W.W. Grainger, Inc. (GWW) CEO Donald Macpherson on Q3 2019 - Earnings Call Transcript

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Q3: 10-23-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $4.26 misses by $-0.14 | Revenue of $2.95B (4.08% Y/Y) beats by $2.01M

Earning Call Audio

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W.W. Grainger, Inc. (NYSE:GWW) Q3 2019 Earnings Conference Call October 23, 2019 11:00 AM ET

Corporate Participants

Irene Holman - VP of Investor Relations

Donald Macpherson - Chairman and Chief Executive Officer

Thomas Okray - Chief Financial Officer

Conference Call Participants

David Manthey - Baird

Ryan Merkel - Williams Blair

Christopher Glynn - Oppenheimer

Deane Dray - RBC Capital Markets

Robert Barry - Buckingham Research

Josh Pokrzwinksi - Morgan Stanley

Karen Lau - Gordon Haskett

Adam Uhlman - Cleveland Research Company

Chris Dankert - Longbow Research

Justin Bergner - G. Research

Nigel Coe - Wolfe Research

Patrick Baughman - JPMorgan

Michael McGinn - Wells Fargo

Operator

Greetings and welcome to the W.W. Grainger Third Quarter 2019 Earnings Conference Call. At this time all participants are in a listen-only mode. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Irene Holman, Vice President, Investor Relations. Please go ahead.

Irene Holman

Good morning. Welcome to Grainger's Q3 earnings call. With me are D.G. Macpherson, Chairman and CEO; and Tom Okray, CFO.

As a reminder, some of our comments may be forward-looking based on our current view of future events. Actual results may differ materially as a result of various risks and uncertainties, including those detailed in our SEC filings. Reconciliations of any non-GAAP financial measures mentioned on today's call with their corresponding GAAP measures are at the end of this slide presentation and in our Q3 press release, both of which are available on the IR Web site.

This morning's call will focus on adjusted results and now I will turn it over to DG.

Donald Macpherson

Thanks Irene. Good morning. Thank you for joining us today.

I'm going to discuss our Q3 results and ensure an update on the U.S. and MS assortment growth initiatives that we introduced earlier this year. Then, Tom will provide details on the quarter and will open it up for questions.

We have solid result so far this year as we managed through the uncertainty of the current environment. Despite soften global demand, we have accelerated our sequential share gain in the U.S. business and continued to invest for growth in our MS assortment business Zoro.

We have also been diligent in partnering with our suppliers to manage cost and difference expense leverage across our U.S. and Canadian businesses. Year-to-date total company operating margin is up 30 basis points and we driven incremental margins of 26%. We have also maintained the guidance that we set on the Q4 call on January for total company total gross profit margin, operating margin and earnings per share. I want to commend our team members for all the work they done to strive during this environment.

From our recent U.S. customer visit, clear that demand has slowed but it's also through the things are not falling off the cliff. And we have great opportunities to continue to gain share. Earlier this month, I spend time with the large manufacturer in the Southeast. They have seen strong growth due to their ability to innovate.

Our team members have built solid relationships with their leadership and operation staff and are delivering solution that matter. This customer view Grainger has providing exceptional service as part of their operation.

We have leveraged our key stock inventory management system to make easy for this customer to have what they need when they needed. We will have a portion of this customer spend today because of our reliable partnership and our ability to deliver real value; we are exploring ways to expand our offer. This means finding ways for this customer to save more money by ensuring that they are using the right products at the right cost and managing usage and inventory effectively. When we do these things well we gain share. I rarely visit a customer with the opportunity to create value and gain share is not significant. And we do this across our business through two models.

Through out high tech solutions model, we provide relevant products and services to customers to drive efficiencies and to save their money. Through our endless assortment model, we provide value through an expansive assortment that is easily accessed to streamline search experience.

In these challenging times, we continue to focus on what matters. We are investing for growth in both business models. Our strong balance sheet allows us to invest in good times and bad. And we are rigorous in our expense management. We have already achieved roughly $200 million in savings in the last two years and have expectations for continued productivity moving forward.

