

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

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

**For the fiscal year ended December 31, 2008**

**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**

(State or other jurisdiction of  
incorporation or organization)

**36-1150280**

(I.R.S. Employer  
Identification No.)

**100 Grainger Parkway, Lake Forest, Illinois**

(Address of principal executive offices)

**60045-5201**

(Zip Code)

**(847) 535-1000**

(Registrant's telephone number including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

**Title of each class**

Common Stock \$0.50 par value, and accompanying  
Preferred Share Purchase Rights

**Name of each exchange on which registered**

New York Stock Exchange  
Chicago Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes  No

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [ ]

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

Yes  No

The aggregate market value of the voting common equity held by nonaffiliates of the registrant was \$5,897,949,081 as of the close of trading as reported on the New York Stock Exchange on June 30, 2008. The Company does not have nonvoting common equity.

The registrant had 74,855,074 shares of common stock outstanding as of January 31, 2009.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the proxy statement relating to the annual meeting of shareholders of the registrant to be held on April 29, 2009, are incorporated by reference into Part III hereof.

---

## TABLE OF CONTENTS

	<u>Page(s)</u>
<b>PART I</b>	
<b>Item 1:</b> BUSINESS .....	<b>3-5</b>
THE COMPANY .....	<b>3</b>
GRAINGER BRANCH-BASED .....	<b>3-4</b>
INDUSTRIAL SUPPLY .....	<b>3-4</b>
MEXICO .....	<b>4</b>
CHINA .....	<b>4</b>
ACKLANDS – GRAINGER BRANCH-BASED .....	<b>4</b>
LAB SAFETY .....	<b>4</b>
COMPETITION .....	<b>5</b>
EMPLOYEES .....	<b>5</b>
WEB SITE ACCESS TO COMPANY REPORTS .....	<b>5</b>
<b>Item 1A:</b> RISK FACTORS .....	<b>5-6</b>
<b>Item 1B:</b> UNRESOLVED STAFF COMMENTS .....	<b>6</b>
<b>Item 2:</b> PROPERTIES .....	<b>6-7</b>
<b>Item 3:</b> LEGAL PROCEEDINGS .....	<b>7</b>
<b>Item 4:</b> SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS .....	<b>8</b>
<b>Executive Officers</b> .....	<b>8</b>
<b>PART II</b>	
<b>Item 5:</b> MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES .....	<b>9-10</b>
<b>Item 6:</b> SELECTED FINANCIAL DATA .....	<b>10-11</b>
<b>Item 7:</b> MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS .....	<b>11-22</b>
<b>Item 7A:</b> QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK .....	<b>22</b>
<b>Item 8:</b> FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA .....	<b>22</b>
<b>Item 9:</b> CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE .....	<b>22</b>
<b>Item 9A:</b> CONTROLS AND PROCEDURES .....	<b>22</b>
<b>Item 9B:</b> OTHER INFORMATION .....	<b>22</b>
<b>PART III</b>	
<b>Item 10:</b> DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE .....	<b>23</b>
<b>Item 11:</b> EXECUTIVE COMPENSATION .....	<b>23</b>
<b>Item 12:</b> SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS .....	<b>23</b>
<b>Item 13:</b> CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE .....	<b>23</b>
<b>Item 14:</b> PRINCIPAL ACCOUNTING FEES AND SERVICES .....	<b>23</b>
<b>PART IV</b>	
<b>Item 15:</b> EXHIBITS AND FINANCIAL STATEMENT SCHEDULES .....	<b>23-24</b>
<b>Signatures</b> .....	<b>25</b>
<b>Certifications</b> .....	<b>65-68</b>

---

## PART I

### Item 1: Business

#### The Company

W.W. Grainger, Inc., incorporated in the State of Illinois in 1928, distributes facilities maintenance products and provides services and related information used by businesses and institutions primarily in the United States, Canada and Mexico to keep their facilities and equipment running. In this report, the words “Grainger” or “Company” mean W.W. Grainger, Inc. and its subsidiaries.

Grainger is the leading broad-line supplier of facilities maintenance and other related products in North America. 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 approximately 1.8 million customers through a network of 617 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 (Industrial Supply), Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico), Grainger China LLC (China) and Grainger Panama S.A. (Panama). Acklands – Grainger is the Company’s Canadian branch-based distribution business. Lab Safety is a direct marketer of safety and other industrial products. Late in 2008, the Company announced plans to integrate Lab Safety Supply with Grainger Industrial Supply. During 2009, Grainger will be integrating the Lab Safety business into the Grainger Industrial Supply business as well as reviewing the Company’s current operating structure to ensure that it will meet the current and future needs of the business. Grainger is also evaluating the impact that this integration will have on reportable segments. Any changes to reportable segments will include a restatement of prior periods for consistency purposes. For segment and geographical information and consolidated net sales and operating earnings see “**Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations**” and Note 18 to the Consolidated Financial Statements.

Grainger has internal business support functions that provide coordination and guidance in the areas of accounting and finance, business development, communications and investor relations, compensation and benefits, information systems, health and safety, human resources, insurance and risk management, internal audit, legal, real estate, security, tax and treasury. These services are provided in varying degrees to all business units.

Grainger does not engage in product research and development activities. Items are regularly added to and deleted from Grainger’s product lines on the basis of customer demand, market research, recommendations of suppliers, sales volumes and other factors.

#### Grainger Branch-based

The Grainger Branch-based businesses provide customers with solutions for facilities maintenance and other product needs through logistics networks that are configured for rapid product availability. Grainger offers a broad selection of facilities maintenance and other products through local branches, catalogs and the Internet. The more significant businesses in this segment are described below.

##### Industrial Supply

Industrial Supply offers U.S. businesses and institutions a combination of product breadth, local availability, speed of delivery, detailed product information, and competitively priced products. Industrial Supply distributes material handling equipment, safety and security supplies, lighting and electrical products, power and hand tools, pumps and plumbing supplies, cleaning and maintenance supplies and many other items primarily focused on the facilities maintenance market. Its customers range from small and medium-sized businesses to large corporations, governmental entities and other institutions. During 2008, Industrial Supply completed an average of 95,000 sales transactions daily.

Industrial Supply operates 437 branches located in all 50 states. These branches are located within 20 minutes of the majority of U.S. businesses and serve the immediate needs of their local markets by allowing customers to pick up items directly from the branches.

Branches range in size from small, will-call branches to large master branches. Branches primarily fulfill counter and will-call needs and provide customer service. An average branch is 22,000 square feet in size, has 12 employees and handles about 125 transactions per day. In 2008, Industrial Supply opened 13 branches, relocated 13, expanded or remodeled 11 and closed 10 branches.

Industrial Supply’s logistics network is comprised of nine distribution centers (DCs). Using automated equipment and processes, the DCs handle the majority of the customer shipping and replenish branch inventories.

Industrial Supply has a sales force of approximately 2,200 professionals that help businesses and institutions select the right products to reduce their operating expenses and improve cash flow, and find immediate solutions to maintenance problems. Industrial Supply’s primary customers work in facilities maintenance departments and service

---

shops across a wide range of industries such as: manufacturing, hospitality, transportation, government, retail, healthcare and education. Sales transactions during 2008 were made to approximately 1.3 million customers. Approximately 24% of 2008 sales consisted of private label items bearing Grainger's registered trademarks, including DAYTON® motors, SPEEDAIRE® air compressors, AIR HANDLER® air filtration equipment, DEM-KOTE® spray paints, WESTWARD® tools, CONDOR™ safety products and LUMAPRO® lighting products. Grainger has taken steps to protect these trademarks against infringement and believes that they will remain available for future use in its business. Sales of remaining items generally consisted of products carrying the names of other well-recognized brands.

The Industrial Supply catalog, most recently issued in February 2009, offers approximately 237,000 facilities maintenance and other products and is used by customers, sales representatives and branch personnel to assist in customer product selection. Approximately 1.9 million copies of the catalog were produced.

Customers can also purchase products through grainger.com. With access to more than 475,000 products, this Web site serves as a prominent service channel for Industrial Supply. Grainger.com provides real-time product availability and detailed product information and offers advanced features such as product search and compare capabilities. For customers with sophisticated electronic purchasing platforms, Grainger utilizes technology that allows these systems to communicate directly with grainger.com.

Industrial Supply purchases products for sale from approximately 1,600 key suppliers, most of which are manufacturers. No single supplier comprised more than 5% of Industrial Supply's purchases and no significant difficulty has been encountered with respect to sources of supply.

Through a global sourcing operation, Industrial Supply procures competitively priced, high-quality products produced outside the United States from approximately 320 suppliers. Grainger businesses sell these items primarily under private labels. Products obtained through the global sourcing operation include DAYTON® motors, WESTWARD® tools, LUMAPRO® lighting products and CONDOR™ safety products, as well as products bearing other trademarks.

#### Mexico

Grainger's operations in Mexico provide local businesses with facilities maintenance products and other products from both Mexico and the United States. In 2008, Mexico opened six branches and one master branch, bringing their total number of locations to 22. The business ships products to customers as well as fulfills counter and will-call needs. The largest facility, an 85,000 square foot DC, is located outside of Monterrey, Mexico. During 2008, approximately 1,000 sales transactions were completed daily. Customers have access to approximately 35,000 products through a Spanish-language catalog or through grainger.com.mx.

#### China

Grainger operates in China from a 126,000 square foot DC with a showroom located in Shanghai and has 10 sales offices that allow sales representatives to work remotely and meet with customers. Customers have access to approximately 50,000 products through a Chinese-language catalog or through grainger.com.cn.

### **Acklands – Grainger Branch-based**

Acklands – Grainger is Canada's leading broad-line distributor of industrial and safety supplies. It serves customers through 154 branches and five DCs across Canada. Acklands – Grainger distributes tools, fasteners, safety supplies, instruments, welding and shop equipment, and many other items. During 2008, approximately 14,000 sales transactions were completed daily. A comprehensive catalog, printed in both English and French, showcases the product line to facilitate the customer's product selection. This catalog, with more than 61,000 products, is used by customers, sales account managers and branch personnel to assist in customer product selection. In addition, customers can purchase products through acklandsgrainger.com, a fully bilingual Web site.

