

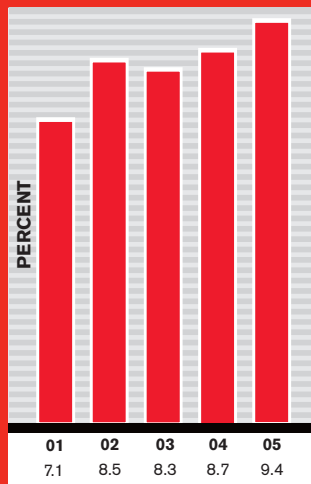
PROFITABILITY

Long-term financial goals:

**Operating Margins
10 to 12%**

Five-year results:

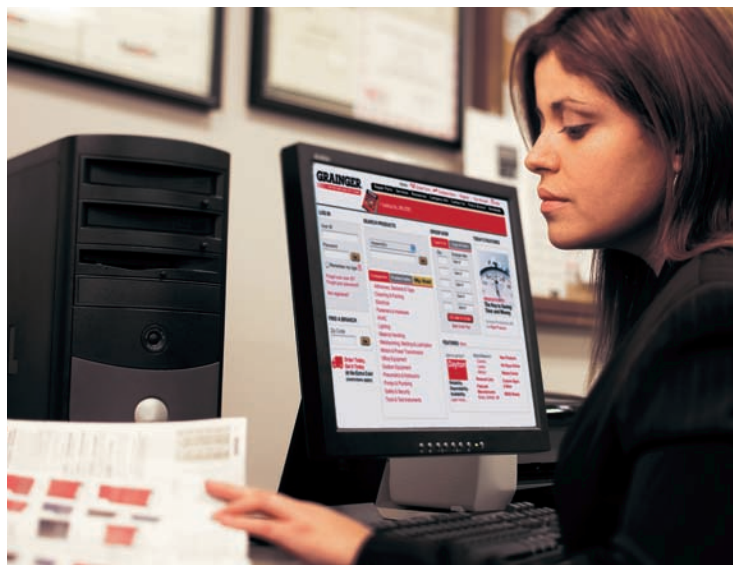
Operating Margins



In 2005, Grainger raised its long-term operating margin growth goal to 10 to 12 percent. Grainger is targeting an operating margin around 10 percent for 2006. The company looks to improve its operating margin by implementing efficient systems and processes that drive down costs. To do that, Grainger plans to:

- Increase the use of electronic ordering
- Improve productivity in its supply chain
- Source products globally and improve costs with all suppliers
- Gain the benefits of its integrated information systems

Grainger seeks ways to deliver higher levels of service more profitably. Grainger's operating margin expansion demonstrates improvements in the company's operations and marketing strategy. For 2006, Grainger expects continued performance driven by its efforts to enhance its ERP system and continue other gross margin improvement programs, including increased global sourcing and the impact of exiting lower-margin integrated supply contracts.



Grainger's Web site is a profitable channel because the customer is inputting the orders and nearly 90 percent are shipped, the company's most cost-effective delivery method. The Web site offers 24/7 self-service with real-time product availability, customer-specific pricing, multiple product search capability, customer personalization and links to customer support and fulfillment.

Ordering options

Maintaining a facility is a 24/7 job. Grainger installed a phone system in 2004 that enables the company to handle after-hours requests for products that can be shipped the next business day. Use of the system added \$60 million to sales in 2005. With a comprehensive menu of e-Commerce solutions, Grainger facilitates customer Internet ordering.

Grainger began offering customers the option of ordering online in 1996. Today, its state-of-the-art capabilities continue to lead the industry, providing customers fast and easy access to facilities maintenance products through:

- grainger.com and other Web sites in Mexico, Canada and Lab Safety Supply (LSS)
- Electronic data interchange (EDI)
- Electronic marketplaces
- Direct connections to customers' Enterprise Resource Planning (ERP) systems
- CD-ROM

Sales through Grainger's Internet channels grew by roughly 20 percent and represented approximately 15 percent of total sales in 2005. On average, operating margins through electronic channels are higher than phone or branch orders. Customers who buy from Grainger online have shown incremental sales growth across the other channels, branch and telephone, as well.