With that, let's take a closer look at our performance in the U.S. in Q3. Similar to what we are seeing from economic indicators, we estimate that U.S. market growth accelerated from approximately 2% to 2.5% Q1 and approximately 1% in Q2 to about flat in Q3.

We are seeing softness across most end markets including heavy manufacturing, natural resources, contractors and in pockets like manufacturing. We have seen some of our customers particular with heavy manufacturing and natural resources slow production. Healthcare market remains quite strong and we are seeing flat to modest growth in government and retail end markets.

U.S. segment share gain accelerated sequentially in the third quarter by 250 basis points of out growth versus the market. U.S. large business grew 2% and 10% on a two year stack and U.S. midsize grew 5% and 23% on a two year stack.

Let me spend a few minutes providing an update on our U.S. growth initiatives which we introduced in May of this year. As previously communicated, these initiatives fall under two buckets. First, our improvements to our foundation that ensure that we stay competitive, this includes improving the quality of our product and customer data, embedding our keep stock offer and enhancing the customer experience.

Second bucket of initiatives are incremental investments that contribute to our long-term goal of 300 to 400 basis points of growth above market. Our initiatives are beginning to take hold as evidenced by 250 basis points of share gain in the quarter.

Our merchandising efforts are showing strong incremental revenue lift driven by our comprehensive category review process. About $0.5 billion of product revenue has been remerchandised and we're seeing good results. We expect to get through about $1 billion for our assortment by year end.

We made incremental marketing investments in the third quarter and our return on these investments has steadily improved throughout the year, which has exceeded our expectations. We have made solid progress in improving the customer experience and have increased the effectiveness of our order to cash process since the beginning of this year. Our customer feedback suggests that we provide the best experience in our space. We have re-energized our corporate account work and have seen improvements in share gain with this group of customers.

Finally, we are on track to start receiving inbound shipments to our Louisville DC in the fourth quarter. We are encouraged by our ability to accelerate sequential share gain in the U.S. and we remain fully committed to 300 to 400 basis points of outgrowth versus the market on an ongoing basis.

I also want to spend a few minutes on our growth initiatives at Zoro U.S. You've heard us talk about expanding the product assortment of Zoro. Our goal is to add 10 million items over the next three to five years. In the third quarter we added about 350,000 SKUs, which brings us to 800,000 SKUs for the year.

These product adds are driving incremental revenue growth on a first new basis that is similar to what we've seen historically at MonotaRO. Our investment in systems and people to help drive this growth are also going well. We launched a new marketing campaign in September and the results are promising, although early. We are optimistic about the trajectory of Zoro going forward; the bulk of our investments in this business will be completed by the end of this year. And we expect strong growth and profitability moving forward.

Now, the natural tendency would be to cut back on these types of investments during a soft market. While we are focused on long-term growth of our business and we'll continue to make prudent investments while driving productivity.

Now I'll turn it over to Tom who will discuss the quarter's results in more detail.

Thomas Okray

Thanks DG.

Looking at our total company adjusted results for the quarter daily sales were up 2.5%, volume grew 2.5% and both price and the impact of FX were flat to the prior year.

Two of our businesses, AGI and Cromwell are not only facing challenging end markets but are also in the middle of turnarounds. Their results are adversely impacting the company's performance. For perspective the U S segment and endless assortment. businesses combined were up 4.5% in the quarter and 5% year-to-date versus the prior year.

Moving to gross profit. Our total company gross profit margin declined 80 basis points versus the prior year. The decline in gross profit margin was driven primarily by the timing of U.S. price adjustments during the year, which resulted in negative price cost spread in the U.S in the third quarter. Lower gross profit margin of our endless assortment businesses also contributed to the decline.

Year-to-date, our total company gross profit margin is down 40 basis points versus the prior year. For the fourth quarter, we expect the company's gross profit margin to be higher than the third quarter. We drove operating earnings growth of 2% in the quarter. Our operating margin, however, declined 20 basis points versus the prior year due primarily to the investments we're making to drive growth at Zoro. Excluding the investments in Zoro, SG&A leverage completely offset the gross profit margin decline in the quarter. As expected, SG&A grew at half the rate of sales.