### **Lab Safety**

Lab Safety is a direct marketer of safety and other industrial products to U.S. and Canadian businesses. Lab Safety primarily reaches its customers through the distribution of multiple branded catalogs and other marketing materials distributed throughout the year to targeted markets. Brands include LSS, Ben Meadows (forestry), Gempler's (agriculture), AW Direct (service vehicle accessories), Rand Materials (material handling), Professional Inspection Equipment and Construction Book Express (building and home inspection), McFeely's Square Drive Screws (woodworking) and Highsmith (library equipment, furniture and supplies). Customers can purchase products by telephone, fax or through lss.com and other branded Web sites.

Lab Safety offers extensive product depth, technical support and high service levels. During 2008, Lab Safety issued 16 unique catalogs covering safety supplies, material handling and facilities maintenance products, lab supplies, security and other products targeted to specific customer groups. Lab Safety provides access to approximately 258,000 products through its targeted catalogs and distributes the majority of its products from a central DC.

During 2009, the Lab Safety business will be integrated into Grainger's Branch-based Industrial Supply business. As a result of this integration, Lab Safety will no longer be reported as a separate segment.

---

## Competition

Grainger faces competition in all markets it serves, from manufacturers (including some of its own suppliers) that sell directly to certain segments of the market, wholesale distributors, catalog houses and retail enterprises.

Grainger provides local product availability, a broad product line, sales representatives, competitive pricing, catalogs (which include product descriptions and, in certain cases, extensive technical and application data), electronic and Internet commerce technology and other services to assist customers in lowering their total facilities maintenance costs. Grainger believes that it can effectively compete with manufacturers on small orders, but manufacturers may have an advantage in filling large orders.

Grainger serves a number of diverse markets. Based on available data, Grainger estimates the North American market for facilities maintenance and related products to be more than \$150 billion, of which Grainger's share is approximately 4 percent. There are several large competitors, although most of the market is served by small local and regional competitors.

## Employees

As of December 31, 2008, Grainger had 18,334 employees, of whom 16,374 were full-time and 1,960 were part-time or temporary. Grainger has never had a major work stoppage and considers employee relations to be good.

## Web Site Access to Company Reports

Grainger makes available, free of charge, through its Web site, its Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and amendments to those reports, as soon as reasonably practicable after this material is electronically filed with or furnished to the Securities and Exchange Commission. This material may be accessed by visiting [grainger.com/investor](http://grainger.com/investor).

## Item 1A: Risk Factors

The following is a discussion of significant risk factors relevant to Grainger's business that could adversely affect its financial position or results of operations.

### ***Weakness in the United States and International economies could negatively impact Grainger's sales growth.***

Economic and industry trends affect Grainger's business environments. Economic downturns can cause customers to idle or close facilities, delay purchases and otherwise reduce their ability to purchase Grainger's products and services as well as their ability to make full and timely payments. Thus, a significant or prolonged slowdown in economic activity could negatively impact Grainger's sales growth and results of operations. The recent global economic crisis has had a negative effect on Grainger's sales and could continue to do so into the future, however, the duration of this or any other economic downturn cannot be predicted.

***The facilities maintenance industry is highly fragmented, and changes in competition could result in a decreased demand for Grainger's products and services.*** There are several large competitors in the industry, although most of the market is served by small local and regional competitors. Grainger faces competition in all markets it serves, from manufacturers (including some of its own suppliers) that sell directly to certain segments of the market, wholesale distributors, catalog houses and retail enterprises. Competitive pressures could adversely affect Grainger's sales and profitability.

***Volatility in commodity prices may adversely affect operating margins.*** Some of Grainger's products contain significant amounts of commodity-priced materials, such as steel, copper, or oil, and are subject to price changes based upon fluctuations in the commodities market. Grainger's ability to pass on increases in costs depends on market conditions. The inability to pass along costs increases could result in lower operating margins. In addition, higher prices could impact demand for these products resulting in lower sales volumes.

### ***Unexpected product shortages could negatively impact customer relationships, resulting in an adverse impact on results of operations.***

Grainger's competitive strengths include product selection and availability. Products are purchased from approximately 3,000 key suppliers, no one of which accounts for more than 5% of purchases. Historically, no significant difficulty has been encountered with respect to sources of supply, however, economic downturns can adversely affect a supplier's ability to manufacture or deliver products. If Grainger were to experience difficulty in obtaining products, there could be a short-term adverse effect on results of operations and a longer-term adverse effect on customer relationships and Grainger's reputation. In addition, Grainger has strategic relationships with key vendors. In the event Grainger was unable to maintain those relations, there might be a loss of competitive pricing advantages which could, in turn, adversely affect results of operations.

---

***The addition of new product lines could impact future sales growth.*** Grainger, from time to time, expands the breadth of its offerings by increasing the number of products it distributes. In 2006, Grainger launched a multiyear product line expansion program. The continued success of the expansion program is expected to be a driver of growth in 2009 and beyond. The success of these expansions will depend on Grainger's ability to accurately forecast market demand, obtain products from suppliers and effectively integrate these products into the supply chain. As such, there is a risk that the product line expansion program will not deliver the expected results which could negatively impact anticipated future sales growth.

***Interruptions in the proper functioning of information systems could disrupt operations and cause unanticipated increases in costs and/or decreases in revenues.*** The proper functioning of Grainger's information systems is critical to the successful operation of its business. Although Grainger's information systems are protected with robust backup systems, including physical and software safeguards and remote processing capabilities, information systems are still vulnerable to natural disasters, power losses, unauthorized access, telecommunication failures and other problems. If critical information systems fail or are otherwise unavailable, Grainger's ability to process orders, maintain proper levels of inventories, collect accounts receivable, pay expenses and maintain the security of Company and customer data could be adversely affected.

***In order to compete, Grainger must attract, retain and motivate key employees, and the failure to do so could have an adverse effect on results of operations.*** In order to compete and have continued growth, Grainger must attract, retain and motivate executives and other key employees, including those in managerial, technical, sales, marketing and support positions. Grainger competes to hire employees and then must train them and develop their skills and competencies. Grainger's operating results could be adversely affected by increased costs due to increased competition for employees, higher employee turnover or increased employee benefit costs.

***Fluctuations in foreign currency could have an adverse effect on reported results of operations.*** Foreign currency exchange rates and fluctuations may have an impact on sales, future costs or on future cash flows from international operations, and could adversely affect reported financial performance.

**Item 1B: Unresolved Staff Comments**

None.

**Item 2: Properties**

As of December 31, 2008, Grainger's owned and leased facilities totaled 20.7 million square feet, an increase of approximately 5% from December 31, 2007. This increase primarily related to branch expansion programs in the United States and Mexico. Industrial Supply and Acklands – Grainger accounted for the majority of the total square footage. Industrial Supply facilities are located throughout the United States and Acklands – Grainger facilities are located throughout Canada.

Industrial Supply branches range in size from 1,300 to 109,000 square feet. Most are located in or near major metropolitan areas with many located in industrial parks. Typically, a branch is on one floor, consists primarily of warehouse space, sales areas and offices and has off-the-street parking for customers and employees. Grainger believes that its properties are generally in good condition and well maintained.

A brief description of significant facilities follows:

Location	Facility and Use (7)	Size in Square Feet (in 000's)
United States (1)	437 Industrial Supply branch locations	9,466
United States (2)	Nine Distribution Centers	5,100
United States (3)	Other facilities	879
United States (4)	Four Lab Safety facilities	833
International (5)	Other facilities	806
Canada (6)	165 Acklands – Grainger facilities	2,303
Chicago Area	Headquarters and General Offices	1,327
	Total Square Feet	<u>20,714</u>

- (1) Industrial Supply branches consist of 290 owned and 147 leased properties. Most leases expire between 2009 and 2017.
- (2) These facilities are all owned.
- (3) These facilities primarily include leased locations, including storage facilities and idle properties.
- (4) Lab Safety facilities consist of general offices, distribution centers, and storage facilities, of which one is owned and three are leased.
- (5) These facilities include owned and leased locations for Puerto Rico, Mexico, China and Panama.
- (6) Acklands – Grainger facilities consist of general offices, distribution centers and branches, of which 56 are owned and 109 leased.
- (7) Owned facilities are not subject to any mortgages.

### Item 3: Legal Proceedings

Grainger has been named, along with numerous other nonaffiliated companies, as a defendant in litigation in various states involving asbestos and/or silica. These lawsuits typically assert claims of personal injury arising from alleged exposure to asbestos and/or silica as a consequence of products purportedly distributed by Grainger. As of February 3, 2009, Grainger is named in cases filed on behalf of approximately 2,200 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. Grainger has denied, or intends to deny, the allegations in all of the above-described lawsuits.

In 2008, lawsuits relating to asbestos and/or silica and involving approximately 660 plaintiffs were dismissed with respect to Grainger, typically based on the lack of product identification. If a specific product distributed by Grainger is identified in any of these lawsuits, Grainger would attempt to exercise indemnification remedies against the product manufacturer. In addition, Grainger believes that a substantial number of these claims are covered by insurance. Grainger has entered agreements with its major insurance carriers relating to the scope, coverage and costs of defense. While Grainger is unable to predict the outcome of these lawsuits, it believes that the ultimate resolution will not have, either individually or in the aggregate, a material adverse effect on Grainger's consolidated financial position or results of operations.

Grainger is a party to a contract with the United States General Services Administration (the "GSA") first entered into in 1999 and subsequently extended in 2004. The GSA contract had been the subject of an audit performed by the GSA's Office of the Inspector General. In December 2007, the Company received a letter from the Commercial Litigation Branch of the Civil Division of the Department of Justice (the "DOJ") regarding the GSA contract. The letter suggested that the Company had not complied with its disclosure obligations and the contract's pricing provisions, and had potentially overcharged government customers under the contract.

