | 2006 | (Decrease) |
| Net sales | 100.0% | 100.0% | 8.5% |
| Cost of merchandise sold | 59.6 | 60.2 | 7.2 |
| Gross profit | 40.4 | 39.8 | 10.3 |
| Operating expenses | 29.9 | 30.2 | 7.9 |
| Operating earnings | 10.5 | 9.6 | 18.0 |
| Other income | 0.2 | 0.5 | (52.3) |
| Income taxes | 4.1 | 3.9 | 14.2 |
| Net earnings | 6.6 | 6.2 | 14.8 |

Grainger s net sales of $3,147.7 million in the first six months of 2007 increased 8.5% compared with sales of $2,902.0 million for the comparable 2006 period. First half sales benefited from ongoing strategic initiatives such as market expansion and product line expansion.

Partially offsetting these improvements was the negative effect of the wind-down of low margin integrated supply contracts. An increase in net sales was realized in all three segments of the business.

The gross profit margin for the six months ended June 30, 2007 improved 0.6 percentage point to 40.4% from 39.8% in the comparable period of 2006. The improvement in the gross profit margin was primarily driven by positive inflation recovery.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Operating expenses of $943.4 million in 2007 increased 7.9% over the prior year. The increase was driven by payroll and benefits, primarily the result of increased headcount and higher profit sharing and incentive compensation accruals.

Operating earnings for the six months ended June 30, 2007 totaled $329.2 million, an increase of 18.0% over the first six months of 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and operating expenses which grew at a slower rate than sales.

Net earnings for the six months ended June 30, 2007 increased by 14.8% to $206.6 million from $180.0 million in 2006. The growth in net earnings for the six months ended June 30, 2007 primarily resulted from the improvement in operating earnings, partially offset by lower interest income and no counterpart in the second quarter of 2007 to a gain realized in the 2006 second quarter on the sale of Acklands Grainger s interest in the USI-AGI Prairies joint venture. Diluted earnings per share of $2.38 in the first half of 2007 were 22.1% higher than the $1.95 for the first half of 2006. This improvement was higher than the percentage increase for net earnings due to the effect of the Company s share repurchase program.

***Segment Analysis***

The following comments at the segment level refer to external and intersegment net sales. Comments at the business unit level include external and inter- and intrasegment net sales. See Note 8 to the Condensed Consolidated Financial Statements.

*Grainger Branch-based*

Net sales of $2,629.2 million increased by 9.1% in the first six months of 2007 compared to net sales of $2,410.7 million in the first six months of 2006.

Sales in the United States were up 9.0%, with growth in all customer end markets, led by the government and commercial sectors. The wind-down of the Company s low margin integrated supply contracts reduced sales growth by approximately 1 percentage point. The sales growth benefited from its two strategic initiatives: market expansion and product line expansion.

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

| | 2007 Year-to-Date Sales Increase | Percent Complete |
|---|---|---|

| | | |
|---|---|---|
| Phase 1 (Atlanta, Denver, Seattle) | 13% | 100% |
| Phase 2 (Four markets in Southern California) | 6% | 95% |
| Phase 3 (Houston, St. Louis, Tampa) | 13% | 95% |
| Phase 4 (Baltimore, Cincinnati, Kansas City, Miami, Philadelphia, Washington D.C.) | 12% | 95% |
| Phase 5 (Dallas, Detroit, New York City, Phoenix) | 10% | 55% |

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Product line expansion contributed approximately 2 percentage points to the sales growth for the segment. Over the past two years, the Company has added approximately 60,000 new products in the plumbing, fastener, material handling and security product lines as part of its ongoing product line expansion initiative.

Sales in Mexico increased 23.0% in the first half of 2007 versus 2006. In local currency, sales were up 23.3% driven by the ongoing branch expansion program and an improved economy.

The segment gross profit margin increased 0.6 percentage point in the first half of 2007 over the comparable 2006 period, driven by positive inflation recovery, partially offset by unfavorable selling mix.