As an organization, we will continue to rigorously manage expenses while ensuring we're providing the absolute best experience for our customers. Year-to-date, operating margin has expanded 30 basis points and we've driven incremental margin of 26%. We were also focused on generating strong cash flow while operating cash flow in the quarter decreased 8% driven primarily by unfavorable timing of supplier payments, operating cash flow was up 3.5% year-to-date and close to a 100% of reported net income.

Year-to-date, we've returned $842 million to shareholders through $242 million in dividends and $600 million in share buybacks. We expect to continue to buyback shares in the fourth quarter.

Now, let's turn to our performance in the U.S. The demand environment has slowed throughout the year and the market was flat in the third quarter. Daily sales were up 2.5% comprised of volume growth of 2.5%, flat price inflation, 0.5% increase of inter company sales to Zoro and a 0.5% decline in specialty brands.

In the quarter, we grew 250 basis points faster than the market driven by strong execution of our U.S. growth initiative. U.S. gross profit margin declined 80 basis points in the quarter versus the prior year driven primarily by product cost inflation outpacing price inflation partially offset by favorability and supply chain.

At the beginning of 2019, we wanted to ensure that our pricing was sufficient to cover product cost increases related to tariffs and general inflation. In retrospect, we were a little too aggressive. To ensure that our pricing was market-based, we dialed pricing back in the second quarter, while third quarter gross profit margin was a little below our expectations, we estimate that gross profit margin will be higher in the fourth quarter and the third quarter and the results for the entire year will be consistent with the expectations set at the start of the year.

In an environment with uncertainty around tariffs and market demand, quarterly noise is common place. Year-to-date picture is often more useful on the evaluating performance. More perspective on a year-to-date basis excluding the write down of remaining contract negotiations, our price cost spread is favorable. Further, we continue to effectively manage product cost inflation related to both tariffs and general inflation.

In the quarter both improved sequentially and we expect that trend to continue in the fourth quarter. U.S operating earnings increased 4% in the quarter, U S operating margin was flat versus the prior year as lower gross profit margin was completely offset by SG&A

leverage. SG&A was flat on sales growth of 4%. In Canada, daily sales declined 14.5% on a constant currency basis. Price inflation was 1% in the quarter and volume declined 15.5%. Volume remains the main issue in Canada. While optimization of the cost structure is strong, it's taking time for us to stabilize top-line performance.

Operating margin was positive in the third quarter for the first time in 2019 driven by improvement to gross profit margin and continued diligence on the SG&A line. Gross profit margin improved 50 basis points versus the prior year largely due to supply chain efficiencies, offsetting negative price cost spread.

Moving to other businesses, which includes our endless assortment model and our international portfolio. Daily sales were up 9% in the third quarter on a constant currency basis due to revenue growth from our endless assortment model. Together MonotaRO and Zoro daily sales grew 19.5% in the quarter.

Gross profit margin for the other businesses declined 130 basis points driven by promotional activities at Zoro and freight headwinds at both Zora and MonotaRO.

Operating margin declined 220 basis points for the other businesses, primarily driven by long-term growth investments in Zoro U.S. and performance at Cromwell. As we've mentioned in the past, the Cromwell business is facing operational challenges while also experiencing a difficult economic climate. The business is taking action to improve service and the customer experience to drive top-line growth while also improving the cost structure.

Page 14 covers our guidance for 2019. At the total company level, we are reiterating all of our guided metrics. At the segment level, we expect the U.S. segment and other businesses to be within their guided ranges. For AGI, we now expect to finish the year below the guided range.

Now I'll turn it back to DG for closing remarks.

Donald Macpherson

Thanks Tom.

Our performance so far this year has been solid even in a slower growth environment and with the added uncertainty around tariffs. While AGI and Cromwell continue to be challenged, customer feedback is much better in both businesses. We have done a lot of work to get the cost structure and service right in AGI and Cromwell and are well positioned to grow in the future.