Discussions relating to the Company's compliance with its disclosure obligations and the contract's pricing provisions are ongoing. The timing and outcome of these discussions are uncertain and could include settlement or civil litigation by the DOJ to recover, among other amounts, treble damages and penalties under the False Claims Act. While this matter is not expected to have a material adverse effect on the Company's financial position, an unfavorable resolution could result in significant payments by the Company. The Company continues to believe that it has complied with the GSA contract in all material respects.

In addition to the foregoing, from time to time Grainger is involved in various other legal and administrative proceedings that are incidental to its business, including claims relating to product liability, general negligence, environmental issues, employment, intellectual property and other matters. As a government contractor, Grainger is also subject to governmental or regulatory inquiries or audits or other proceedings, including those related to 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 Grainger's consolidated financial position or results of operations.

---

**Item 4: Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of security holders during the fourth quarter of 2008.

**Executive Officers**

Following is information about the Executive Officers of Grainger including age as of February 26, 2009. Executive Officers of Grainger generally serve until the next annual election of officers, or until earlier resignation or removal.

Name and Age	Positions and Offices Held and Principal Occupations and Employment During the Past Five Years
Court D. Carruthers (36)	Senior Vice President of Grainger, a position assumed in 2007, and President of Acklands – Grainger Inc., a position assumed in 2006. Previously, Mr. Carruthers served as Vice President, National Accounts and Sales of Acklands – Grainger Inc., a position assumed in 2002 when he joined that company.
Nancy A. Hobor (62)	Senior Vice President, Communications and Investor Relations, a position assumed in 1999.
John L. Howard (51)	Senior Vice President and General Counsel, a position assumed in 2000.
Gregory S. Irving (50)	Vice President and Controller, a position assumed in 2008. Previously, Mr. Irving served as Vice President, Finance, for Acklands – Grainger Inc. since 2004. After joining Grainger in 1999 he served in various management positions including Vice President, Financial Services and Director, Internal Audit.
Ronald L. Jadin (48)	Senior Vice President and Chief Financial Officer, a position assumed in 2008. Previously, Mr. Jadin served as Vice President and Controller, a position assumed in 2006 after serving as Vice President, Finance. Upon joining Grainger in 1998, he served as Director, Financial Planning and Analysis.
Richard L. Keyser (66)	Chairman of the Board, a position assumed in 1997. From 1995 through 2008, Mr. Keyser served as Grainger's Chief Executive Officer. He joined Grainger in 1986 and became a director in 1992.
Larry J. Loizzo (54)	Vice President, Specialty Brands, a position assumed in 2009 and President of Lab Safety Supply, Inc., a position assumed in 1996. Previously, Mr. Loizzo was Senior Vice President of Grainger, a position assumed in 2003.
Donald G. Macpherson (41)	Senior Vice President, Global Supply Chain, a position assumed in 2008. Mr. Macpherson joined Grainger in 2008 as Senior Vice President, Supply Chain. Before joining Grainger, he was Partner and Managing Director of the Boston Consulting Group, a global management consulting firm and advisor on business strategy.
Michael A. Pulick (44)	Senior Vice President and President, Grainger U.S., a position assumed in 2008 after serving as Senior Vice President of Customer Service, a position assumed in 2006. After joining Grainger in 1999, Mr. Pulick has held a number of increasingly responsible positions in Grainger's supplier and product management areas including Vice President, Product Management and Vice President, Merchandising.
James T. Ryan (50)	President and Chief Executive Officer of Grainger, a position assumed in 2008. Mr. Ryan became a director in 2007. Previously he had been Grainger's President and Chief Operating Officer. Before assuming that position in 2007, Mr. Ryan served as President, a position assumed in 2006, and served as Group President since 2004. Since joining Grainger in 1980, he has served in increasingly responsible roles, including Executive Vice President, Marketing, Sales and Service; Vice President, Information Services; President, grainger.com; and President, Grainger Parts.

## PART II

### Item 5: Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

#### Market Information and Dividends

Grainger's common stock is listed on the New York Stock Exchange and the Chicago Stock Exchange, with the ticker symbol GWW. The high and low sales prices for the common stock and the dividends declared and paid for each calendar quarter during 2008 and 2007 are shown below.

	Quarters	Prices		Dividends
		High	Low	
2008	First	\$87.92	\$69.00	\$0.35
	Second	93.12	75.94	0.40
	Third	93.99	79.66	0.40
	Fourth	86.90	58.86	0.40
	Year	\$93.99	\$58.86	\$1.55
2007	First	\$80.37	\$68.77	\$0.29
	Second	94.75	76.00	0.35
	Third	98.60	79.38	0.35
	Fourth	96.00	84.40	0.35
	Year	\$98.60	\$68.77	\$1.34

Grainger expects that its practice of paying quarterly dividends on its Common Stock will continue, although the payment of future dividends is at the discretion of Grainger's Board of Directors and will depend upon Grainger's earnings, capital requirements, financial condition and other factors.

#### Holders

The approximate number of shareholders of record of Grainger's common stock as of January 31, 2009, was 1,050 with approximately 70,000 additional shareholders holding stock through nominees.

#### Issuer Purchases of Equity Securities – Fourth Quarter

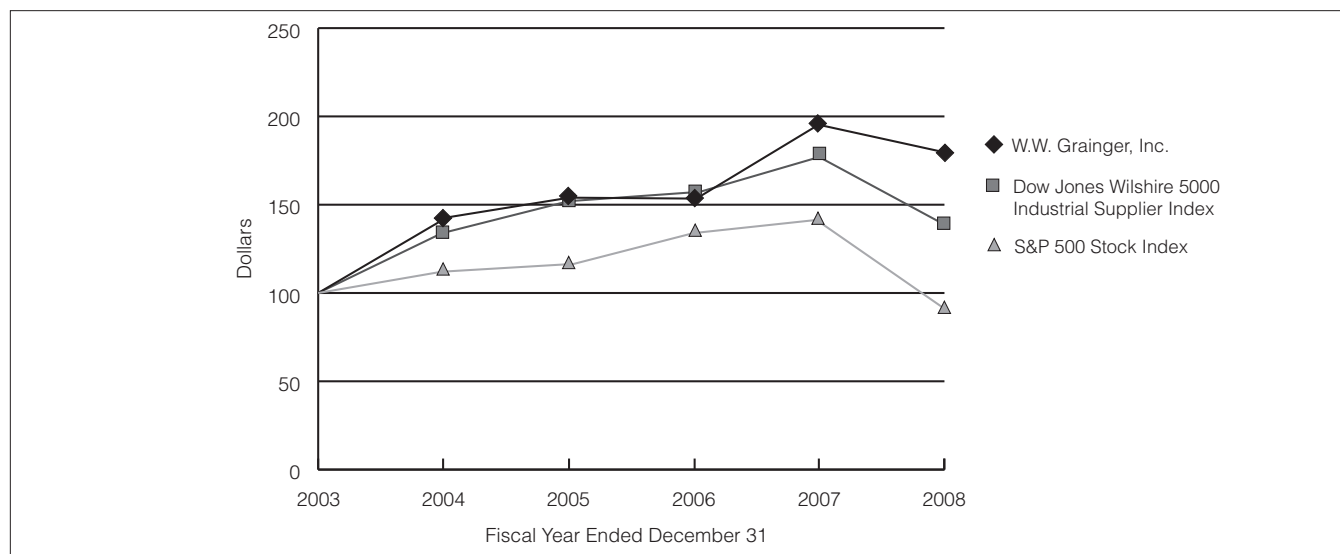
Period	Total Number of Shares Purchased (A)	Average Price Paid per Share (B)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (C)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
Oct. 1 – Oct. 31.....	—	—	—	8,811,100 shares
Nov. 1 – Nov. 30 .....	—	—	—	8,811,100 shares
Dec. 1 – Dec. 31 .....	1,409,274	\$73.47	1,409,274	7,401,826 shares
Total .....	1,409,274	\$73.47	1,409,274	

- (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 through a share repurchase program approved by Grainger's Board of Directors. On April 30, 2008, 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.

#### Company Performance

The following stock price performance graph compares the cumulative total return on an investment in Grainger common stock with the cumulative total return of an investment in each of the S&P 500 Stock Index and the Dow Jones Wilshire 5000 Industrial Supplier Index. It covers the period commencing December 31, 2003, and ending

December 31, 2008. The graph assumes that the value for the investment in Grainger common stock and in each index was \$100 on December 31, 2003, and that all dividends were reinvested.



	December 31,					
	2003	2004	2005	2006	2007	2008
W.W. Grainger, Inc.....	\$100	\$143	\$155	\$154	\$196	\$180
S&P 500 Stock Index.....	100	111	116	135	142	90
Dow Jones Wilshire 5000 Industrial Supplier Index .....	100	135	152	157	180	140

#### Other

On May 30, 2008, Grainger timely submitted to the New York Stock Exchange (NYSE) an Annual CEO Certification, in which Grainger's Chief Executive Officer certified that he was not aware of any violation by Grainger of the NYSE's corporate governance listing standards as of the date of the certification.

#### Item 6: Selected Financial Data

	2008	2007	2006	2005	2004
	(In thousands of dollars, except for per share amounts)				
Net sales .....	\$6,850,032	\$6,418,014	\$5,883,654	\$5,526,636	\$5,049,785
Net earnings .....	475,355	420,120	383,399	346,324	286,923
Net earnings per basic share .....	6.21	5.10	4.36	3.87	3.18
Net earnings per diluted share .....	6.04	4.94	4.24	3.78	3.13
Total assets .....	3,515,417	3,094,028	3,046,088	3,107,921	2,809,573
Long-term debt (less current maturities) .....	488,228	4,895	4,895	4,895	—
Cash dividends paid per share .....	\$ 1.550	\$ 1.340	\$ 1.110	\$ 0.920	\$ 0.785

The results for 2006 included an effective tax rate, excluding the equity in net income of unconsolidated entities, of 36.7%, compared to 38.5% in 2007. The 2006 rate included tax benefits from the resolution of uncertainties related to the audit of the 2004 tax year and a tax benefit from a reduction of deferred tax liabilities related to property, buildings and equipment. These benefits increased diluted earnings per share by \$0.15.