Efficient supply chain

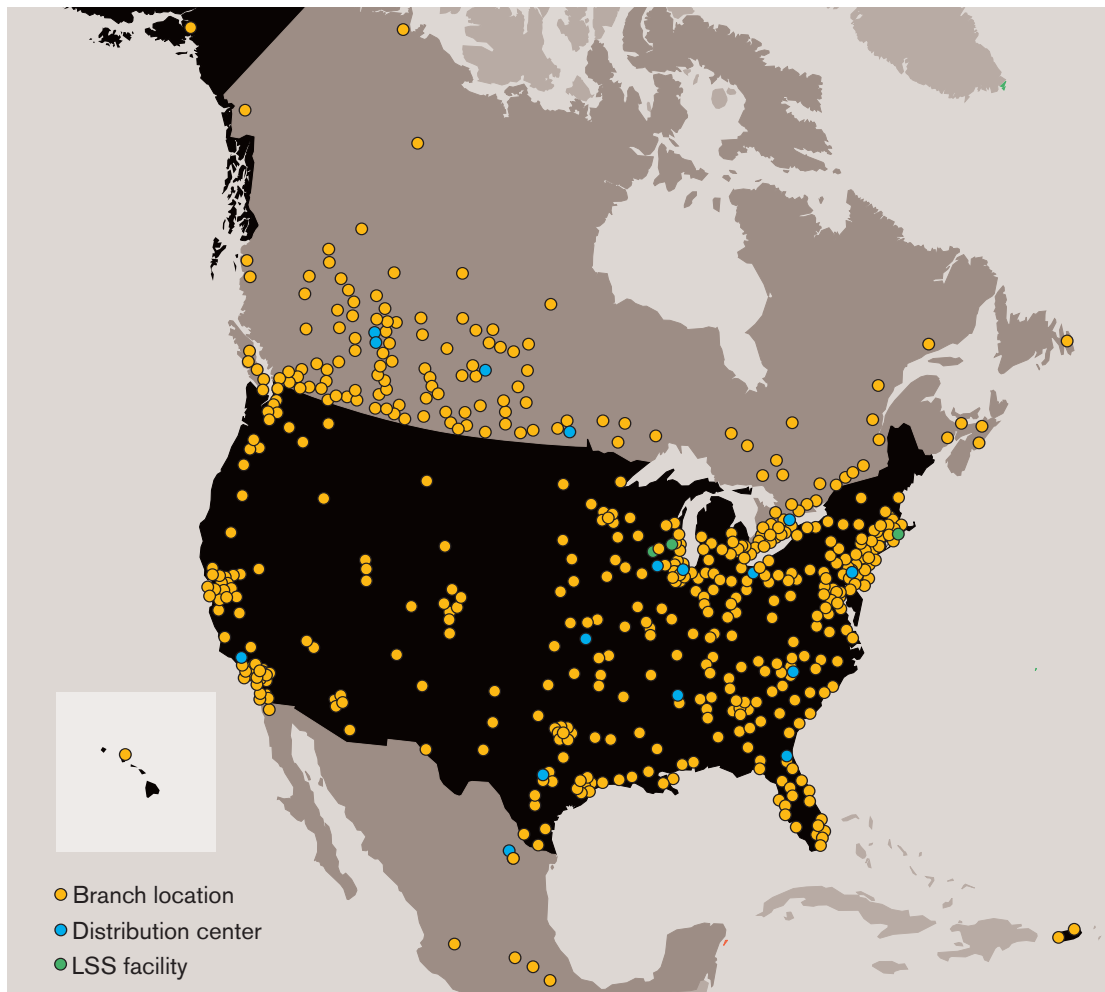
Grainger uniquely provides value to customers by being their one-stop solution for their unplanned purchases. Customers have told Grainger that they want a broad product offering in close proximity and quick, reliable service. In North America, Grainger has developed a supply chain that efficiently delivers the products that customers need.