I was at Cromwell earlier this month and even with the economic challenges customers were pleased with our improved service, we are exploring how to expand these relationships. We are happy with the growth of our endless assortment businesses and the progress we're seeing with our U.S. growth initiatives. We have driven strong incremental margin year-to-date and are maintaining our total company guidance. We are committed to delivering strong performance over the short-term and long-term.

Our performance expectations remain the following; we expect our initiatives in the U.S. to drive 300 to 400 basis points of outgrowth versus the market on an ongoing basis. We believe Canada is an attractive market for Grainger and we will continue our work to drive profitable growth in that business.

We expect to accelerate growth with our endless assortment model through the strength of MonotaRO in Japan and the investments we're making in Zor0 U.S. Overall, we expected our strong SG&A leverage and operating margin improvement for the year, resulting in incremental margin of 20% to 25%.

Now, we'll open it up for questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question today is coming from David Manthey from Baird. Your line is now live.

David Manthey

Thank you. Good morning. You mentioned the long-term goal of growing SG&A at half the rate of sales growth and you've obviously done a great job over the past several years. And clearly that equation is lot easier when you're growing 8% than when you're growing 2%, but you've actually done it in both environments. What I'm wondering is, as we go forward here -- we're looking ahead to the next year or so. Do you have a specific plan in place that'll keep that expense leverage going or at some point that we just see natural low single digit inflation returned to the cost stack in any case?

Donald Macpherson

Thanks, Dave. I would say that we are constantly working on improving our expenses and our cost structure. We have a built in an expectation that the functions and the business will cover things like merit going forward. And we're working through plans for next year right now as you might guess. But, we feel pretty confident that we can continue to get cost productivity throughout the business and we'll work hard to make sure that we continue to deliver the performance we've been delivering.

David Manthey

Okay. Thanks. And then, DG, when you said that you expect a return to strong profitability in the endless assortment business or something along those lines that improved profitability. I'm just wondering if you can help us define that. Historically when you look at segment contribution margins, following periods of investment you've gotten as high as maybe the mid or higher teens, is that what we should be thinking about for contribution margins in the other business segment going forward?

Donald Macpherson

I would say that if you look at the online businesses, which are part of the other segment. Our expectation is we will return Zoro to profitability and we'll begin the migration over the next several years up to very strong profitability that we see in MonotaRO. And I think, the MonotaRO P&L give you a sense for where we hope to be able to get with the Zoro business. So that's our objective and it'll take several years to get there as we come out of these investments. But we're pretty confident we can continue to grow profits.

Operator

Thank you. Our next question today is coming from Ryan Merkel from Williams Blair. Your line is now alive.

Ryan Merkel

Hey, thanks. Couple of questions. So, first, I just want to clarify why gross margins are going to improve in the fourth quarter versus the third quarter. I apologize if I missed it.

Thomas Okray

Yes. Gross margins typically improve sequentially Q3 versus Q4 this year. Q4 versus Q3, they typically will improve. And this quarter is going to be no different going into Q4. We are seeing general inflation and tariff inflation going down and that's the main driver for gross profit going up in Q4.

Ryan Merkel

Got it. Okay. And then, you mentioned a price adjustment in the second quarter. Can you just tell us how much did you lower prices maybe on average, and was it broad based across all the SKUs or was it more targeted?

Thomas Okray

It was more targeted. And obviously, we're working on this on a continuous basis. As we said in the prepared remarks, coming up to Q1, we thought we overshot a little bit. So, we went back and really scrubbed. Some SKUs, we raised, some SKUs we lowered overall though we lowered.

Ryan Merkel

Got it. Okay. I'll pass it on. Thanks.

Thomas Okray

One other comment related to the first question on gross margin, we also expect some favorability in supply chain to help us out related to Q4. We see softening in the supply chain area, the transportation area. We expect that to also be a factor in Q4.

Operator

Thank you. Our next question is coming from Christopher Glynn from Oppenheimer. Your line is now live.

Christopher Glynn

Hey, thanks. Good afternoon out there. So, a lot of emphasis on the 300 to 400 basis points of long-term sustainable outgrowth. I wanted to narrow that down into medium, get a little more detail on traction on your initiatives and prospect to kind of inflect that growth higher. I think last quarter you talked about things like assortment, sales coverage and digital experience. So, wondering how you're seeing those kind of discreet drivers kind of ramp on the ground level.