Effective January 1, 2006, Grainger adopted Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment," for the accounting of employee stock-based compensation using the modified prospective method. The effect of the adoption was an approximately \$0.14 earnings per share reduction for 2006. See Note 12 to the Consolidated Financial Statements for further discussion of information related to SFAS No. 123R.

The results for 2005 included an effective tax rate, excluding the equity in net income of unconsolidated entities, of 35.2%. The 2005 rate included tax benefits related to a favorable revision to the estimate of income taxes for various state taxing jurisdictions and the resolution of certain federal and state tax contingencies. These benefits increased diluted earnings per share by \$0.10.

---

The results for 2004 included an effective tax rate, excluding the equity in net income of unconsolidated entities, of 35.6%, which was down from 40.0% in the prior year. The lower tax rate resulted in an increase of \$0.21 per diluted share. The tax rate reduction was primarily due to a lower tax rate in Canada, the realization of tax benefits related to operations in Mexico and to capital losses, the recognition of tax benefits from the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" and the resolution of certain federal and state tax contingencies.

For further information see "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations."

## **Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

**General.** Grainger distributes facilities maintenance products and provides services and related information used by businesses and institutions primarily in the United States, Canada and Mexico to keep their facilities and equipment running. Grainger reports its operating results in three segments: Grainger Branch-based, Acklands – Grainger Branch-based (Acklands – Grainger) and Lab Safety Supply, Inc. (Lab Safety). 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 617 branches, 18 distribution centers and multiple Web sites.

**Business Environment.** Several economic factors and industry trends shape Grainger's business environment. The current overall economy and leading economic indicators provide insight into anticipated economic factors for the near term and help in forming the development of projections for the upcoming year. In February 2009, Consensus Forecast-USA projected a 2009 GDP decline of 2.1% and an Industrial Production decline of 7.2% for the United States, as compared to 2008 GDP growth of 1.3% and a 1.7% decline in Industrial Production. In February 2009, Consensus Forecast-USA projected a GDP decline of 1.1% for Canada, as compared to the 2008 growth estimate of 0.6%.

Historically, Grainger's sales trends have tended to correlate positively with industrial production growth and non-farm payrolls. In more recent years, Grainger's sales growth in the United States has outperformed both economic indicators. For the first five months of 2008, Grainger benefited from the growth in industrial production and non-farm payrolls. Both economic indicators began to deteriorate in May 2008, however, Grainger continued to outperform both until late 2008, at which time Grainger's sales began to be negatively affected by the economic downturn.

The light and heavy manufacturing customer sectors, which comprised approximately 25% of Grainger's total 2008 sales, have historically correlated with manufacturing employment levels and manufacturing production. Manufacturing employment levels in the United States declined approximately 5.7% from December 2007 to December 2008, while manufacturing output decreased 9.9% from December 2007 to December 2008. This decline in manufacturing employment and output contributed to low single-digit sales growth in the light manufacturing customer sector and flat sales growth in the heavy manufacturing customer sector for Grainger in 2008.

Given the steep decline in the economic trends in Grainger's markets in the fourth quarter of 2008, it is difficult to project future results. During the fourth quarter, Grainger began implementing contingency plans to deal with the changing environment, which included a hiring freeze on all non-customer-facing positions, a reduction in hours of part-time employees and a significant reduction to travel, consulting and relocation expenses. In response to a continuing decline in sales, on February 11, 2009, Grainger announced plans to freeze salaries of all executives and salaried employees and indicated that the payment of any management incentive bonuses for 2009 would occur only if Grainger meets aggressive sales targets. Additionally, Grainger announced 300 to 400 jobs would be eliminated as a result of lower sales volume and the combination of its Lab Safety Supply and Grainger Industrial Supply businesses, resulting in annualized cost savings of between \$25 million and \$35 million. See Note 22 to the Consolidated Financial Statements.

In 2004, Grainger launched a multiyear market expansion program in the United States to strengthen its presence in top metropolitan markets and better position itself to serve the local customer. The expansion program was completed in 2008, however, the benefits realized from this initiative are expected to continue.

In 2006, Grainger launched a multiyear product line expansion program in the United States. Over the past three years, Grainger has added over 150,000 new products to supplement Industrial Supply's plumbing, fastener, material handling and security product lines. The product line expansion program contributed to the sales growth in 2007 and 2008, and is expected to be a driver of growth in 2009 and beyond. In 2009, Grainger expects to add 50,000 new products to further supplement Industrial Supply's product lines.

Grainger's financial strength enables it to fund major initiatives, acquisitions and productivity improvements. Capital spending in 2008 for the U.S. market expansion program was approximately \$40 million, with total capital expenditures of \$196 million.

Capital expenditures are expected to range from \$175 million to \$200 million in 2009. Projected investments include improved infrastructure in distribution centers, both in the U.S. and Canada, information technology, including

upgraded electronic commerce platforms, and the normal recurring replacement of equipment. Grainger expects to fund 2009 capital investments from operating cash flows, with spending planned for the following major projects:

- \$90 million to \$105 million for supply chain infrastructure;
- \$15 million to \$35 million for information technology.

**Matters Affecting Comparability.** There were 256 sales days in 2008, compared to 255 sales days in 2007 and 254 sales days in 2006.

Since June 2008, Grainger's operating results have included the operating results of Excel F.I.G. Inc. (Excel) in the Acklands – Grainger segment, and since July 2008 Grainger's operating results have included the operating results of Highsmith Inc. (Highsmith) in the Lab Safety segment.

Since May 2007, Grainger's operating results have included the operating results of McFeely's Square Drive Screws (McFeely's) in the Lab Safety segment.

See Note 3 to the Consolidated Financial Statements for additional information regarding business acquisitions.

## Results of Operations

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

For the Years Ended December 31,

	As a Percent of Net Sales			Percent Increase/(Decrease) from Prior Year	
	2008	2007	2006	2008	2007
	Net sales.....	100.0%	100.0%	100.0%	6.7%
Cost of merchandise sold .....	59.0	59.4	60.0	6.0	8.1
Gross profit.....	41.0	40.6	40.0	7.9	10.6
Operating expenses.....	29.6	30.1	30.2	4.8	8.8
Operating earnings .....	11.4	10.5	9.8	16.7	16.0
Other income (expense).....	(0.1)	0.2	0.4	(184.3)	(55.1)
Income taxes .....	4.4	4.1	3.7	13.8	19.2
Net earnings .....	6.9%	6.6%	6.5%	13.1%	9.6%

### 2008 Compared to 2007

Grainger's net sales of \$6,850.0 million for 2008 increased 6.7% when compared with net sales of \$6,418.0 million for 2007. There was one more selling day in 2008 versus 2007. Daily sales were up 6.3%. The increase in net sales was led by high single-digit sales growth in the government sector, and mid single-digit sales growth in the commercial and reseller sectors. Approximately 1 percentage point of the sales growth came from Grainger's product line expansion initiative and approximately 5 percentage points came from price and volume. Refer to the **Segment Analysis** below for further detail of Grainger's ongoing strategic initiatives.

The gross profit margin for 2008 improved 0.4 percentage point to 41.0% from 40.6% in 2007. The improvement in the gross profit margin was primarily driven by positive inflation recovery, partially offset by unfavorable selling price category mix.

Operating earnings of \$782.7 million for 2008 increased 16.7% over the \$670.7 million for 2007. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and positive operating expense leverage.

Net earnings for 2008 increased by 13.1% to \$475.4 million from \$420.1 million in 2007. The growth in net earnings for 2008 primarily resulted from the improvement in operating earnings, partially offset by lower interest income, higher interest expense and the write-off of Grainger's \$6.0 million investment in Asia Pacific Brands India Ltd. (Asia Pacific Brands). Diluted earnings per share of \$6.04 in 2008 were 22.3% higher than the \$4.94 for 2007. This improvement was higher than the percentage increase for net earnings due to the effect of Grainger's share repurchase program.

### Segment Analysis

The following comments at the segment level include external and intersegment net sales and operating earnings. Comments at the business unit level include external and inter- and intrasegment net sales and operating earnings. See Note 18 to the Consolidated Financial Statements.

#### Grainger Branch-based

Net sales were \$5,678.8 million for 2008, an increase of \$326.3 million, or 6.1%, when compared with net sales of \$5,352.5 million for 2007. Daily sales were up 5.7%. Daily sales in the United States were up 5.5%. Sales were led by high single-digit sales growth in the government sector, and mid single-digit sales growth in the commercial and

reseller sectors. Approximately 2 percentage points of the sales growth came from Grainger's product line expansion initiative and approximately 4 percentage points came from price and volume. Sales volume was negatively affected by approximately 1 percentage point due to a decline in sales of seasonal products.

In 2004, Grainger launched a multiyear market expansion program to strengthen its presence in top metropolitan markets and better position itself to serve local customers. The market expansion program was completed in 2008, however, the benefits realized from this initiative are expected to continue.

Consistent with the overall downturn in the economy, beginning in October most of these markets saw negative sales growth, which significantly affected sales growth for 2008. Results for the market expansion program were as follows:

	Daily Sales Increase 2008 vs. 2007
Phase 1 (Atlanta, Denver, Seattle).....	7%
Phase 2 (Four markets in Southern California) .....	5%
Phase 3 (Houston, St. Louis, Tampa) .....	10%
Phase 4 (Baltimore, Cincinnati, Kansas City, Miami, Philadelphia, Washington, D.C.) .....	2%
Phase 5 (Dallas, Detroit, New York, Phoenix).....	3%
Phase 6 (Chicago, Minneapolis, Pittsburgh, San Francisco) .....	6%

Over the past three years, Grainger has added over 150,000 new products to supplement Industrial Supply's plumbing, fastener, material handling and security product lines as part of its ongoing product line expansion initiative. The most recent catalog, issued in 2009, offers a total of 237,000 products, an increase of 50,000 products over the 2008 catalog.

