UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2004

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	**Name of each exchange on which registered**
Common Stock $0.50 par value, and accompanying Preferred Share Purchase Rights	New York Stock Exchange Chicago Stock Exchange

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes __X__ No _______

Indicate by check mark 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 of 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 an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes __X__ No _______

The aggregate market value of the voting common equity held by nonaffiliates of the registrant was $4,477,602,395 as of the close of trading reported on the Consolidated Transaction Reporting System on June 30, 2004. The Company does not have nonvoting common equity.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Common Stock $0.50 par value — 90,665,414 shares outstanding as of January 31, 2005

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement relating to the annual meeting of shareholders of the registrant to be held on April 27, 2005, are incorporated by reference into Part III hereof.

TABLE OF CONTENTS

PART I

Item 1: Business

The Company

W.W. Grainger, Inc., incorporated in the State of Illinois in 1928, is in the service business. It distributes products used by businesses and institutions across North America to keep their facilities and equipment running. In this report, the words "Grainger" or "Company" mean W.W. Grainger, Inc. and its subsidiaries.

Grainger uses a multichannel business model to serve approximately 1.6 million customers of all sizes with multiple ways to find and purchase facilities maintenance and other products through a network of branches, field sales representatives, call centers, direct marketing media and the Internet. Orders can be placed via telephone, fax, Internet or in person. Products are available for immediate pick-up or for shipment.

Operating results are reported in three segments: Branch-based Distribution, Lab Safety and Integrated Supply. The Branch-based Distribution businesses primarily serve the needs of North American businesses for facility maintenance products. Lab Safety Supply, Inc. (Lab Safety), a direct marketing company, serves customers who purchase safety, industrial and other products. Integrated Supply serves customers seeking to outsource some or all of their indirect materials management processes.

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

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

Branch-based Distribution

The Branch-based Distribution businesses provide North American customers with product solutions for facility maintenance and other product needs through logistics networks, which are configured for rapid product availability. Grainger offers a broad selection of facility maintenance and other products through local branches, catalogs and the Internet. The Branch-based Distribution businesses consist of the following Grainger divisions: Industrial Supply, Acklands – Grainger Inc. (Canada), FindMRO, Export, Global Sourcing, Parts, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico) and China Distribution. The more significant of these businesses 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, simplicity of ordering and competitively priced products. Industrial Supply distributes material handling equipment, safety and security supplies, lighting and electrical products, tools and test instruments, pumps and plumbing supplies, cleaning and painting supplies and many other items. Its customers range from small and medium-sized businesses to large corporations and governmental and other institutions. During 2004, Industrial Supply completed an average of 89,000 sales transactions daily.

Industrial Supply operates 408 branches located in all 50 states. These branches are generally 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. The Grainger Express® will-call branches average 1,800 square feet, do not stock inventory and provide convenient pick-up locations. Branches primarily fulfill counter and will-call needs and provide customer service. Master branches handle a higher volume of counter and will-call customers daily, in addition to shipping to customers for other branches in their area. On average, a branch is 20,000 square feet in size, has 11 employees and handles about 136 transactions per day. In 2004, Industrial Supply opened 19 new branches, relocated 15 branches and expanded or remodeled 17 branches. Five branches were closed in 2004.

In March 2004, Industrial Supply completed the project of reconfiguring its distribution network. The new network is comprised of nine distribution centers (DCs) – five new and four redesigned facilities – which handle most of the customer shipping and also replenish branch inventories. The new facilities average more than 300,000 square feet in size. The DCs, using automated equipment and processes, ship orders, including Internet orders, directly to customers for all branches located in their service areas. The DC located in Chicago is also a national distribution center providing customers and the entire network with slower moving inventory items.

Industrial Supply sells principally to customers in industrial and commercial maintenance departments, service shops, manufacturers, hotels, government, retail organizations, transportation businesses, contractors, and healthcare and educational facilities. Sales transactions during 2004 were made to approximately 1.3 million customers. Approximately 24% of 2004 sales consisted of private label items bearing the Company's registered trademarks, including DAYTON® (principally electric motors, heating and ventilation equipment), TEEL® (liquid pumps), SPEEDAIRE® (air compressors), AIR HANDLER® (air filtration equipment), DEM-KOTE® (spray paints), WESTWARD® (principally hand and power tools), CONDOR™ (safety products) and LUMAPRO® (task and outdoor lighting). 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 current Industrial Supply catalog, issued in February 2005, offers more than 82,000 facility maintenance and other products. Approximately 1.4 million copies of the catalog were produced. A CD-ROM version of the catalog supplements the paper version. Approximately 690,000 copies of the CD-ROM catalog were produced.

Customers can also purchase products through grainger.com. This Web site serves as a prominent service channel for the Industrial Supply division. Customers have access to a much larger selection of products through grainger.com than is contained in the catalog. It is available 24/7, providing real-time product availability, customer-specific pricing, multiple product search capabilities, customer personalization, and links to customer support and the fulfillment system. For large customers interested in connecting to grainger.com through sophisticated purchasing platforms, grainger.com has a universal connection. This technology translates the different data formats used by electronic marketplaces, exchanges, and e-procurement systems and allows these systems to communicate directly with Industrial Supply's operating platform. Orders processed through grainger.com resulted in sales of $611.3 million in 2004, $478.6 million in 2003 and $419.5 million in 2002.

Industrial Supply purchases products for sale from approximately 1,100 suppliers, most of which are manufacturers. No single supplier comprised more than 10% of Industrial Supply's purchases and no significant difficulty has been encountered with respect to sources of supply.

Acklands – Grainger Inc. (Acklands)

Acklands is Canada's leading broad-line distributor of industrial, automotive fleet and safety supplies. It serves customers through 166 branches and five distribution centers across Canada. Acklands distributes tools, lighting products, safety supplies, pneumatics, instruments, welding equipment and supplies, motors, shop equipment and many other items. During 2004, approximately 14,000 sales transactions were completed daily. A comprehensive catalog, printed in both English and French, showcases the product line to facilitate customer selection. This catalog, with more than 43,000 products, supports the efforts of field sales representatives throughout Canada. In addition, customers can purchase products through www.acklandsgrainger.com.

FindMRO

FindMRO is a sourcing service. Through sophisticated search technologies and sourcing expertise, FindMRO locates facilities maintenance and other products when a source is unknown to the customer. FindMRO has access to more than 4,000 suppliers and five million products. Orders can be placed with a Grainger sales representative or a branch employee.

Global Sourcing

Global Sourcing procures competitively priced, high-quality products produced outside the United States. Grainger businesses sell these items primarily under private labels. Products obtained through Global Sourcing include WESTWARD® tools, LUMAPRO® lighting products and CONDOR™ safety products, as well as products bearing other trademarks.

