

Profitability

Long-Term Financial Goal
Operating Margins of 10 to 12%

Operating Margin



Gross Profit Margin



In 2007, Grainger is targeting an operating margin of 10 to 10.5 percent. This compares to an operating margin of 9.8 percent in 2006. The company looks to improve its profitability by:

- Accelerating sales growth (see Growth on pages 4–11)
- Expanding gross profit margins
- Improving its cost structure

Gross Profit Margin Expansion

Grainger has a powerful combination of programs that are driving gross profit margin improvement. Between 2002 and 2006, Grainger’s gross profit margins increased from 35.7 percent to 40.0 percent. At the core of this initiative are efforts to successfully manage product cost. Grainger is leveraging its industry-leading size and scale through the following initiatives:

Product Line Reviews: Grainger conducts thorough reviews of approximately one-third of its product lines every year, comparing existing suppliers against prospective ones. For these reviews, Grainger has developed a sophisticated supplier evaluation scorecard to measure, evaluate and manage supplier performance. The scorecard is a Web-based tool that can be accessed by suppliers online, 24 hours a day, seven days a week.

Private Label: Grainger first established its private label program more than 50 years ago, to enable the company to compete in a bygone era of exclusive manufacturer/distributor agreements. Since that time, private labels such as Dayton®, Speedaire® and Air Handler® have grown into established and accepted brands in the facilities maintenance industry. Customers have as much confidence and comfort with a Grainger private label product as they do with many national brands. Best of all, gross profit margins on private label products are better than the company average.



For 2006, sales of private label products represented 22 percent of total sales for the core business in the United States. By increasing the mix of private label sales – especially globally sourced sales – Grainger expects to further expand its margins and enhance profitability.

Global Sourcing: Established in 1997, Grainger’s global sourcing operation procures a broad spectrum of high-quality, low-cost products from around the world. Global sourcing represents a very attractive path to improved profitability and is a capability that most of Grainger’s competitors do not possess. These products are imported to North America and sold under private label by the company’s other business units. Brands include Condor™ safety equipment, LumaPro® lighting products and Westward® hand and power tools.

With procurement offices in Hong Kong and Shanghai, Grainger’s Asian global sourcing operation is experiencing explosive growth. Product is sourced from 26 countries around the globe. These products carry gross margins that are approximately 50 percent higher than the company average. While globally sourced products represented approximately 7 percent of sales in 2006, Grainger plans to double these sales over the next three to five years, as Canada and Mexico, as well as the United States, increase the proportion of globally sourced product sales. To help drive this growth, the company plans to open a new procurement office in India in 2007.



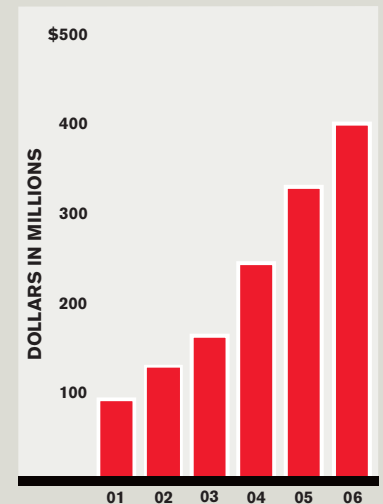
Grainger’s global sourcing operation procures a broad spectrum of high-quality, low-cost products from around the world.

Global Sourcing



KEY
 ● Origin of Globally Sourced Products

Globally Sourced Products Sales

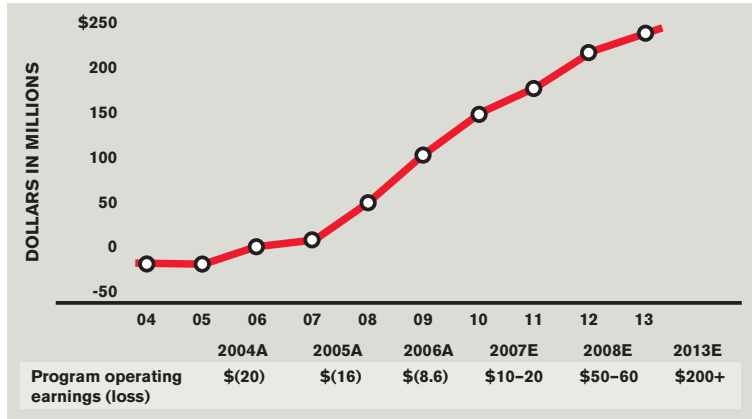


Profitability

Cost Structure Improvements

The maturation of several important growth programs is also contributing to a more efficient cost structure and improved profitability at Grainger.

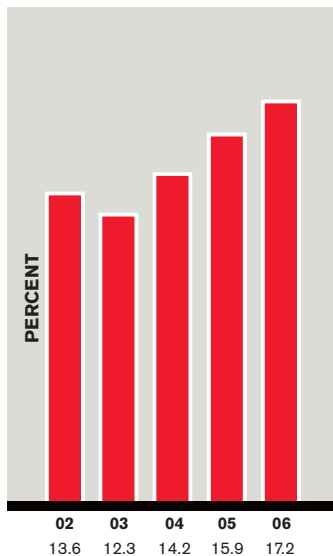
Market Expansion – Earnings



Market Expansion: The Market Expansion Program, as described on pages 6 and 7, is contributing incremental sales growth to the company. The year 2007 represents an important turning point in the profitability of this program. Due to the aggressive investments made since 2004, Market Expansion has generated an operating loss for the past three years. The company is forecasting that this program will contribute \$10 million to \$20 million in operating earnings in 2007, representing an \$18.6 million to \$28.6 million incremental benefit from the operating loss of \$8.6 million reported in 2006.