Sales in Mexico increased 11.9% in 2008 versus 2007. Daily sales were up 11.5%. In local currency, daily sales were up 12.7%, driven primarily by increased market share coming from the ongoing branch expansion program.

The segment gross profit margin increased 0.5 percentage point in 2008 over 2007, driven primarily by positive inflation recovery, partially offset by unfavorable selling price category mix.

Operating expenses in this segment were up 3.4% in 2008. Expenses grew at a slower rate than sales primarily due to lower advertising expenses, bonus accruals, severance and lower bad debt expense, the result of improved collection efficiency.

For the segment, operating earnings of \$782.7 million for 2008 increased 16.9% over the \$669.4 million for 2007. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and positive operating expense leverage.

#### Acklands – Grainger Branch-based

Net sales at Acklands – Grainger were \$728.0 million for 2008, an increase of \$91.5 million, or 14.4%, when compared with \$636.5 million for 2007. Daily sales were up 13.9%. In local currency, daily sales increased 13.1%. The increase was led by sales growth in the contractor, agriculture and mining and government sectors.

The gross profit margin increased 0.3 percentage points in 2008 over 2007. The improvement in the gross profit margin was primarily due to positive inflation recovery.

Operating expenses were up 13.7% in 2008. The increase in operating expenses was primarily due to payroll and benefits as a result of increased headcount, merit increases and commissions, and higher advertising and occupancy expenses, and expenses related to the bankruptcy of a provider of freight payment services.

Operating earnings of \$54.3 million for 2008 were up \$10.0 million, or 22.7%. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and operating expenses that grew at a slower rate than sales.

#### Lab Safety

Net sales at Lab Safety were \$450.7 million for 2008, an increase of \$16.0 million, or 3.7%, when compared with \$434.7 million for 2007. Daily sales were up 3.3%. Excluding sales from the Highsmith acquisition, sales declined 3.3%.

The gross profit margin decreased 0.6 percentage point in 2008 over 2007, driven primarily by unfavorable selling price category mix and product mix.

Operating expenses were up 10.0% in 2008. Expenses grew at a faster rate than sales primarily due to costs associated with the Highsmith acquisition.

Operating earnings of \$45.4 million for 2008 were down 16.4% over 2007. Operating earnings were down as a result of lower gross profit margins and higher operating expenses.

---

### **Other Income and Expense**

Other income and expense was \$9.5 million of expense in 2008, a decrease of \$20.7 million as compared with \$11.2 million of income in 2007. The following table summarizes the components of other income and expense (in thousands of dollars):

	For the Years Ended December 31,	
	2008	2007
<b>Other income and (expense):</b>		
Interest income (expense) – net .....	\$(9,416)	\$ 9,151
Equity in net income of unconsolidated entities .....	3,642	2,016
Write-off of investment in unconsolidated entity .....	(6,031)	—
Unclassified – net .....	2,351	41
	<u>\$(9,454)</u>	<u>\$11,208</u>

The change from net interest income to net interest expense was primarily attributable to the four-year bank term loan obtained in May 2008. The write-off of the investment relates to Asia Pacific Brands as described in Note 6 to the Consolidated Financial Statements. Unclassified – net increased primarily due to higher foreign exchange transaction gains.

### **Income Taxes**

Income taxes of \$297.9 million in 2008 increased 13.8% as compared with \$261.7 million in 2007.

Grainger's effective tax rates were 38.5% and 38.4% in 2008 and 2007, respectively. Excluding the effect of after tax items related to the write-off and the earnings of unconsolidated entities, the effective income tax rates were 38.4% and 38.5% for 2008 and 2007, respectively.

For 2009, Grainger is projecting its estimated effective tax rate to be approximately 38.9%, excluding equity in net income of unconsolidated entities.

### **2007 Compared to 2006**

Grainger's net sales of \$6,418.0 million for 2007 increased 9.1% when compared with net sales of \$5,883.7 million for 2006. There was one more selling day in 2007 versus 2006. Daily sales were up 8.7%. The increase in net sales was led by sales growth in the upper teens in the government sector, high single-digit sales growth in the commercial sector and mid single-digit sales growth in the manufacturing sector. Approximately 3 percentage points of the sales growth came from Grainger's ongoing strategic initiatives, market expansion and product line expansion, with another 1 percentage point from foreign exchange. Partially offsetting these sales improvements was a negative 1 percentage point effect from the continued wind-down of low margin integrated supply contracts. Refer to the **Segment Analysis** below for further detail of Grainger's ongoing strategic initiatives.

The gross profit margin for 2007 improved 0.6 percentage point to 40.6% from 40.0% in 2006. The improvement in the gross profit margin was primarily driven by positive inflation recovery, partially offset by unfavorable selling price category mix.

Operating earnings for 2007 totaled \$670.7 million, an increase of 16.0% over 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and operating expenses which grew at a slightly slower rate than sales.

Net earnings for 2007 increased by 9.6% to \$420.1 million from \$383.4 million in 2006. The growth in net earnings for 2007 primarily resulted from the improvement in operating earnings, partially offset by lower interest income, no counterpart to a gain on the sale of Acklands – Grainger's interest in the USI-AGI Prairies joint venture in 2006, and a higher effective tax rate in 2007. The results for 2006 included tax benefits from the resolution of uncertainties related to the audit of the 2004 tax year and a tax benefit from a reduction of deferred tax liabilities related to property, buildings and equipment. These benefits increased diluted earnings per share by \$0.15 in 2006. Diluted earnings per share of \$4.94 in 2007 were 16.5% higher than the \$4.24 for 2006. This improvement was higher than the percentage increase for net earnings due to the effect of Grainger's share repurchase program.

### **Segment Analysis**

The following comments at the segment level include external and intersegment net sales and operating earnings. Comments at the business unit level include external and inter- and intrasegment net sales and operating earnings. See Note 18 to the Consolidated Financial Statements.

---

### Grainger Branch-based

Net sales were \$5,352.5 million for 2007, an increase of \$441.7 million, or 9.0%, when compared with net sales of \$4,910.8 million for 2006. Daily sales were up 8.6%. Daily sales in the United States were up 8.5%, with growth in all customer end markets, led by sales growth in the upper teens in the government sector and high single-digit sales growth in the commercial sector. Approximately 4 percentage points of the sales growth came from Grainger's ongoing strategic initiatives, market expansion and product line expansion. The wind-down of Grainger's low margin integrated supply contracts reduced sales growth by approximately 1 percentage point.

In 2004, Grainger launched a multiyear market expansion program to strengthen its presence in top metropolitan markets and better position itself to serve local customers.

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

	Daily Sales Increase 2007 vs. 2006	Estimated Percent Complete
Phase 1 (Atlanta, Denver, Seattle).....	15%	100%
Phase 2 (Four markets in Southern California) .....	6%	100%
Phase 3 (Houston, St. Louis, Tampa).....	13%	100%
Phase 4 (Baltimore, Cincinnati, Kansas City, Miami, Philadelphia, Washington, D.C.) .....	10%	100%
Phase 5 (Dallas, Detroit, New York, Phoenix).....	9%	75%
Phase 6 (Chicago, Minneapolis, Pittsburgh, San Francisco) .....	9%	65%

Product line expansion contributed approximately 2 percentage points to the growth in the segment. Over the past two years, Grainger has added approximately 90,000 new products in the plumbing, fastener, material handling and security product lines as part of its ongoing product line expansion initiative.

Daily sales in Mexico increased 22.7% in 2007 versus 2006. In local currency, daily sales were up 22.8%, driven primarily by the ongoing branch expansion program and an improved economy.

The segment gross profit margin increased 0.4 percentage point in 2007 over 2006, driven primarily by positive inflation recovery, partially offset by unfavorable selling price category mix.

Operating expenses in this segment were up 9.0% in 2007. Expenses grew at the same rate as sales with payroll and benefits growing at a slower rate than sales offset by other operating expenses growing faster than sales, primarily due to increased bad debt expense and provisions and higher facility costs related to market expansion.

For the segment, operating earnings of \$669.4 million for 2007 increased 12.8% over the \$593.5 million for 2006. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin.

### Acklands – Grainger Branch-based

Net sales at Acklands – Grainger were \$636.5 million for 2007, an increase of \$71.4 million, or 12.6%, when compared with \$565.1 million for 2006. Daily sales were up 12.2%. In local currency, daily sales increased 5.8% due to a stronger economy. This increase was led by the mining sector with sales growth in the low twenties, high single-digit sales growth in the oil sector and mid single-digit sales growth in the government sector. These increases were partially offset by a mid-teens sales decline in the forestry sector.

The gross profit margin increased 2.6 percentage points in 2007 over 2006. The improvement in the gross profit margin was primarily due to positive inflation recovery.

Operating expenses were up 6.7% in 2007. Expenses grew at a slower rate than sales due to operating expense leverage, the result of improved cost management and lower severance costs.

Operating earnings of \$44.2 million for 2007 were up \$29.0 million, or 190%. This earnings improvement exceeded the sales growth rate due to an improved gross profit margin and operating expenses that grew at a slower rate than sales.

### Lab Safety

Net sales at Lab Safety were \$434.7 million for 2007, an increase of \$23.2 million, or 5.6%, when compared with \$411.5 million for 2006. Daily sales were up 5.2%. Sales from the acquisitions made during 2007 and late 2006 contributed 6.1 percentage points to the growth.

The gross profit margin decreased 0.5 percentage point in 2007 over 2006. Gross profit margin was down as a result of increased freight costs and unfavorable selling price category mix and product mix, partially offset by positive inflation recovery.

Operating expenses were 4.6% higher in 2007 and grew at a slower rate than sales due to cost management efforts.