Parts

Parts provides customers access to more than 2.5 million parts and accessories, stocking nearly 76,000 of them in its Northbrook, Illinois, warehouse. Customers can purchase parts over the telephone, at grainger.com, or through a Grainger sales representative or branch employee. Trained customer service representatives have online access to more than 300,000 pages of detailed parts diagrams. Parts handled approximately 1.5 million customer calls in 2004 through its call center in Waterloo, Iowa.

Mexico

Grainger's operations in Mexico provide local businesses with facility maintenance and other products from both Mexico and the United States. From its six locations in Mexico and U.S. branches along the border, the business provides delivery of approximately 43,000 products throughout Mexico. One new branch was opened in 2004. The largest facility, an 85,000 square foot DC, is located outside of Monterrey, Mexico. Customers can order products using a Spanish-language general catalog or purchase them through www.grainger.com.mx.

Lab Safety

Lab Safety is a direct marketer of safety and other industrial products to U.S. and Canadian businesses. Headquartered in Janesville, Wisconsin, Lab Safety primarily reaches its customers through the distribution of multiple branded catalogs, including a CD-ROM version, and other marketing materials distributed throughout the year to targeted markets. Customers can purchase products through www.lss.com, www.benmeadows.com and www.gemplers.com.

Lab Safety offers extensive product depth, technical support and high service levels. During 2004, Lab Safety issued 11 unique catalogs covering safety supplies, material handling and facility maintenance products, lab supplies, security and other products targeted to specific customer groups. Lab Safety provides access to more than 130,000 products through its targeted catalogs.

Integrated Supply

Integrated Supply serves customers who have chosen to outsource some or all of their indirect materials management processes. This service enables customers to focus on their core business objectives. Integrated Supply offers a full complement of on-site outsourcing solutions, including business process reengineering, inventory and tool crib management, purchasing management and information management.

In 2005, Integrated Supply will no longer offer on-site integrated purchasing and tool crib management services. It will be merged into the Industrial Supply division and be reported in the Branch-based Distribution segment. Industrial Supply plans to fulfill, but not renew, existing Integrated Supply contracts.

Industry Segments

For 2004, Grainger is reporting three industry segments: Branch-based Distribution, Lab Safety and Integrated Supply. Beginning January 1, 2005, Integrated Supply will no longer be reported as a separate segment. 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 "**Item 8: Financial Statements and Supplementary Data**."

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 certain retail enterprises.

Grainger provides local product availability, 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 facility 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 United States market for facilities maintenance products to be approximately $100 billion, of which Grainger's share is between 4 and 5 percent. There are a small number of large competitors, although most of the market is served by small, local and regional competitors.

Employees

As of December 31, 2004, Grainger had 15,523 employees, of whom 13,260 were full-time and 2,263 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 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 www.grainger.com/investor.

Item 2: Properties

As of December 31, 2004, Grainger's owned and leased facilities totaled 17,936,000 square feet, essentially the same as 2003. Decreases due to the sale of the former New Jersey facility and to the consolidation of Canadian facilities were offset by increases related to the market expansion program. Industrial Supply and Acklands accounted for the majority of the total square footage. Industrial Supply facilities are located throughout the United States. Acklands facilities are located throughout Canada.

Industrial Supply branches range in size from 1,200 to 109,000 square feet and average approximately 20,000 square feet. Most are located in or near major metropolitan areas with many located in industrial parks. Typically, a branch is on one floor, is of masonry construction, consists primarily of warehouse space, sales areas and offices and has off-the-street parking for customers and employees. Grainger considers that its properties are generally in good condition and well maintained.

A brief description of significant facilities follows:

Location	Facility and Use	Size in Square Feet
Chicago Area (1)	Headquarters and General Offices	1,179,000
United States (1)	Nine Distribution Centers	5,100,000
United States (2)	408 Industrial Supply branch locations	8,059,000
United States and Mexico (3)	Other facilities	1,766,000
Canada (4)	166 Acklands facilities	1,832,000
	Total Square Feet	17,936,000

(1) These facilities are either owned or leased with most leases expiring between 2005 and 2009. The owned facilities are not subject to any mortgages.

(2) Industrial Supply branches consist of 283 owned and 125 leased properties. The owned facilities are not subject to any mortgages.

(3) Other facilities primarily include locations for Lab Safety, other business units and properties under construction. Two facilities are located in Puerto Rico and six are located in Mexico, all of which are leased. The owned facilities are not subject to any mortgages.

(4) Acklands facilities consist of general offices, distribution centers and branches, of which 58 are owned and 108 leased. The 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 January 28, 2005, Grainger is named in cases filed on behalf of approximately 3,700 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. In addition, during 2004, five cases previously filed against Grainger alleging exposure to cotton dust were amended to include allegations relating to asbestos; these cases involve approximately 2,100 plaintiffs.

Grainger has denied, or intends to deny, the allegations in all of the above-described lawsuits. In 2004, lawsuits relating to asbestos and/or silica and involving approximately 700 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 portion of these claims are covered by insurance. Grainger is engaged in active discussions with its insurance carriers regarding the scope and amount of coverage. 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.

On September 28, 2004, the U.S. Environmental Protection Agency (EPA) filed an administrative complaint against Grainger seeking a civil penalty of $0.4 million for alleged violations of federal clean-air law and regulations. The complaint alleges that Grainger sold a "non-essential" wheel chock product which contained and/or was manufactured with an ozone-depleting substance (ODS). The complaint also alleges that Grainger sold aerosol cleaning fluids containing an ODS without displaying proper notification where the products were sold. According to the complaint, Grainger sold the cleaning fluids to persons who did not provide proof that they were commercial purchasers and failed to verify that such persons were commercial purchasers. Grainger does not believe that the resolution of this matter will have a material adverse effect on Grainger's consolidated financial position or results of operations.

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. These include claims relating to product liability, general negligence, environmental issues, employment, intellectual property and other matters. As a government contractor, from time to time Grainger is also subject to governmental or regulatory inquiries or audits. 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 2004.