Product Line Expansion: The Product Line Expansion Program, as described on page 7, contributed \$98 million to sales and delivered incremental operating earnings in 2006. Based on sales growth projections for 2007, the company is forecasting an even larger operating earnings contribution in 2007.

Return on Average Total Capitalization



Electronic Ordering: Orders received through the Internet and other electronic channels deliver both incremental sales and earnings growth. By virtually every measure, Grainger customers who buy through the Web buy more and purchase more frequently. In addition, electronic channels are more profitable than traditional ones because customers perform the data entry work. What’s more, nearly 90 percent of online orders are shipped – the company’s most cost-effective delivery method.

Customers’ behavior regarding this channel reflects the benefit of grainger.com’s round-the-clock self-service with real-time product availability, customer-specific pricing, multiple product search capability, customer personalization and links to customer support and fulfillment.

Sales through Grainger’s electronic channels grew by 16 percent in 2006 and represented approximately 16 percent of total sales.

Efficient Logistics Network

In 2004, Grainger completed a comprehensive overhaul of its U.S. logistics network, providing the company with a sustainable competitive advantage. The project involved:

- Adding five new distribution centers (DCs) and retrofitting four others
- Introducing automation into each DC
- Adding one million square feet of warehousing space
- Centralizing customer shipping at the DCs
- Providing daily replenishment to the branches

This new logistics platform is enabling Grainger to enhance profitability by spurring continuous improvement in several key areas.

Product Availability: Grainger's ability to serve customers is linked directly to the availability of product. The company measures its success rate in fulfilling orders with success defined as having 100 percent of the products a customer requests in the correct quantities and available when and where the customer needs them.

Grainger's logistics platform has enabled the company to measurably improve product availability. With items available for customer pickup at 428 branches, backed by same-day shipping from its network of distribution centers, Grainger is able to meet this service threshold approximately 95 percent of the time in the United States and Puerto Rico.

Inventory Turns: In 2006, Grainger added approximately \$40 million in inventory as part of product line expansion, yet inventory turns essentially remained the same as in 2005 because of better working capital efficiency. The inventory in place prior to the expansion turned faster than in 2005 to accommodate the expanded product line and hold inventory turns to 4.4.

Here are some examples of how Grainger effectively manages its inventory within the logistics network:

- **Inventory Management:** Over the past several years, Grainger has increased its inventory management capabilities. Opportunities for continuous improvement in this area include:
 - Reducing supplier lead time and variability
 - Improving its inventory forecast accuracy
 - Reducing safety stock by aggregating demand
 - Increasing service levels on products most often ordered by customers
- **Reverse Logistics:** In addition to providing customer shipping for Grainger's U.S. business, the DCs also conduct daily branch replenishment. The trucks that transport new products to the branches also return inventory from the branches to the DC. This inventory is held at the DC or redeployed to an area with higher demand for those products.
- **Improved Productivity:** As a result of additional capacity and automation at the DCs, most customer shipping is now concentrated at these facilities. Prior to this conversion, all customer shipping orders were filled in the branches. Shipping orders represent nearly 70 percent of Grainger's sales dollars, so the ability to ship orders from the DCs is driving improved productivity for the company and better profitability for its shareholders.



Profitability Improvements in Canada

The new leadership team at Acklands – Grainger Inc. is taking aggressive steps to improve profitability. This business intends to leverage many of the best practices developed in the United States to improve efficiency and expand operating margins. The company is looking to this business to move its operating margin from 2.7 percent in 2006 to a range of 4.5 to 5.5 percent in 2007.

Supplier Relationships

Grainger has strong relationships with its 1,400 North American suppliers and the 200 international suppliers that fuel its global sourcing operation. Grainger collaborates with each supplier to improve product availability and lower overall costs. In 2007, Grainger recognized those suppliers whose efforts to meet these goals have benefited customers:

Partners In Performance Award Winners

Champion, Garner Denver Co.
 Custom Leathercraft
 Dalloz Fall Protection/Miller
 Dalloz Safety
 Enerpac
 E.R. Wagner Manufacturing Co.
 Federal Signal Corp.
 Howard Leight
 IMI Norgren Actuator
 Ingersoll Rand/Security Technology
 Justrite Manufacturing Company, LLC
 Klein Tools, Inc.
 The M.K. Morse Co.
 Motorola Incorporated
 North Safety Equipment
 Spectrum Brands/RAYOVAC Corporation
 Tripp Lite
 Uvex Safety Inc.
 Weiler Corp.
 Wells Lamont Industrial

Supplier of the Year

Custom Leathercraft

Best Small Supplier

Royal Basket Trucks

Best New Supplier

W.C. Wood Co. Inc.

Best Large Supplier

Milwaukee Electric

Most Innovative Supplier

Greenheck

Most Improved Supplier

Fluke Corporation