Operating earnings of \$54.3 million for 2007 were up 3.8% over 2006. This earnings improvement was less than the sales growth rate primarily due to a lower gross profit margin.

---

### **Other Income and Expense**

Other income and expense was \$11.2 million of income in 2007, a decrease of \$13.8 million as compared with \$25.0 million of income in 2006. The following table summarizes the components of other income and expense (in thousands of dollars):

	For the Years Ended December 31,	
	2007	2006
<b>Other income and (expense):</b>		
Interest income (expense) – net .....	\$ 9,151	\$19,570
Equity in net income of unconsolidated entities .....	2,016	2,960
Gain on sale of unconsolidated entity .....	—	2,291
Unclassified – net .....	41	131
	<u>\$11,208</u>	<u>\$24,952</u>

The decrease in interest income was primarily attributable to lower average cash balances due to working capital needs and share repurchases. There was a decrease in equity in net income of unconsolidated entities in 2007 versus 2006 primarily driven by the absence of earnings related to the joint venture that was sold.

### **Income Taxes**

Income taxes of \$261.7 million in 2007 increased 19.2% as compared with \$219.6 million in 2006.

Grainger's effective tax rates were 38.4% and 36.4% in 2007 and 2006, respectively. Excluding the equity in net income of unconsolidated entities, the effective income tax rates were 38.5% for 2007 and 36.7% for 2006.

The 2006 tax rate benefited from 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.

Excluding the equity in net income of unconsolidated entities and the tax benefits noted above, the effective income tax rate for 2006 was 38.9%.

### **Financial Condition**

Grainger expects its strong working capital position, cash flows from operations and borrowing capacity to continue, allowing it to fund its operations including growth initiatives, capital expenditures, acquisitions, and repurchase of shares, as well as pay cash dividends.

### **Cash Flow**

Net cash flows from operations of \$530.1 million in 2008, \$468.9 million in 2007 and \$436.8 million in 2006 continued to improve Grainger's financial position and serve as the primary source of funding. Net cash provided by operations increased \$61.2 million in 2008 over 2007, driven primarily by increased net earnings. The Change in operating assets and liabilities – net of business acquisitions used cash of \$143.1 million in 2008. This use of cash was driven primarily by an increase in inventory due to the product line expansion initiative.

The increase in net cash flows from operations from 2006 to 2007 of \$32.1 million was primarily attributable to increased net earnings. The Change in operating assets and liabilities – net of business acquisitions used cash of \$106.4 million in 2007. This use of cash was primarily driven by increases in inventory and trade accounts receivable as well as a decrease in trade accounts payable due to the timing of payments at year-end. The increases in inventory and trade accounts receivable were due to product line expansion and increased sales. These changes were partially offset by an increase in other current liabilities due to higher compensation, benefit and profit sharing accruals, the result of increased headcount and improved Company performance.

Net cash flows used in investing activities were \$202.6 million, \$197.0 million and \$139.7 million in 2008, 2007 and 2006, respectively. Cash expended for property, buildings, equipment and capitalized software was \$195.0 million, \$197.4 million and \$136.8 million in 2008, 2007 and 2006, respectively. Additional information regarding capital spending is detailed in the **Capital Expenditures** section below. In 2008, Grainger continued to fund the Company's market expansion initiative (\$40 million) and acquired two companies, Highsmith and Excel (\$34.3 million). In 2007, Grainger funded the market expansion initiative (\$88 million), purchased McFeely's (\$4.7 million) and purchased its distribution center in China (\$6.7 million).

Net cash flows used in financing activities for 2008, 2007 and 2006 were \$36.8 million, \$513.9 million and \$492.9 million, respectively. Treasury stock purchases were \$394.2 million in 2008 as Grainger repurchased 5.5 million shares compared to purchases of \$647.3 million in 2007 to repurchase 7.2 million shares. As of December 31, 2008, approximately 7.4 million shares of common stock remained available under Grainger's repurchase authorization. Dividends paid to shareholders were \$121.5 million in 2008 versus \$113.1 million in 2007. Grainger also used cash in financing activities

to pay off \$81.4 million of short-term borrowings versus an increase in short-term borrowings of \$102.3 million in 2007. Partially offsetting these cash outlays were proceeds of long-term borrowings of \$500 million in 2008, as well as proceeds and excess tax benefits realized from stock options exercised of \$60.4 million in 2008 versus \$144.2 million in 2007.

Treasury stock purchases were \$472.8 million for 7.0 million shares and dividends paid to shareholders were \$97.9 million in 2006. Partially offsetting these cash outlays was proceeds and excess tax benefits realized from stock options exercised of \$77.8 million for 2006.

### **Working Capital**

Internally generated funds have been the primary source of working capital and for funds used in business expansion, supplemented by debt as circumstances dictated. In addition, funds were expended for facilities optimization and enhancements to support growth initiatives, as well as for business and systems development and other infrastructure improvements.

Working capital was \$1,382.4 million at December 31, 2008, compared with \$974.4 million at December 31, 2007, and \$1,155.8 million at December 31, 2006. At these dates, the ratio of current assets to current liabilities was 2.8, 2.2 and 2.6. The increase in the current ratio and working capital for 2008 primarily relates to increases in cash and inventories and the replacement of short-term borrowings with long-term borrowings.

### **Capital Expenditures**

In each of the past three years, a portion of operating cash flow has been used for additions to property, buildings, equipment and capitalized software as summarized in the following table (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Land, buildings, structures and improvements.....	\$107,688	\$100,380	\$ 67,554
Furniture, fixtures, machinery and equipment.....	76,163	87,389	62,233
Subtotal .....	183,851	187,769	129,787
Capitalized software .....	12,297	8,556	8,950
Total.....	<u>\$196,148</u>	<u>\$196,325</u>	<u>\$138,737</u>

In 2008, Grainger completed its investments in the market expansion program in the United States which realigned branches in the top 25 major metropolitan areas. In addition, there was continued international investment, including branch expansion in Mexico, as well as the normal recurring replacement of equipment.

In 2007 and 2006, Grainger's investments included the market expansion program, Mexico and China expansion and the normal recurring replacement of equipment.

Capital expenditures are expected to range from \$175 million to \$200 million in 2009. Projected investments include improved infrastructure in distribution centers, both in the U.S. and Canada, information technology, including upgraded electronic commerce platforms, and the normal recurring replacement of equipment. Grainger expects to fund 2009 capital investments from operating cash flows.

### **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. A four-year bank term loan of \$500 million was obtained in May 2008. At December 31, 2008, Grainger's long-term debt rating by Standard & Poor's was AA+. Grainger's available lines of credit, as further discussed in Note 8 to the Consolidated Financial Statements, were \$250.0 million at December 31, 2008, 2007 and 2006. Total debt as a percent of total capitalization was 20.7%, 5.0% and 0.4% as of the same dates. The increase in total debt as a percent of total capitalization in 2008 was primarily the result of the \$500 million bank term loan. Grainger believes any circumstances that would trigger early payment or acceleration with respect to any outstanding debt securities would not have a material impact on its results of operations or financial position.

---

### **Commitments and Other Contractual Obligations**

At December 31, 2008, Grainger's contractual obligations, including estimated payments due by period, are as follows (in thousands of dollars):

	Payments Due by Period				
	Total Amounts Committed	Less than 1 Year	1 – 3 Years	4 – 5 Years	More than 5 Years
Long-term debt obligations .....	\$ 509,485	\$ 21,257	\$100,728	\$387,500	\$ —
Interest on long-term debt .....	18,538	6,130	10,782	1,626	—
Operating lease obligations.....	218,375	41,150	66,471	49,917	60,837
Purchase obligations:					
Uncompleted additions to property, buildings and equipment.....	17,916	17,916	—	—	—
Commitments to purchase inventory .....	187,526	187,498	28	—	—
Other purchase obligations .....	80,938	68,665	11,181	1,092	—
Other liabilities .....	171,489	7,408	15,181	17,329	131,571
Total .....	<u>\$1,204,267</u>	<u>\$350,024</u>	<u>\$204,371</u>	<u>\$457,464</u>	<u>\$192,408</u>

Purchase obligations for inventory are made in the normal course of business to meet operating needs. While purchase orders for both inventory purchases and noninventory purchases are generally cancelable without penalty, certain vendor agreements provide for cancellation fees or penalties depending on the terms of the contract.

Other liabilities represent future benefit payments for postretirement benefit plans and postemployment disability medical benefits as determined by actuarial projections. Other employment-related benefits costs of \$31.0 million have not been included in this table as the timing of benefit payments is not statistically predictable. See Note 10 to the Consolidated Financial Statements.

See also Notes 9 and 11 to the Consolidated Financial Statements for further detail related to the interest on long-term debt and operating lease obligations, respectively.

Grainger has recorded a noncurrent liability of \$26.3 million for tax uncertainties and interest at December 31, 2008. This amount is excluded from the table above, as Grainger cannot make reliable estimates of these cash flows by period. See Note 15 to the Consolidated Financial Statements.

### **Off-Balance Sheet Arrangements**

Grainger does not have any material exposures to off-balance sheet arrangements. Grainger does not have any variable interest entities or activities that include non-exchange-traded contracts accounted for at fair value.

### **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 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 highly uncertain at the time the estimates are made and when there are different estimates that management reasonably could have made, which would have a material impact on the presentation of Grainger's financial condition, changes in financial condition or results of operations.

Note 2 to the Consolidated Financial Statements describes the significant accounting policies used in the preparation of the Consolidated Financial Statements. The most significant areas involving management judgments and estimates follow. Actual results in these areas could differ materially from management's estimates under different assumptions or conditions.

***Allowance for Doubtful Accounts.*** Grainger uses several factors to estimate the allowance for uncollectible accounts receivable including the age of the receivables and the historical ratio of actual write-offs to the age of the receivables. The analyses performed also take into consideration economic conditions that may have an impact on a specific industry, group of customers or a specific customer.

Write-offs could be materially different than the reserves provided if economic conditions change or actual results deviate from historical trends.