Executive Officers

Following is information about the Executive Officers of Grainger including age in February 2005. 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
Judith E. Andringa (44)	Vice President and Controller. Before joining Grainger in 2002, she was Controller of the Foodservice Division of Kraft Foods, Inc., a position assumed in 2000 after serving Kraft as Director of Finance, Marketing Services Group.
Nancy A. Hobor (58)	Senior Vice President (formerly Vice President), Communications and Investor Relations, a position assumed in 1999.
John L. Howard (47)	Senior Vice President and General Counsel, a position assumed in 2000.
Richard L. Keyser (62)	Chairman of the Board, a position assumed in 1997, and Chief Executive Officer, a position assumed in 1995.
Larry J. Loizzo (50)	Senior Vice President (formerly Vice President) of Grainger, a position assumed in 2003, and President of Lab Safety Supply, Inc., a position assumed in 1996.
P. Ogden Loux (62)	Senior Vice President, Finance and Chief Financial Officer, a position assumed in 1997.
James T. Ryan (46)	Group President, a position assumed in April 2004 after serving as Executive Vice President, Marketing, Sales and Service (for Grainger Industrial Supply). Before assuming the last-mentioned position in 2001, he served as Vice President of Grainger and President of grainger.com.

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 traded 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 2004 and 2003 are shown below.

		Prices		
	Quarters	High	Low	Dividends
2004	First	$49.02	$45.00	$0.185
	Second	57.66	47.55	0.200
	Third	58.90	50.33	0.200
	Fourth	66.99	56.26	0.200
	Year	$66.99	$45.00	$0.785
2003	First	$53.30	$41.40	$0.180
	Second	50.80	42.54	0.185
	Third	52.33	45.86	0.185
	Fourth	50.83	43.70	0.185
	Year	$53.30	$41.40	$0.735

Holders

The approximate number of shareholders of record of Grainger's common stock as of January 31, 2005 was 1,300.

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	2,601	$ —	—	7,197,700 shares
Nov. 1 – Nov. 30	60,545	$58.93	52,000	7,145,700 shares
Dec. 1 – Dec. 31	66,285	$60.93	65,000	7,080,700 shares
Total	129,431	$60.04	117,000	7,080,700 shares

(A) The total number of shares purchased includes Grainger's retention of 12,431 shares 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 settlement date basis.

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors. As reported in Grainger's Form 10-Q for the quarter ended September 30, 2002, which was filed on November 11, 2002, authority under the program was restored to 10 million shares on October 30, 2002. The program has no specified expiration date. No share repurchase plan or program expired, or was terminated, during the period covered by this report.

Other

On May 21, 2004, Grainger timely submitted to the New York Stock Exchange (NYSE) a 2004 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

	2004	2003	2002	2001	2000
	(In thousands of dollars, except for per share amounts)				
Net sales	$5,049,785	$4,667,014	$4,643,898	$4,754,317	$4,977,044
Net earnings	286,923	226,971	211,567	174,530	192,903
Net earnings per basic share	3.18	2.50	2.30	1.87	2.07
Net earnings per diluted share	3.13	2.46	2.24	1.84	2.05
Total assets	2,809,573	2,624,678	2,437,448	2,331,246	2,459,601
Long-term debt (less current maturities)	—	4,895	119,693	118,219	125,258
Cash dividends paid per share	$ 0.785	$ 0.735	$ 0.715	$ 0.695	$ 0.670

The results for 2004 included an effective tax rate, excluding the effect of equity in unconsolidated entities, of 35.6%, which was down from 40.0% in the prior year. The lower tax rate resulted in an increase to earnings of $19.4 million or $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" (the Medicare Act) and the resolution of certain federal and state tax contingencies.

The results for 2002 included an after-tax gain on the sale of securities of $4.5 million, or $0.04 per diluted share, and an after-tax gain on the reduction of restructuring reserves established for the shutdown of the Material Logic business of $1.2 million, or $0.01 per diluted share. These were offset by the cumulative effect of a change in accounting for the write-down of goodwill of $23.9 million after-tax, or $0.26 per diluted share, related to Grainger's Canadian subsidiary.

The results for 2001 included an after-tax charge of $36.6 million, or $0.39 per diluted share, related to the restructuring charge established in connection with the closing of the Material Logic business and the write-down of investments in other digital enterprises.

The results for 2000 included an after-tax gain of $17.9 million, or $0.19 per diluted share, related to sales of investment securities.

For further information see "**Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations**" and Notes 3 and 5 to the Consolidated Financial Statements.

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

Overview

General. Grainger is the leading broad-line supplier of facilities maintenance and other related products in North America. For each of the three years presented in this Annual Report on Form 10-K for the year ended December 31, 2004, Grainger reported its operating results in three segments: Branch-based Distribution, Lab Safety and Integrated Supply. 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, field sales forces, direct marketing including catalogs, and a variety of electronic and Internet channels. Grainger serves customers through a network of 582 branches, 17 distribution centers and multiple Web sites.

Beginning January 1, 2005, Grainger's Integrated Supply business will no longer offer on-site integrated purchasing and tool crib management services and will be merged into Grainger's Industrial Supply division within the Branch-based Distribution segment. Grainger Industrial Supply plans to fulfill, but not renew, existing Integrated Supply contracts. As such, in 2005 Integrated Supply will no longer be reported as a separate segment and Grainger will report its operating results in two segments: Branch-based Distribution and Lab Safety.

Business Environment. Several economic factors and industry trends shape Grainger's business environment. The current overall economy and leading economic indicators forecast by economists provide insight into anticipated economic factors for the near term and help in the development of projections for the upcoming year. At the start of 2005, the Consensus Forecast-USA is predicting GDP and Industrial Production growth of 3 to 4 percent for 2005.

In 2004, Grainger benefited from the economic recovery in the United States. Grainger's sales correlate positively with production growth. With the improvement in Industrial Production and general growth in the economy, Grainger realized an increase in sales across all customer segments. Grainger's sales also tend to increase when non-farm payrolls grow, especially during economic recoveries. Non-farm payrolls increased approximately 1%, on average, in 2004 over 2003. For 2004, Grainger benefited from the combination of increased Industrial Production and non-farm payroll growth.

The light and heavy manufacturing customer segments, which comprised over 25% of Grainger's total 2004 sales, have historically correlated with manufacturing employment levels and manufacturing production. Manufacturing employment levels increased less than 1% during 2004, while manufacturing output increased approximately 4.8%. This contributed to the double-digit sales growth in the light and heavy manufacturing customer segments for Grainger in 2004. Economic forecasts suggest that the manufacturing sector will continue to expand in 2005.

In 2004, Grainger launched a multiyear initiative to strengthen its presence in top metropolitan markets and better position itself to serve the local customer. The success of the market expansion program is expected to be a driver of growth in 2005 and beyond. Three phases of the market expansion program were in progress at December 31, 2004, and are scheduled for completion in 2005. Additional phases are scheduled for 2005 and beyond.