Customers in the United States access one of some 400 branches to buy more frequently needed products, knowing that Grainger's distribution centers can supply the rest the next day, shipped either to the customers' facilities or to a branch. Customers experience exceptional service levels for all products, even those they may need only once or twice a year. Grainger's size, scale and locations allow it to aggregate demand across the entire network, fulfilling random demand better than its smaller competitors.

Five distribution centers in Canada ship products to customers and replenish branches. Customers and branches in Mexico are served by a distribution center in Monterrey. Customers and branches located near the Mexico/U.S. border are served by the U.S. logistics network.

In 2004, Grainger completed a reconfiguration of its U.S. logistics network to increase capacity, improve product availability and enhance productivity. Nearly 99 percent of customers can receive orders shipped from Grainger's distribution centers or selected branches next day, an achievement no other national industrial distributor can match. In markets where sales volume does not yet warrant a distribution center, Grainger has master branches that ship to customers as well as provide counter and will-call sales.

Grainger's overall productivity in its distribution centers has improved. The network redesign from 2001 to 2004 reduced overall inventory by \$115 million; in 2005 the network contributed approximately \$20 million to operating earnings.



The Distribution Flow



1. Inventory enters Grainger when suppliers ship product in bulk. The company has worked with suppliers to improve purchase order communication to avoid costly one-off shipments.



2. Inventory leaves one of Grainger's distribution centers when it ships product directly to customers – about half of all customer orders are shipped. Grainger has contracts with dedicated national shippers to reduce costs.



3. Inventory also leaves Grainger's distribution centers to replenish branches each day. This reduces the inventory depth that branches must stock, leaving space for a broad line of products.



4. Inventory leaves branches when customers pick up orders at the will-call counter or make spot purchases – about half of all branch sales are will-call orders, while the other half are spot purchases. Growing spot purchase sales requires having the right products in the branch, which the logistics network ensures each and every day.

Supplier relationships

Grainger works with approximately 1,200 suppliers to provide customers with the products they need and the brands they want.

Grainger negotiates with suppliers to help reduce total product cost. In 2004, Grainger reduced product costs by 150 basis points over 2003. This was achieved through an aggressive line review process, an increase in the global sourcing and private label product sales, and continued work with suppliers to reduce costs in the supply chain. In 2005, Grainger was able to offset its product cost inflation with an average 2 percent increase in product prices.

Information is critical to supplier relationships. Through its supplier management process, Grainger has a continuous flow of accurate and timely performance information to monitor the supply chain, helping to maximize efficiency.

Over the past year, Grainger and its suppliers have reduced product cycle time from supplier to available for sale by nearly 5 percent. This enables Grainger to drive higher levels of product availability without increasing its inventory investment.

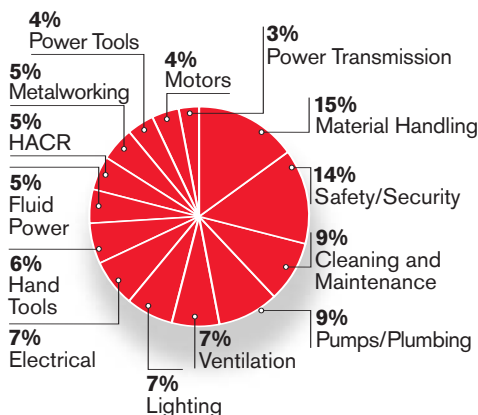


Grainger customers use different types of facilities maintenance products every day. One project can require products from several categories to get the job done. Grainger works with approximately 1,200 suppliers to provide the broad range of products customers need.