**Inventory Reserves.** Grainger establishes inventory reserves for shrinkage and excess and obsolete inventory. Provisions for inventory shrinkage are based on historical experience to account for unmeasured usage or loss. Actual inventory shrinkage could be materially different from these estimates, affecting Grainger's inventory values and cost of merchandise sold.

Grainger regularly reviews inventory to evaluate continued demand and identify any obsolete or excess quantities of inventory. Grainger records provisions for the difference between excess and obsolete inventory and its estimated realizable value. Estimated realizable value is based on anticipated future product demand, market conditions and liquidation values. Actual results differing from these projections could have a material effect on Grainger's results of operations.

**Stock Incentive Plans.** Grainger maintains stock incentive plans under which a variety of incentive grants may be awarded to employees and directors. Grainger uses a binomial lattice option pricing model to estimate the value of stock option grants. The model requires projections of the risk-free interest rate, expected life, volatility, expected dividend yield and forfeiture rate of the stock option grants. The fair value of options granted used the following assumptions:

	For the Years Ended December 31,		
	2008	2007	2006
Risk-free interest rate.....	3.2%	4.6%	4.9%
Expected life.....	6 years	6 years	6 years
Expected volatility.....	25.2%	24.3%	23.9%
Expected dividend yield.....	1.8%	1.7%	1.5%

The risk-free interest rate is selected based on yields from U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected term of the options being valued. The expected life selected for options granted during each year presented represents the period of time that the options are expected to be outstanding based on historical data of option holders exercise and termination behavior. Expected volatility is based upon implied and historical volatility of the closing price of Grainger's stock over a period equal to the expected life of each option grant. The dividend yield assumption is based on history and expectation of dividend payouts. Because stock option compensation expense is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures, using historical forfeiture experience.

The amount of stock option compensation expense is significantly affected by the valuation model and these assumptions. If a different valuation model or different assumptions were used, the stock option compensation expense could be significantly different from what is recorded in the current period.

Compensation expense for other stock-based awards is based upon the closing market price on the last trading date preceding the date of the grant.

For additional information concerning stock incentive plans, see Note 12 to the Consolidated Financial Statements.

**Postretirement Healthcare Benefits.** Postretirement healthcare obligations and net periodic costs are dependent on assumptions and estimates used in calculating such amounts. The assumptions used include, among others, discount rates, assumed rates of return on plan assets and healthcare cost trend rates. Changes in assumptions (caused by conditions in equity markets or plan experience, for example) could have a material effect on Grainger's postretirement benefit obligations and expense, and could affect its results of operations and financial condition. These changes in assumptions may also affect voluntary decisions to make additional contributions to the trust established for funding the postretirement benefit obligation.

The discount rate assumptions used by management reflect the rates available on high-quality fixed income debt instruments as of December 31, the measurement date, of each year. A lower discount rate increases the present value of benefit obligations and net periodic postretirement benefit costs. As of December 31, 2008, Grainger decreased the discount rate used in the calculation of its postretirement plan obligation from 6.5% to 5.9% to reflect the decrease in market interest rates. Grainger estimates that the decrease in the expected discount rate will decrease 2009 pretax earnings by approximately \$2.5 million, although other changes in assumptions may increase, decrease or eliminate this effect.

Grainger considers the long-term historical actual return on plan assets and the historical performance of the Standard & Poor's 500 Index in developing its expected long-term return on plan assets. In 2008, Grainger maintained the expected long-term rate of return on plan assets of 6.0% (net of tax at 40%) based on the historical average of long-term rates of return.

A 1 percentage point change in assumed healthcare cost trend rates would have had the following effects on December 31, 2008 results (in thousands of dollars):

	1 Percentage Point	
	Increase	(Decrease)
Effect on total of service and interest cost.....	\$ 4,206	\$ (3,293)
Effect on accumulated postretirement benefit obligation.....	37,268	(29,601)

Grainger may terminate or modify the postretirement plan at any time, subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code, as amended. In the event the postretirement plan is terminated, all assets of the Group Benefit Trust inure to the benefit of the participants. The foregoing assumptions are based on the presumption that the postretirement plan will continue. Were the postretirement plan to terminate, different actuarial assumptions and other factors might be applicable.

Grainger has used its best judgment in making assumptions and estimates and believes such assumptions and estimates used are appropriate. Changes to the assumptions may be required in future years as a result of actual experience or new trends and, therefore, may affect Grainger's retirement plan obligations and future expense.

For additional information concerning postretirement healthcare benefits, see Note 10 to the Consolidated Financial Statements.

**Insurance Reserves.** Grainger retains a significant portion of the risk of certain losses related to workers' compensation, general liability and property losses through the utilization of high deductibles and self-insured retentions. There are also certain other risk areas for which Grainger does not maintain insurance.

Grainger is responsible for establishing accounting policies on insurance reserves. Although it relies on outside parties to project future claims costs, it retains control over actuarial assumptions, including loss development factors and claim payment patterns. Grainger performs ongoing reviews of its insured and uninsured risks, which it uses to establish the appropriate reserve levels.

The use of assumptions in the analysis leads to fluctuations in required reserves over time. Any change in the required reserve balance is reflected in the current period's results of operations.

**Income Taxes.** Grainger recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. The tax balances and income tax expense recognized by Grainger are based on management's interpretations of the tax laws of multiple jurisdictions. Income tax expense reflects Grainger's best estimates and assumptions regarding, among other items, the level of future taxable income, interpretation of tax laws and tax planning opportunities. Future rulings by tax authorities and future changes in tax laws and their interpretation, changes in projected levels of taxable income and future tax planning strategies could impact the actual effective tax rate and tax balances recorded by Grainger.

**Other.** Other significant accounting policies, not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. Policies such as revenue recognition, depreciation, intangibles, long-lived assets and warranties require judgments on complex matters that are often subject to multiple external sources of authoritative guidance such as the Financial Accounting Standards Board and the Securities and Exchange Commission. Possible changes in estimates or assumptions associated with these policies are not expected to have a material effect on the financial condition or results of operations of Grainger. More information on these additional accounting policies can be found in Note 2 to the Consolidated Financial Statements.

### New Accounting Standards

The following new accounting standards exclude those pronouncements that are unlikely to have an effect on Grainger upon adoption.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS No. 141R). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The statement is effective for fiscal years beginning after December 15, 2008, and will be applied to acquisitions after adoption by the Company.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51" (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the

parent and the interests of the noncontrolling owners. The statement is effective for fiscal years beginning after December 15, 2008. The Company currently does not have any noncontrolling interest in consolidated financial statements, therefore does not expect the adoption of SFAS No. 160 to have a material effect on its results of operations or financial position.

In June 2008, the FASB issued Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (FSP 03-6-1). FSP 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. Upon adoption, a company is required to retrospectively adjust its earnings per share data presentation to conform with the FSP 03-6-1 provisions. FSP 03-6-1 is effective for fiscal years beginning after December 15, 2008.

The Company's unvested share-based payment awards, such as Performance Shares, Restricted Stock and Restricted Stock Units (see Note 12 to the Consolidated Financial Statements) that contain nonforfeitable rights to dividends meet the criteria of a participating security as defined by FSP 03-6-1. Accordingly, the adoption of FSP 03-6-1 will change the methodology of computing the Company's earnings per share to the two-class method. This change will not affect previously reported consolidated net earnings or net cash flows from operations. Under the two-class method, earnings will be allocated between common stock and participating securities, resulting in lower earnings per share. Refer to the table below for further analysis of the impact adoption would have had on 2008 earnings per share.

	2008 Quarter Ended				
	Mar. 31	June 30	Sept. 30	Dec. 31	Total
Earnings Per Share as previously reported					
Basic .....	\$1.47	\$1.48	\$1.84	\$1.42	\$6.21
Diluted.....	\$1.43	\$1.43	\$1.79	\$1.39	\$6.04
Earnings Per Share Two-class method					
Basic .....	\$1.44	\$1.44	\$1.80	\$1.39	\$6.07
Diluted.....	\$1.41	\$1.42	\$1.77	\$1.37	\$5.97

See Note 2 to the Consolidated Financial Statements for further discussion of new accounting standards.

### **Inflation and Changing Prices**

Inflation during the last three years has not had a significant effect on operations. The predominant use of the last-in, first-out (LIFO) method of accounting for inventories and accelerated depreciation methods for financial reporting and income tax purposes result in a substantial recognition of the effects of inflation in the financial statements.

The major impact of inflation is on buildings and improvements, where the gap between historic cost and replacement cost accumulates for these long-lived assets. The related depreciation expense associated with these assets would likely increase if adjustments were to be made for the cumulative effect of inflation.

Grainger believes the most positive means to combat inflation and advance the interests of investors lies in the continued application of basic business principles, which include improving productivity, maintaining working capital turnover and offering products and services which can command appropriate prices in the marketplace.

### **Forward-Looking Statements**

This Form 10-K contains statements that are not historical in nature but concern future results and business plans, strategies and objectives and other matters that may be deemed to be "forward-looking statements" under the federal securities laws. Grainger has generally identified such forward-looking statements by using words such as "anticipate, anticipated, assumed, assumes, assumption, assumptions, believe, believes, contingency, continue, continued, continues, could, estimate, estimated, estimates, expect, expectation, expected, expects, forecasts, intended, intends, may, might, percent complete, planned, predict, predictable, predicted, presumption, project, projected, projecting, projection, projections, potential, reasonably likely, scheduled, should, unlikely, will, and would" or similar expressions.

Grainger cannot guarantee that any forward-looking statement will be realized, although Grainger does believe that its assumptions underlying its forward-looking statements are reasonable. Achievement of future results is subject to risks and uncertainties which could cause Grainger's results to differ materially from those which are presented.

Factors that could cause actual results to differ materially from those presented or implied in a forward-looking statement include, without limitation: higher product costs or other expenses; a major loss of customers; loss or disruption of source of supply; increased competitive pricing pressures; failure to develop or implement new technologies or business strategies; the outcome of pending and future litigation or governmental or regulatory proceedings; 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; and the factors identified in Item 1A, Risk Factors.