The customer's buying behavior is also important in Grainger's business environment. Grainger believes that customers will continue to focus on reducing their cost to procure facilities maintenance products. Grainger is therefore increasing product information available to employees for improved service to customers by installing an upgraded SAP operating system and accelerating the replacement of its legacy information systems with a new integrated software package also provided by SAP, starting with the U.S. branch-based businesses. Integration, volume and user acceptance testing is currently scheduled for the third quarter of 2005.

Grainger's financial strength, including its low debt and strong cash flow, leaves it well positioned to fund major initiatives, improve effectiveness and accelerate top line growth. Capital spending in 2004 related to the branch network and information technology was approximately $118 million, with total capital expenditures of nearly $161 million. Capital spending was approximately $20 million higher than the most recent forecast due to the acceleration of the replacement and upgrade of the branch communication systems and the ongoing SAP initiatives.

In 2005, total capital expenditures of $150 to $180 million are anticipated. Grainger intends to continue its investment in the market expansion program and information technology enhancements with spending planned for the following major projects:

- $60 to $70 million for continued market expansion;
- $35 to $40 million for information technology; and
- $10 to $12 million for Canadian branch programs.

Capital spending for the market expansion program may be affected by lease or purchase decisions, based on availability of facilities.

Matters Affecting Comparability. Grainger's operating results for 2004 included a full year of operating results of Gempler's. Grainger's operating results for 2003 included the results of Gempler's only from the acquisition date of April 14, 2003. Gempler's results are included in the Lab Safety segment.

Grainger has made reclassifications to the prior years ended December 31, 2003 and 2002, to reduce cost of merchandise sold and increase operating (advertising) expenses for vendor provided funding in order to maintain comparable reporting with the year ended December 31, 2004. See Note 2 to the Consolidated Financial Statements.

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, Items in Consolidated Statements of Earnings				
	As a Percent of Net Sales			Percent Increase/(Decrease) from Prior Year	
	2004	2003	2002	2004	2003
Net sales	100.0%	100.0%	100.0%	8.2%	0.5%
Cost of merchandise sold	62.2	63.8	64.3	5.6	(0.3)
Gross profit	37.8	36.2	35.7	12.7	1.9
Operating expenses	29.1	27.9	27.2	12.5	3.0
Operating earnings	8.7	8.3	8.5	13.5	(1.5)
Other income (expense)	0.1	(0.1)	0.1	190.9	(231.8)
Income taxes	3.1	3.3	3.5	2.7	(5.1)
Cumulative effect of accounting change – expense	—	—	0.5	N/A	100.0
Net earnings	5.7%	4.9%	4.6%	26.4%	7.3%

2004 Compared to 2003

Grainger's net sales for 2004 of $5,049.8 million were up 8.2% versus 2003. The increase in net sales was a result of the strengthening in the manufacturing and commercial sectors. Full year results also benefited from the completion of the logistics network upgrade, which improved product availability, as well as from the launch of the market expansion project, an expanded sales force and new communication technology in the U.S. branches. The increase in net sales was realized in the Branch-based Distribution and Lab Safety segments of the business, while net sales in the Integrated Supply segment were essentially flat year over year.

The gross profit margin of 37.8% in 2004 improved 1.6 percentage points over the gross profit margin of 36.2% in 2003, principally due to product cost reduction programs, including the global sourcing of products, combined with selected price increases in 2004 and the positive effect of product mix. These margin improvements were partially offset by unfavorable changes in selling price category mix.

Grainger's operating earnings of $439.5 million in 2004 increased $52.3 million, or 13.5%, over the prior year. The operating margin of 8.7% in 2004 improved 0.4 percentage point over 2003, as the combined effect of increased sales and improvement in gross profit margin exceeded the increase in operating expenses. Operating expenses were up 12.5% in 2004 principally due to higher variable compensation and benefits associated with the improved performance for the year, as well as to incremental costs related to the market expansion and information technology programs.

In 2004, net earnings of $286.9 million increased $60.0 million, or 26.4%, over the prior year. The growth in net earnings was due to the improvement in operating earnings, higher interest income and a lower tax rate. Diluted earnings per share for 2004 of $3.13 were 27.2% higher than the $2.46 for 2003.

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 21 to the Consolidated Financial Statements.

Branch-based Distribution

Net sales of $4,520.0 million in 2004 increased 8.5% over 2003 net sales of $4,167.2 million. Sales in the United States were up 8.2% over the prior year. All customer segments increased, with the strongest sales growth in the manufacturing and commercial sectors. National account sales, which include all customer segments, were up 12%. Sales to government accounts were up 5% primarily due to increased sales to the U.S. Postal Service and to federal, state and local governments. Sales processed through the grainger.com Web site were $611.3 million for 2004, an increase of 27.7% over 2003.

Net sales in Canada were 11.1% higher in 2004 than in 2003, benefiting primarily from a favorable Canadian exchange rate. In local currency, sales increased 3.3%, primarily due to a strengthening in the Canadian economy in the second half of the year driven by the natural resources sector. Sales in Mexico were up 15.4% in 2004 as compared to 2003, driven by an improving local economy, expanded telesales operations and several branch facility enhancements during the year.

Cost of merchandise sold of $2,778.2 million increased $148.6 million, or 5.6%, over 2003 due to increased volume, while gross profit margins improved 1.6 percentage points to 38.5% in 2004 from 36.9% in 2003. Contributing to the improvement in gross profit margin were product cost reduction programs, which included the global sourcing of additional products, combined with selected price increases and the positive effect of product mix. These margin improvements were partially offset by unfavorable changes in selling price category mix.

Operating expenses for the Branch-based Distribution businesses increased 11.6% in 2004. Operating expenses were up primarily as a result of higher sales commissions and bonus and profit sharing accruals associated with the improved 2004 performance, as well as increased costs related to strategic initiatives such as the market expansion program and technology upgrades. Partially offsetting these increases was improved productivity achieved from the redesigned logistics network.

In 2004, operating earnings of $461.4 million increased by $71.2 million, or 18.2%, over 2003. The effect of sales growth, combined with the improvement in gross profit margin, more than offset the increase in operating expenses.

Lab Safety

Net sales at Lab Safety were $336.7 million in 2004, an increase of $31.2 million, or 10.2%, when compared with $305.5 million of sales in 2003. Higher sales were principally driven by growth in nonsafety products. Sales through Lab Safety's Web sites were up 26.1% in 2004 over 2003. Also contributing to the year-over-year increase were incremental sales from Gempler's, which was acquired on April 14, 2003. Excluding Gempler's, sales increased 6.1% over 2003.

The gross profit margin of 41.8% decreased 0.4 percentage point when compared to the gross profit margin of 42.2% for 2003. Contributing to the decline was the negative effect of selling price category mix combined with the effect of a full year of Gempler's sales which carry a lower gross profit margin.