Operating expenses were up 8.2% for the six months ended June 30, 2007. The operating expense growth was primarily driven by higher payroll and benefits costs due to increased headcount and higher accruals for profit sharing and incentive compensation, in addition to lower gains on fixed asset disposals compared to the same period in 2006.

Operating earnings of $331.9 million for the first half of 2007 increased 16.6% over the $284.7 million for the first half of 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and operating expenses which grew at a slower rate than sales.

*Acklands Grainger Branch-based*

Net sales at Acklands Grainger were $301.3 million for the first six months of 2007, an increase of $15.4 million, or 5.4%, when compared with $285.9 million for the same period in 2006. In local currency, sales increased 4.9% due to stronger sales in the construction, mining, and oil and gas sectors, partially offset by weakness in the forestry and manufacturing sectors.

The gross profit margin increased 2.3 percentage points in the first half of 2007 over the first half of 2006. The improvement in the gross profit margin was primarily due to positive inflation recovery, partially offset by higher freight costs.

Operating expenses decreased 0.5% in the first six months of 2007 primarily driven by lower payroll costs, including lower severance costs of $1.0 million.

Operating earnings of $19.5 million in the first six months of 2007 were up 180%. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and lower operating expenses.

*Lab Safety*

Net sales at Lab Safety were $219.5 million for the first six months of 2007, an increase of $12.3 million, or 5.9%, when compared with $207.2 million for the same period in 2006. Sales from the acquisitions made during 2007 and late 2006 contributed approximately 6 percentage points to the growth.

The gross profit margin decreased 0.7 percentage point in the first half of 2007 over the first half of 2006. The gross profit margin was down as a result of unfavorable selling and product mix.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Operating expenses were 5.7% higher in the first six months of 2007. This increase was driven primarily by non-payroll related operating expenses, partially offset by payroll and benefits which increased at a slower rate than sales.

Operating earnings of $29.0 million for the first six months of 2007 were up 1.0% over 2006. This earnings improvement was less than the sales growth rate due to a lower gross profit margin, partially offset by operating expenses which grew at a slightly slower rate than sales.

***Other Income and Expense***

Other income and expense was income of $6.8 million in the first half of 2007 compared with $14.3 million in the first half of 2006. The decrease in other income and expense was primarily attributable to lower interest income in 2007 and no counterpart in the second quarter of 2007 to a gain realized in the 2006 second quarter on the sale of Acklands Grainger s interest in the USI-AGI Prairies joint venture. In addition, there was a loss on equity of unconsolidated entities in 2007 versus income in 2006 primarily driven by the absence of earnings resulting from the joint venture sale.

***Income Taxes***

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

**Financial Condition**

For the six months ended June 30, 2007, working capital of $1,317.5 million increased by $161.7 million when compared to $1,155.8 million at December 31, 2006. The ratio of current assets to current liabilities was 2.9 at June 30, 2007, versus 2.6 at December 31, 2006.

Net cash provided by operating activities was $180.3 million and $100.5 million for the six months ended June 30, 2007 and 2006, respectively. Net cash flows from operating activities serve as the Company s primary source to fund its growth initiatives. Contributing to cash flows from operations were net earnings in the first six months ended June 30, 2007 of $206.6 million and the change in non-cash items such as stock-based compensation, and depreciation and amortization. Partially offsetting these amounts were Changes in operating assets and liabilities net of business acquisitions, which resulted in a net use of cash of $102.7 million for the first six months of 2007. The principal operating uses of cash were increases in accounts receivable and a reduction of other current liabilities. The increase in receivables was due to a higher sales volume. Other current liabilities declined primarily due to the timing of annual cash payments for profit sharing and bonuses. Partially offsetting these uses in cash was an increase in trade accounts payable.