Grainger has strong relationships with its suppliers. With its 1,200 key suppliers across North America, Grainger works to lower overall costs and improve availability. In 2006, Grainger recognized top suppliers whose efforts to meet these goals have benefited customers:

- 3M Mexico S.A. de C.V.**
- Advance Transformer Company**
- Aero Technology**
- Akro-Mils, Inc.**
- Albion Industries, Inc.**
- Arrow Pneumatics, Inc.**
- Bradley Corporation**
- Brady Corporation**
- E.R. Wagner Manufacturing Company**
- Elkay Sales, Inc.**
- Enerpac**
- Grane Transportation Lines, Ltd.**
- Halsey Taylor**
- ITW Red Head**
- Justrite Manufacturing Company LLC**
- Lift-All**
- Loctite Industrial Group**
- Mi-T-M Corporation**
- Motorola**
- Norgren, Inc.**
- Nupla Corporation**
- Reelcraft Industries, Inc.**
- Schneider Electric**
- Spectrum Brands, Inc.**
- The M. K. Morse Company**
- Weiler Corporation**
- Wells Lamont Industry Group**
- Wiremold Legrand**

United States – 2005 Sales by Product Line

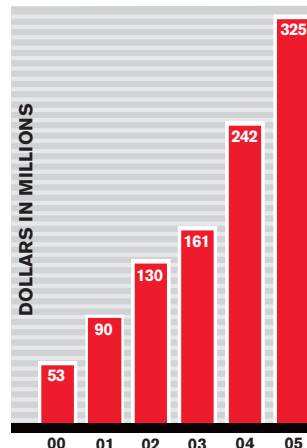


Global sourcing

Grainger sources 5 percent of its products directly from outside the United States, mostly from Asia. These products are sold under private label brands that cover a broad spectrum of categories, including tools, material handling, motors and safety equipment.

With procurement offices in the United States, Hong Kong and Shanghai, Grainger selects suppliers that meet stringent quality requirements. These products represented \$325 million in sales in 2005 and are projected to grow in 2006 by approximately 30 percent. Because the company manages the sourcing process and sells them under various private label brands, these quality products carry attractive gross profit margins.

Globally Sourced Products Sales



Integrated systems

Grainger's information systems need to handle hundreds of thousands of products, 1.7 million customers, hundreds of physical locations, and 115,000+ transactions per day in a way that makes \$185 orders profitable. That's why in January 2006, Grainger implemented an integrated end-to-end system for its U.S. branch-based business. The Enterprise Resource Planning (ERP) system should make the company more efficient.

With this implementation, Grainger is upgrading the technology throughout its U.S. branches and moving business support functions, such as finance, marketing and human resources, onto an integrated platform. Grainger expects the new SAP system to provide the tools needed to be more efficient at saving customers time and money and plans to roll out the system to other areas, including its operations in Mexico and Canada.

Benefits of the new system include:

- Having the ability to more efficiently track order histories and customer preferences.
- Updating company information in real time. This means customers will be able to get answers on product specifications and inventory availability more quickly. Returned products will be available for sale immediately. Customer orders and billing records will be updated quickly.
- Providing better visibility to the different ways its customers interact with the company, improving its sales coverage and marketing efforts.
- Decommissioning antiquated legacy systems, saving about \$15 million annually.

Grainger expects to see \$50 to \$60 million in benefits from this project, including the \$15 million from decommissioning, by the end of 2007.



Grainger's distribution centers use automated equipment and processes to ship orders, including Internet orders, directly to customers for all branches located in their service areas.

Exiting less profitable business

In 2005, Grainger discontinued its fee-for-service integrated supply business, which had been a separate segment for reporting purposes. The business was folded into Grainger's U.S. business, offering customers a range of outsourcing alternatives that leverage Grainger's branch, service and sourcing capabilities.

Throughout 2005, Grainger disengaged from lower-margin integrated supply contracts representing approximately one third of the \$211 million in integrated supply sales reported in 2004. Grainger will continue to exit these contracts over the next few years. Grainger anticipates these disengagements to continue to benefit gross profit margins.