Operating expenses were $95.3 million in 2004, up $8.4 million, or 9.6%, over 2003. The increase over the prior year was principally driven by higher variable compensation expense related to the strong performance for the year, higher catalog media costs and higher benefits expenses from increases in healthcare costs. Also contributing to the increase were costs associated with Gempler's for a full year in 2004 versus a partial year in 2003.

Operating earnings of $45.5 million were up 8.6% in 2004 over 2003, resulting primarily from the increase in sales, partially offset by the lower gross profit margin and increased operating expenses.

Integrated Supply

Integrated Supply net sales of $211.1 million in 2004 were down $0.6 million, or essentially flat when compared with 2003. Incremental sales at ten new customer locations were more than offset by the disengagement of two large customers late in 2003, lower sales to two large customers and lower management fees. Sales included both product sales, which are passed through to the customer at cost, and management fees.

Gross profit declined $0.8 million in 2004 and the gross profit margin of 11.6% declined 0.3 percentage point from 11.9% in 2003. The primary driver of these declines was lower management fees. Operating expenses decreased slightly in 2004, down 0.5%, principally due to a reduction in data processing costs and related contract services.

Operating earnings of $2.5 million for 2004 for Integrated Supply declined $0.7 million, or 23.1%, compared to $3.2 million in 2003.

Other Income and Expense

Other income and expense was $5.6 million of income in 2004, an improvement of $11.8 million as compared with $6.2 million of expense in 2003. The following table summarizes the components of other income and expense:

	For the Years Ended December 31,	
	2004	2003
	(In thousands of dollars)	
Other income and (expense)		
Interest income (expense) – net	$ 1,988	$(2,668)
Equity in income (loss) of unconsolidated entities – net	996	(2,288)
Gain on sale of unconsolidated entity	750	—
Write-off of investments in unconsolidated entities	—	(1,921)
Unclassified – net:		
Gains on sales of investment securities	50	1,208
Write-down of investment securities	—	(1,614)
Gains (losses) on sales of fixed assets – net	1,725	1,607
Other	100	(495)
	$ 5,609	$(6,171)

The improvement in other income and expense in 2004 over 2003 was primarily attributable to net interest income in 2004 versus net interest expense in 2003, as well as a $3.3 million improvement in the results of unconsolidated entities. The change to net interest income in 2004 from net interest expense in 2003 was due to the combination of higher interest rates and invested balances, together with the reduction in outstanding long-term debt balances. Additionally, 2003 included $1.9 million in expense for the write-off of investments in two Asian joint ventures and $1.6 million in expense for the write-down of investment securities. See Note 9 to the Consolidated Financial Statements.

Income Taxes

Income taxes of $158.2 million in 2004 increased 2.7% as compared with $154.1 million in 2003.

Grainger's effective tax rates were 35.5% and 40.4% in 2004 and 2003, respectively. Excluding the effect of equity in unconsolidated entities and the write-off of these investments, which are recorded net of tax, the effective income tax rates were 35.6% for 2004 and 40.0% for 2003. The tax rate reduction was primarily due to a lower tax rate in Canada, as well as the realization of tax benefits related to operations in Mexico and to capital losses, the recognition of tax benefits from the Medicare Act and the resolution of certain federal and state tax contingencies.

For 2005, Grainger is projecting its estimated effective tax rate to be 37.0%, excluding the effects of equity in unconsolidated entities.

2003 Compared to 2002

Grainger's net sales of $4,667.0 million for 2003 were essentially flat compared to 2002. Full-year results were affected by the general weakness in the U.S. economy. Sales in the Branch-based Distribution business segment increased $19.2 million over 2002, or 0.5%, generally unchanged year over year. Revenue increased in the Lab Safety segment, while sales for Integrated Supply declined.

Despite the limited sales growth experienced during the year, gross profit margins improved in 2003 to 36.2% from 35.7%, principally due to favorable changes in product mix and selected price increases designed to offset increased freight and other costs. Grainger's operating earnings of $387.3 million in 2003 decreased 1.5% from the prior year. Operating margins declined to 8.3% in 2003 from 8.5% in 2002 reflecting higher operating expenses year over year. The principal driver of the operating expense increase was higher severance and healthcare expenses.

Grainger's net earnings of $227.0 million in 2003 increased $15.4 million, or 7.3%, as compared with 2002 net earnings of $211.6 million. Diluted earnings per share for the year increased to $2.46 in 2003 from $2.24 in 2002. In 2002, Grainger recorded a $23.9 million after-tax charge for the cumulative effect of a change in accounting principle. The results for 2002 also included an after-tax gain of $1.2 million, or $0.01 per diluted share, from the reduction of restructuring reserves established for the shutdown of Material Logic.

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 21 to the Consolidated Financial Statements.

Branch-based Distribution

Net sales at the Branch-based Distribution businesses totaled $4,167.2 million in 2003 and were essentially flat when compared with 2002 sales of $4,148.0 million. Sales in the United States declined approximately 1% in 2003 as compared with 2002. Government account sales were up nearly 11% in 2003, while all other customer segments, including light and heavy manufacturing, were down when compared with 2002. The declines noted in the other customer segments were primarily due to the weakness in the U.S. economy, particularly in manufacturing. Within these customer segments, sales to national accounts increased approximately 2% over 2002.

Sales growth through Internet channels continued in 2003, 15.9% over 2002 and represented 12.6% of segment sales.

Sales in Canada increased 15.4% in 2003, principally due to a favorable exchange rate. In local currency, sales grew 2.7%, primarily in Ontario and national accounts. In Mexico, sales declined 3.7% in 2003 as compared with 2002, principally due to a weak economy in Mexico.

Cost of merchandise sold of $2,629.7 million for 2003 in the Branch-based Distribution businesses was essentially flat compared to $2,638.6 million in 2002. Gross profit margins increased 0.5 percentage point to 36.9% in 2003 from 36.4% in 2002. Selected price increases designed to offset increased freight and other costs both in the United States and Canada, combined with a favorable change in product mix, contributed to the margin increase.

Branch-based Distribution operating expenses increased 2.9% in 2003, primarily due to higher severance and healthcare expenses and increased occupancy costs.

Operating earnings of $390.2 million in 2003 declined by $4.7 million, or 1.2%, as compared with 2002. The increase in operating expenses year over year more than offset the improvement in gross profit margin.