---

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

**Item 7A: Quantitative and Qualitative Disclosures About Market Risk**

Grainger is exposed to foreign currency exchange risk related to its transactions, assets and liabilities denominated in foreign currencies. For 2008, a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect Grainger and its joint ventures would have resulted in a \$2.6 million decrease in net earnings. Comparatively, in 2007 a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect Grainger and its joint ventures would have resulted in a \$2.1 million decrease in net earnings. A uniform 10% weakening of the U.S. dollar would have resulted in a \$3.1 million increase in net earnings for 2008, as compared with an increase in net earnings of \$2.6 million for 2007. This sensitivity analysis of the effects of changes in foreign currency exchange rates does not factor in potential changes in sales levels or local currency prices or costs. Grainger does not hold derivatives for trading purposes.

Grainger is also exposed to interest rate risk in its debt portfolio. During 2008 and 2007, all of its long-term debt was variable rate debt. A 1 percentage point increase in interest rates paid by Grainger would have resulted in a decrease to net earnings of approximately \$2.5 million for 2008 and \$0.3 million for 2007. A 1 percentage point decrease in interest rates would have resulted in an increase to net earnings of approximately \$2.5 million for 2008 and \$0.3 million for 2007. This sensitivity analysis of the effects of changes in interest rates on long-term debt does not factor in potential changes in long-term debt levels.

Grainger has limited primary exposure to commodity price risk on certain products for resale, but does not purchase commodities directly.

**Item 8: Financial Statements and Supplementary Data**

The financial statements and supplementary data are included on pages 27 to 64. See the Index to Financial Statements and Supplementary Data on page 26.

**Item 9: Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

**Item 9A: 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.

Internal Control Over Financial Reporting

(A) Management's Annual Report on Internal Control Over Financial Reporting

Management's report on the Company's internal control over financial reporting is included on page 27 of this Report under the heading Management's Annual Report on Internal Control Over Financial Reporting.

(B) Attestation Report of the Registered Public Accounting Firm

The report from Ernst & Young LLP on its audit of the effectiveness of Grainger's internal control over financial reporting as of December 31, 2008, is included on page 28 of this Report under the heading Report of Independent Registered Public Accounting Firm.

(C) Changes in Internal Control Over Financial Reporting

There have been no changes in Grainger's internal control over financial reporting during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, Grainger's internal control over financial reporting.

**Item 9B: Other Information**

None.

---

## PART III

### **Item 10: Directors, Executive Officers and Corporate Governance**

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 29, 2009, under the captions "Election of Directors," "Board of Directors and Board Committees" and "Section 16(a) Beneficial Ownership Reporting Compliance." Information required by this item regarding executive officers of Grainger is set forth in Part I of this report under the caption "Executive Officers."

Grainger has adopted a code of ethics that applies to the principal executive officer, principal financial officer and principal accounting officer. This code of ethics is incorporated into Grainger's business conduct guidelines for directors, officers and employees. Grainger intends to satisfy the disclosure requirement under Item 5.05 of Form 8-K relating to its code of ethics by posting such information on its Web site at [www.grainger.com/investor](http://www.grainger.com/investor). A copy of the code of ethics incorporated into Grainger's business conduct guidelines is also available in print without charge to any person upon request to Grainger's Corporate Secretary. Grainger has also adopted Operating Principles for the Board of Directors, which are available on its Web site and are available in print to any person who requests them.

### **Item 11: Executive Compensation**

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 29, 2009, under the captions "Board of Directors and Board Committees," "Director Compensation," "Report of the Compensation Committee of the Board" and "Compensation Discussion and Analysis."

### **Item 12: Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 29, 2009, under the captions "Ownership of Grainger Stock" and "Equity Compensation Plans."

### **Item 13: Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 29, 2009, under the captions "Election of Directors" and "Transactions with Related Persons."

### **Item 14: Principal Accounting Fees and Services**

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 29, 2009, under the caption "Audit Fees and Audit Committee Pre-Approval Policies and Procedures."

## PART IV

### **Item 15: Exhibits and Financial Statement Schedules**

- (a) 1. Financial Statements. See Index to Financial Statements and Supplementary Data.
2. Financial Statement Schedules. The schedules listed in Reg. 210.5-04 have been omitted because they are either not applicable or the required information is shown in the consolidated financial statements or notes thereto.
3. Exhibits
  - (3) (a) Restated Articles of Incorporation, incorporated by reference to Exhibit 3(i) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998.
  - (b) Bylaws, as amended March 31, 2008, incorporated by reference to Exhibit 3 to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008.
- (4) Instruments Defining the Rights of Security Holders, Including Indentures
  - (a) Agreement dated as of April 28, 1999, between Grainger and Fleet National Bank (formerly Bank Boston, NA), as rights agent, incorporated by reference to Exhibit 4 to Grainger's Current Report on Form 8-K dated April 28, 1999, and related letter concerning the appointment of EquiServe Trust Company, N.A. (now Computershare Trust Company, N.A.), as successor rights agent, effective August 1, 2002, incorporated by reference to Exhibit 4 to Grainger's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.
  - (b) No instruments which define the rights of holders of Grainger's Industrial Development Revenue Bonds are filed herewith, pursuant to the exemption contained in Regulation S-K, Item 601(b)(4)(iii). Grainger hereby agrees to furnish to the Securities and Exchange Commission, upon request, a copy of any such instrument.
- (10) Material Contracts
  - (a) (i) Accelerated share repurchase agreement, incorporated by reference to Exhibit 10 to Grainger's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007.
  - (ii) A Credit Agreement with Wachovia Bank, National Association, as administrative agent, and other lenders incorporated by reference to Exhibit 10 to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2008.

---

(b) Compensatory Plans or Arrangements

- (i) Director Stock Plan, as amended, incorporated by reference to Exhibit 10(c) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.
- (ii) Office of the Chairman Incentive Plan, incorporated by reference to Appendix B of Grainger's Proxy Statement dated March 26, 1997.
- (iii) 1990 Long-Term Stock Incentive Plan, as amended, incorporated by reference to Exhibit 10(a) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.
- (iv) 2001 Long-Term Stock Incentive Plan, as amended, incorporated by reference to Exhibit 10(b) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.
- (v) Executive Death Benefit Plan, as amended, incorporated by reference to Exhibit 10(v) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2007.
  - (1) First amendment to the Executive Death Benefit Plan.
- (vi) Executive Deferred Compensation Plan, incorporated by reference to Exhibit 10(e) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1989.
- (vii) 1985 Executive Deferred Compensation Plan, as amended, incorporated by reference to Exhibit 10(d)(vii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1998.
- (viii) Supplemental Profit Sharing Plan, as amended, incorporated by reference to Exhibit 10(viii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2003.
- (ix) Supplemental Profit Sharing Plan II, as amended, incorporated by reference to Exhibit 10(ix) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2007.
- (x) Form of Change in Control Employment Agreement between Grainger and certain of its executive officers, as amended, incorporated by reference to Exhibit 10(x) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2007.
- (xi) Voluntary Salary and Incentive Deferral Plan, as amended, incorporated by reference to Exhibit 10(xi) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2007.
- (xii) Summary Description of Directors Compensation Program effective April 30, 2008, incorporated by reference to Exhibit 10 to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 2007.
- (xiii) Summary Description of Directors Compensation Program effective April 29, 2009.
- (xiv) 2005 Incentive Plan, as amended, incorporated by reference to Exhibit 10(d) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006.
- (xv) Form of Stock Option Award Agreement between Grainger and certain of its executive officers, incorporated by reference to Exhibit 10(xiv) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2005.
- (xvi) Form of Stock Option and Restricted Stock Unit Agreement between Grainger and certain of its executive officers, incorporated by reference to Exhibit 10(xv) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2005.
- (xvii) Form of Performance Share Award Agreement between Grainger and certain of its executive officers, incorporated by reference to Exhibit 10(xvi) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2005.
- (xviii) Form of Performance Share Award Agreement (non-dividend equivalent) between Grainger and certain of its executive officers.
- (xix) Summary Description of 2007 Management Incentive Program, incorporated by reference to Exhibit 10(xvii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2006.
- (xx) Summary Description of 2008 Management Incentive Program, incorporated by reference to Exhibit 10(xviii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2007.
- (xxi) Summary Description of 2009 Management Incentive Program.

(21) Subsidiaries of Grainger.

(23) Consent of Independent Registered Public Accounting Firm.

(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 Section 13 of the Securities Exchange Act of 1934, Grainger has duly issued this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DATE: February 26, 2009

W.W. GRAINGER, INC.

By: James T. Ryan  
James T. Ryan  
President and  
Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of Grainger on February 26, 2009, in the capacities indicated.

James T. Ryan  
James T. Ryan  
President and Chief Executive Officer  
(Principal Executive Officer and Director)

Ronald L. Jadin  
Ronald L. Jadin  
Senior Vice President  
and Chief Financial Officer  
(Principal Financial Officer)

Gregory S. Irving  
Gregory S. Irving  
Vice President and Controller  
(Principal Accounting Officer)

Richard L. Keyser  
Richard L. Keyser  
Chairman of the Board

Brian P. Anderson  
Brian P. Anderson  
Director

Wilbur H. Gantz  
Wilbur H. Gantz  
Director

V. Ann Hailey  
V. Ann Hailey  
Director

William K. Hall  
William K. Hall  
Director

Stuart L. Levenick  
Stuart L. Levenick  
Director

John W. McCarter, Jr.  
John W. McCarter, Jr.  
Director

Neil S. Novich  
Neil S. Novich  
Director

Michael J. Roberts  
Michael J. Roberts  
Director

Gary L. Rogers  
Gary L. Rogers  
Director

James D. Slavik  
James D. Slavik  
Director

Harold B. Smith  
Harold B. Smith  
Director