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

Net cash used in investing activities was $68.1 million and $44.0 million for the six months ended June 30, 2007 and 2006, respectively. In the first half of 2007, Grainger continued funding the Company s growth initiatives including market expansion and product line expansion and the acquisition of the McFeely s business. Cash expended for additions to property, buildings, equipment and capitalized software was $83.2 million in the first six months of 2007 versus $64.0 million in the first six months of 2006. In the second quarter of 2006, Acklands Grainger s interest in the USI-AGI Prairies joint venture was sold for $27.4 million in cash.

Net cash used in financing activities was $75.6 million and $148.6 million for the six months ended June 30, 2007 and 2006, respectively. Grainger s treasury stock purchases of $147.3 million were $2.8 million lower in the first six months of 2007 versus 2006 as Grainger repurchased 1.7 million shares compared to 2.0 million shares in the first six months of 2006. As of June 30, 2007, approximately 6.0 million shares of common stock remained available under Grainger s repurchase authorization. Dividends paid to shareholders were $54.1 million and $47.7 million for the first half of 2007 and 2006, respectively. Partially offsetting these financing cash outlays were proceeds and excess tax benefits realized from stock options exercised of $119.5 million in 2007 versus $49.2 million in 2006.

Grainger maintains a debt ratio and liquidity position that provide flexibility in funding working capital needs and long-term cash requirements. In addition to internally generated funds, Grainger has various sources of financing available, including commercial paper sales and bank borrowings under lines of credit. Total debt as a percent of total capitalization was 0.7% at June 30, 2007 and 0.4% at December 31, 2006.

**Critical Accounting Policies and Estimates**

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the financial statements. Management bases its estimates on historical experience and other assumptions, which it believes are reasonable. If actual amounts are ultimately different from these estimates, the revisions are included in Grainger s results of operations for the period in which the actual amounts become known.

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

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

**MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**Forward-Looking Statements**

This document may contain forward-looking statements under the federal securities laws. The forward-looking statements relate to Grainger s expected future financial results and business plans, strategies and objectives and are not historical facts. They are often identified by qualifiers such as will, believes, intends, intended, tends to correlate, expect, expected, is expected, anticipate, estimates, estimated, contingent, projection, percent complete, scheduled, goals, target, trends or similar expressions. There are risks and uncertainties the o which could cause Grainger s results to differ materially from what is projected.

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

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

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

**PART I FINANCIAL INFORMATION**

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

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

**Item 4. Controls and Procedures**

Disclosure Controls and Procedures

Grainger carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of Grainger s disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that Grainger s disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting

There were no changes in Grainger s internal control over financial reporting that occurred during the second quarter, that have materially affected, or are reasonably likely to materially affect, Grainger s internal control over financial reporting.

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

**PART II OTHER INFORMATION**

Items 1, 1A, 3, 4 and 5 not applicable.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**
**Issuer Purchases of Equity Securities Second 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 | |
|---|---|---|---|---|---|
| April 1 April 30 | 23,700 | $ 82.77 | 23,700 | 6,528,400 | shares |
| May 1 May 31 | 93,200 | $ 84.47 | 93,200 | 6,435,200 | shares |
| June 1 June 30 | 445,400 | $ 86.92 | 445,400 | 5,989,800 | shares |
| Total | 562,300 | $ 86.34 | 562,300 | | |

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

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

**Item 6. Exhibits**

(a) Exhibits (numbered in accordance with Item 601 of Regulation S-K)

- (10) Material Contract
- (11) Computations of Earnings per Share
- (31) Rule 13a 14(a)/15d 14(a) Certifications
  - (a) Chief Executive Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - (b) Chief Financial Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- (32) Section 1350 Certifications
  - (a) Chief Executive Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - (b) Chief Financial Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

W.W. Grainger, Inc.
(Registrant)

| | | |
|---|---|---|
| Date: August 1, 2007 | By: | /s/ P. O. Loux<br>P. O. Loux, Senior Vice President, Finance and Chief Financial Officer |
| Date: August 1, 2007 | By: | /s/ R. L. Jadin<br>R. L. Jadin, Vice President<br>and Controller |