Lab Safety

Net sales at Lab Safety increased by $18.7 million to $305.5 million in 2003, a 6.5% increase over 2002. The sales growth was attributable to incremental sales from Gempler's, acquired on April 14, 2003. Excluding the results of Gempler's, year-over-year net sales decreased 2.0% as a result of weakness in the manufacturing sector of the U.S. economy. A major portion of Lab Safety's sales are to manufacturers. The overall decline in the manufacturing sector was partially offset by increased sales to customers in the forestry and public safety markets.

The gross profit margin of 42.2% decreased 0.7 percentage point due to incremental sales of Gempler's products, which have lower gross margins than the rest of Lab Safety's products. In addition, in 2003 there was a shift in sales mix to lower margin new product sales.

Lab Safety operating expenses of $87.0 million increased 14.6% in 2003, when compared with $75.9 million for 2002. The primary driver of the year-over-year increase was the incremental costs associated with the addition of Gempler's during the year and higher spending on catalog media.

As a result, operating earnings of $41.9 million for Lab Safety in 2003 declined 11.1% from operating earnings of $47.1 million in 2002.

Integrated Supply

Integrated Supply net sales of $211.7 million in 2003 were $14.3 million lower than $226.0 million of net sales in 2002. The 6.3% decrease in net sales resulted from six site disengagements, as well as lower volumes from existing customers. The decrease in sales was partially offset by incremental sales at seven new customer sites. Sales included both product sales, which are passed through to the customer at cost, and management fees.

Gross profit declined $1.9 million in 2003 due to lower management fees. Operating expenses of $22.1 million increased 5.4% in 2003, when compared with $21.0 million for 2002. The increase of $1.1 million was principally due to a higher provision for bad debts, combined with incremental costs associated with a systems upgrade.

Operating earnings of $3.2 million in 2003 for Integrated Supply declined $3.0 million from operating earnings of $6.2 million in 2002.

Other Income and Expense

Other income and expense was $6.2 million of expense in 2003, an unfavorable change of $10.9 million as compared with $4.7 million of income in 2002. The following table summarizes the components of other income and expense:

	For the Years Ended December 31,	
	2003	2002
	(In thousands of dollars)	
Other income and (expense)		
Interest income (expense) – net	$(2,668)	$(1,590)
Equity in loss of unconsolidated entities – net	(2,288)	(3,025)
Write-off of investments in unconsolidated entities	(1,921)	—
Unclassified – net:		
Gains on sales of investment securities	1,208	7,308
Write-down of investment securities	(1,614)	(3,192)
Gains (losses) on sales of fixed assets – net	1,607	5,219
Other	(495)	(38)
	$(6,171)	$ 4,682

In the fourth quarter of 2003, Grainger wrote off its investment in two Asian joint ventures resulting in an after-tax charge to earnings of $1.9 million. See Note 9 to the Consolidated Financial Statements. The reduction in gains on sales of fixed assets resulted from the sale of one facility in 2003 versus two in 2002.

Income Taxes

Income taxes of $154.1 million in 2003 declined 5.1% as compared with $162.3 million in 2002.

Grainger's effective tax rates were 40.4% and 40.8% in 2003 and 2002, respectively. Excluding the effect of the equity losses in unconsolidated entities and the write-off of these investments, which did not result in tax benefits, the effective income tax rates were 40.0% for 2003 and 40.5% for 2002. This change in effective tax rate was primarily driven by lower nondeductible losses in Mexico and a lower tax rate in Canada.

Cumulative Effect of Accounting Change

Effective January 1, 2002, Grainger adopted Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets."

In the second quarter of 2002, Grainger completed the initial process of evaluating goodwill for impairment under SFAS No. 142. Fair values of reporting units were estimated using a present value method that discounted future cash flows. When available and as appropriate, comparative market multiples were used to corroborate results of the discounted cash flows. As a result of the application of the impairment methodology introduced by SFAS No. 142, Grainger recorded a noncash charge to earnings of $32.3 million ($23.9 million after-tax, or $0.26 per diluted share) related to the write-down of goodwill of its Canadian subsidiary, Acklands. Previous accounting rules required a comparison of book value to undiscounted cash flows, whereas the new rules require a comparison of book value to discounted cash flows, which are lower. See Note 3 to the Consolidated Financial Statements.

Financial Condition

Grainger expects its strong working capital position and cash flows from operations to continue, allowing it to fund its operations including growth initiatives and capital expenditures, as well as the payment of long-term debt, the repurchases of shares and the payment of cash dividends at or above historical levels.

Cash Flow

Net cash flows from operations of $406.5 million in 2004, $394.1 million in 2003 and $303.5 million in 2002 continued to improve Grainger's financial position and serve as the primary source of funding. Net cash provided by operations increased $12.4 million in 2004 over 2003 driven primarily by increased net earnings. The Change in operating assets and liabilities – net of business acquisition and joint venture contributions generated cash of $8.3 million in 2004. Trade accounts payable increased due to higher inventory purchases in the fourth quarter of 2004. Increases in profit sharing and bonus accruals, driven by an improved 2004 performance, resulted in an increase in other current liabilities. These changes were essentially offset by increases in inventory, as well as trade accounts receivable, which were up due to higher December sales. The increase in net cash flows from operations from 2002 to 2003 was primarily attributable to increased net earnings and an improvement in working capital management. A reduction in inventory, resulting from efficiencies realized from the redesigned logistics network, was partially offset by a decrease in trade accounts payable from lower inventory purchases during the fourth quarter of 2003.

Net cash flows used in investing activities were $142.4 million, $105.3 million and $105.8 million for 2004, 2003 and 2002, respectively. Capital expenditures for property, buildings, equipment and capitalized software were $160.8 million, $80.5 million and $144.0 million in 2004, 2003 and 2002, respectively. Additional information regarding capital spending is detailed in the ***Capital Expenditures*** section below. In 2003, Grainger also funded $36.7 million to purchase Gempler's, which is part of the Lab Safety segment. The results of operations for Gempler's have been included in the consolidated financial statements since the acquisition date of April 14, 2003.

Net cash flows used in financing activities for 2004, 2003 and 2002 were $240.6 million, $97.9 million and $158.1 million, respectively. During 2004, Grainger liquidated its cross-currency swap and related commercial paper debt with payments totaling $140.8 million. Grainger's funding of treasury stock purchases increased $59.7 million in 2004, as Grainger repurchased 2,001,000 shares in 2004, compared with 918,300 shares in 2003. Treasury stock purchases were 2,221,500 in 2002. As of December 31, 2004, approximately 7.1 million shares of common stock remained available under Grainger's repurchase authorization. Dividends paid to shareholders were $71.2 million in 2004, $67.3 million in 2003 and $66.5 million in 2002. Partially offsetting these cash outlays were proceeds from stock options exercised of $72.3 million, $15.2 million and $17.1 million for 2004, 2003 and 2002, respectively.

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 $1,092.3 million at December 31, 2004, compared with $926.8 million at December 31, 2003, and $898.7 million at December 31, 2002. At these dates, the ratio of current assets to current liabilities was 2.6, 2.3 and 2.5, respectively. The current ratio increased in 2004 principally due to Grainger's liquidation of the cross-currency swap and related commercial paper debt that had been classified in current liabilities in 2003.

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:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Land, buildings, structures and improvements	$ 41,929	$ 24,960	$ 61,083
Furniture, fixtures, machinery and equipment	86,347	49,104	72,895
Subtotal	128,276	74,064	133,978
Capitalized software	32,482	6,422	10,047
Total	$160,758	$ 80,486	$144,025

In 2004, Grainger's investments included the market expansion program, which is designed to re-align branches in several metropolitan markets, ongoing SAP initiatives, an upgrade of the branch communication systems and expenditures related to Canadian branch and systems projects. Capital expenditures in 2003 related to Grainger's investment in its logistics network, which was completed in March 2004, spending for information technology upgrades, as well as the normal, recurring replacement of equipment. Capital spending in 2002 reflects incremental spending for the logistics network project that began in 2000.

Capital expenditures are expected to range between $150 to $180 million in 2005 and include investments for the ongoing market expansion program, information technology and Canadian branch programs, as well as other general projects including the normal, recurring replacement of equipment. Grainger believes that cash flows from operations will remain strong and expects to fund the 2005 capital investments from existing working capital.

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 commercial paper sales and bank borrowings under lines of credit. At December 31, 2004, Grainger's long-term debt rating by Standard & Poor's was AA+. Grainger's available lines of credit, as further discussed in Note 12 to the Consolidated Financial Statements, were $250.0 million, $265.4 million and $264.7 million, as of December 31, 2004, 2003 and 2002, respectively. Total debt as a percent of total capitalization was 0.5%, 7.5% and 7.2% as of the same dates.

In September 2002, Grainger received net proceeds of $113.7 million from the issuance of commercial paper. The proceeds were used to repay outstanding long-term debt in the amount of C$180.4 million. The long-term debt that was repaid with the proceeds of the commercial paper issuance had been designated by Grainger as a nonderivative hedge of Grainger's net investment in its Canadian subsidiary. Grainger entered into a two-year cross-currency swap on September 25, 2002, which replaced the Canadian dollar long-term debt as a hedge of the net investment in Grainger's Canadian subsidiary. The counterparty to the financial instrument was an investment grade financial institution. Grainger did not incur any loss from nonperformance by this counterparty. Since Grainger had the ability to refinance the commercial paper with debt having a longer maturity, and its intent was to keep the debt outstanding for the two-year period of the cross-currency swap, the commercial paper was originally classified as long-term debt. At December 31, 2003, Grainger had not determined if it would renew the cross-currency swap when it came due in 2004 and as a result the commercial paper debt was classified as Current maturities of long-term debt. On September 27, 2004, the cross-currency swap and related commercial paper debt matured and were liquidated with payments totaling $140.8 million. See Note 14 to the Consolidated Financial Statements.

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 condition. Holders of industrial revenue bonds have various rights to require Grainger to redeem these bonds, thus they are classified as Current maturities of long-term debt.

Commitments and Other Contractual Obligations

At December 31, 2004, Grainger's contractual obligations, including estimated payments due by period, are as follows:

	Payments Due by Period				
	Total Amounts Committed	Less than 1 Year	1 – 3 Years	4 – 5 Years	More than 5 Years
	(In thousands of dollars)				
Long-term debt obligations	$ 9,485	$ 9,485	$ —	$ —	$ —
Capital lease obligations	—	—	—	—	—
Operating lease obligations	85,870	22,728	31,190	19,487	12,465
Purchase obligations:					
Uncompleted additions to property, buildings and equipment	48,224	41,954	6,270	—	—
Commitments to purchase inventory	186,391	186,391	—	—	—
Other purchase obligations	115,656	67,799	46,123	1,734	—
Other long-term liabilities reflected on the balance sheet	—	—	—	—	—
Total	$ 445,626	$328,357	$83,583	$21,221	$ 12,465

Purchase obligations consist primarily of inventory purchases 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.

The Commitments and Other Contractual Obligations table does not include $74.7 million of accrued employment-related benefits costs, of which $45.8 million is related to Grainger's postretirement benefits. These amounts are excluded because a portion of the projected benefit payments has already been funded by Grainger and the timing of future funding requirements is not known. See Note 13 to the Consolidated Financial Statements.

See also Notes 14 and 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 nonexchange-traded contracts accounted for at fair value.

Critical Accounting Policies and Estimates

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

Accounting policies are considered critical when they require management to make assumptions about matters that are highly uncertain at the time the estimate is made and when different estimates than those management reasonably could have made have a material impact on the presentation of Grainger's financial condition, changes in financial condition or results of operations.

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.

Postretirement Healthcare Benefits. Postretirement obligation and net periodic cost 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 in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." A lower discount rate increases the present value of benefit obligations and net periodic postretirement benefit costs. As of December 31, 2004, Grainger reduced the discount rate used in the calculation of its postretirement plan obligation from 6.00% to 5.75% to reflect the decline in interest rates. Grainger estimates that the reduction in the expected discount rate will decrease 2005 pretax earnings by approximately $0.6 million.

Grainger considers the long-term historical actual return on plan assets and the historical performance of the Standard & Poor's 500 Index to develop its expected long-term return on plan assets. In 2004, 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.

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.

While 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 and new trends and therefore, may affect Grainger's retirement plan obligations and future expense.

For additional information concerning postretirement healthcare benefits, see Note 13 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 deductibles and self-insured retentions. There are also certain other risk areas for which Grainger does not maintain insurance.

Grainger is responsible for establishing 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 level.

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.

Allowance for Doubtful Accounts. Grainger uses several factors to estimate the allowance for uncollectible accounts receivable including the age of the receivable and the historical ratio of actual write-offs to the age of the receivable. 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.

Income Taxes. Grainger accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, deferred tax assets and liabilities are determined based on the differences between the financial statement 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 tax authorities' rulings 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 relating to 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.

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 continues for these long-lived assets. The related depreciation expense associated with these assets increases 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, increasing working capital turnover and offering products and services which can command appropriate prices in the marketplace.

Forward-Looking Statements

This document contains forward-looking statements under the federal securities laws. The forward-looking statements relate to Grainger's expected future financial results and business plans, strategies and objectives and are not historical facts. They are often identified by qualifiers such as "will," "expects," "intends," "is likely," "anticipated," "scheduled," "believes," "positioned to," "continue," "estimates," "forecast," "predicting," "projection," "potential," "assumption" or similar expressions. There are risks and uncertainties the outcome of which could cause Grainger's results to differ materially from what is projected.

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

Trends and projections could also be affected by general industry and market conditions, gross domestic product growth rates, general economic conditions including interest rate and currency rate fluctuations, global and other conflicts, employment levels and other factors.

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. During a portion of 2004 and all of 2003, Grainger partially hedged its net Canadian dollar investment in Acklands with a cross-currency swap agreement. This agreement was terminated in 2004. See Note 14 to the Consolidated Financial Statements. For 2004, 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 $0.9 million decrease in net income. Comparatively, in 2003 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 $0.4 million decrease in net income. A uniform 10% weakening of the U.S. dollar would have resulted in a $1.1 million increase in net income for 2004, as compared with an increase in net income of $0.3 million for 2003. 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. Grainger does not hold derivatives for trading purposes.

Grainger is also exposed to interest rate risk in its debt portfolio. During 2004 and 2003, all of its long-term debt was variable rate debt. A one-percentage-point increase in interest rates paid by Grainger would have resulted in a decrease to income of approximately $0.7 million for 2004 and $0.9 million for 2003. A corresponding increase in net income for the noted periods would have resulted had the interest rates paid decreased by one percentage point. This sensitivity analysis of the effects of changes in interest rates on long-term debt does not factor in potential changes in exchange rates or long-term debt levels. Grainger's level of interest rate risk has been reduced due to the liquidation of the cross-currency swap and related commercial paper debt during 2004. See Note 14 to the Consolidated Financial Statements.

Grainger is not exposed to commodity price risk since it purchases its goods for resale and does not purchase commodities directly.

Item 8: Financial Statements and Supplementary Data

The financial statements and supplementary data are included on pages 25 to 58. See the Index to Financial Statements and Supplementary Data on page 24.

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

The management of W.W. Grainger, Inc. (Grainger) is responsible for establishing and maintaining adequate internal control over financial reporting. Grainger's internal control system was designed to provide reasonable assurance to Grainger's management and Board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements under all potential conditions. Therefore, effective internal control over financial reporting provides only reasonable, and not absolute, assurance with respect to the preparation and presentation of financial statements.

Grainger's management assessed the effectiveness of Grainger's internal control over financial reporting as of December 31, 2004, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control – Integrated Framework*. Based on its assessment under that framework and the criteria established therein, Grainger's management concluded that Grainger's internal control over financial reporting was effective as of December 31, 2004.

Grant Thornton LLP, an independent registered public accounting firm, has audited management's assessment of the effectiveness of Grainger's internal control over financial reporting as of December 31, 2004, as stated in their report which is included herein.

(b) Attestation Report of the Registered Public Accounting Firm

The report from Grant Thornton LLP on its audit of management's assessment of the effectiveness of Grainger's internal control over financial reporting as of December 31, 2004, is included on page 25.

(c) Changes in Internal Control Over Financial Reporting

There were no changes in Grainger's internal control over financial reporting that occurred during the period covered by this report 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 and Executive Officers of the Registrant

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 27, 2005, 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 chief executive officer, chief financial officer and chief accounting officer. This code of ethics is incorporated into Grainger's business conduct guidelines for directors, officers and employees. A copy of the business conduct guidelines is available at www.grainger.com/investor and is also available in print without charge to any person upon request to Grainger's Corporate Secretary. Similarly available is a copy of the Operating Principles for the Board of Directors, Grainger's corporate governance guidelines. Grainger intends to satisfy the annual disclosure requirement under Item 5.05 of Form 8-K relating to its code of ethics by posting such information on its Web site.

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 27, 2005, under the captions "Director Compensation" and "Executive Compensation."

Item 12: Security Ownership of Certain Beneficial Owners and Management

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 27, 2005, under the captions "Ownership of Grainger Stock" and "Equity Compensation Plans."

Item 13: Certain Relationships and Related Transactions

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 27, 2005, under the caption "Director Compensation."

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 27, 2005, 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, incorporated by reference to Exhibit 3(ii) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(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., 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:

Compensatory Plans or Arrangements

(i) Director Stock Plan, as amended, incorporated by reference to Exhibit 10(d)(i) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1998.

(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 March 31, 2004.

(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 March 31, 2004.

(v) Executive Death Benefit Plan, as amended, incorporated by reference to Exhibit 10(b)(v) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2001.

(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) Form of Change in Control Employment Agreement between Grainger and certain of its executive officers, incorporated by reference to Exhibit 10(c) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1999.

(x) Voluntary Salary and Incentive Deferral Plan, incorporated by reference to Exhibit 10(x) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2003.

(xi) Summary Description of 2005 Management Incentive Program.

(xii) Separation Agreement and General Release dated March 31, 2004, by and among Grainger, John W. Slayton, Jr. (who previously served as Senior Vice President, Supply Chain Management of Grainger) and Elizabeth Slayton, incorporated by reference to Exhibit 10(c) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(xiii) Separation Agreement and General Release dated May 5, 2004, by and among Grainger, Wesley M. Clark (who previously served as President and Chief Operating Officer of Grainger) and Deborah Clark, incorporated by reference to Exhibit 10(d) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(xiv) Separation Agreement and General Release dated November 30, 2004, by and between Grainger and James A. Garman (who previously served as Senior Vice President, Human Resources of Grainger).

(xv) Summary Description of Directors Compensation Program effective January 1, 2005.

(11) Computations of Earnings Per Share.

(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 25, 2005

W.W. GRAINGER, INC.

By: Richard L. Keyser

Richard L. Keyser
Chairman of the Board
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 25, 2005, in the capacities indicated.

Richard L. Keyser

Richard L. Keyser
Chairman of the Board
and Chief Executive Officer
(Principal Executive Officer and Director)

John W. McCarter, Jr.

John W. McCarter, Jr.
Director

P. Ogden Loux

P. Ogden Loux
Senior Vice President, Finance
and Chief Financial Officer
(Principal Financial Officer)

Neil S. Novich

Neil S. Novich
Director

Judith E. Andringa

Judith E. Andringa
Vice President and Controller
(Principal Accounting Officer)

Gary L. Rogers

Gary L. Rogers
Director

Brian P. Anderson

Brian P. Anderson
Director

James D. Slavik

James D. Slavik
Director

Wilbur H. Gantz

Wilbur H. Gantz
Director

Harold B. Smith

Harold B. Smith
Director

David W. Grainger

David W. Grainger
Director