Donald Macpherson

Yes. Thanks Chris. We continue to expect our midsize customer growth and share gain to be higher than the overall U.S. share gain. We continue to see that. We certainly given the way we cover and interact with customers, things like merchandising and marketing have an outsized impact. They impact all of our customers, but they have an outsized impact on the midsize customers and that has continued to play out.

And our expectation is that we will continue to grow significantly faster in the next several years with midsize customers than with the whole. And the initiatives are playing out pretty much as expected at this point.

Christopher Glynn

Okay. And then, with Canada, just want to, I think you talked a little bit more about sales stabilization and prior quarters. Just wondering where's the cross section between the customer re-engagement you've talked about with stabilized service levels versus kind of softening macro up above?

Donald Macpherson

Yes. I'd say that. We have a number of our sales leaders in and we interact with them frequently and I've been talking to them and I've been in hearing from customer feedback. We are now having conversations and getting permission to grow with our customers. And that's -- it's been several years, frankly, since that's been the case. And so, we are right at the -- it feels like we're right at the precipice now of being able to start climbing again and grow based on the work we've done. And it's been a long haul, but we feel like we're having the right conversations now. So we're a lot more confident now than we've been in several years.

Christopher Glynn

Okay. Thank you.

Operator

Thank you. Our next question today is coming from Deane Dray from RBC Capital Markets. Your line is now alive.

Deane Dray

Thank you. Good morning everyone. Hey, I know you're not in the giving of 2020 guidance yet, but just could you talk qualitatively what you're expecting the U.S. MRO market to look like? One of the other big industrial distributors talked about a flattish expectations for the first half. How do you think the operating environment for MRO will be? And then, related to that, what caused you to step up into that 300 to 400 basis points of outgrowth and what might the timeframe be for that? So, two part question. Thanks.

Donald Macpherson

Thanks Deane. So I think, we don't have any crystal ball that's different than others we're seeing. We are planning for a wide range of potential market growth outcomes for next year and building plans around a wide range. I think flattish is not a bad place to start probably and anybody's guess, but that would not be a certainly a wrong estimate at this point. But we are planning for a fairly wide range. We actually are -- we have a set of initiatives that we've talked about that we believe are starting to build by getting us to that 300 to 400 basis points.

If you look at the quarter on a volume basis, we were significantly higher than 300 basis points of growth actually. So we are starting to get confident that we have the right initiatives in place to grow 300 or 400 basis points. And then, things we've been talking about with merchandising, marketing, adding sellers, corporate account growth, reenergizing things like [indiscernible] program. So, we feel like they've got the right initiatives and we're starting to get some of that traction right now.

Deane Dray

Terrific. And just as a follow up, is there any update on gamut? Looks like that website is in transition. You talked a bit about how that might be happening. And then maybe some update on the improvement of the search capability in the rollout there. I appreciate it. Thank you.

Donald Macpherson

Yes. Gamut is no longer a customer facing website. All those learnings have been built into the Grainger processes. We're building a new product information system that will be live in the fourth quarter. We've actually -- when we talk about remerchandising $0.5 billion so far this year, a lot of the insights from gamut are actually in those remerchandising. So if you look at the categories that we've gone through, you see a lot of the lessons there. So we have effectively built what we've learned from gamut into grainger.com, we're getting -- continued to get improved feedback from customers and that will only get better and better as we continue to build out more categories and improve the product information. So we're pretty excited about the path we're on in terms of our search experience right now.

Operator

Thank you. Our next question is coming from Robert Barry from Buckingham Research. Your line is now alive.

Robert Barry

Hey everyone. Good morning. Just a quick follow up on Ryan's question. I think Tom, you mentioned seeing inflation going down. Was that just a comment on freight or is that broader?

Thomas Okray

I mean, sequentially, if you look at what we've experienced in Q3 versus Q2, we saw both tariff related inflation and general inflation go down. We expect that to continue in Q4 as well.

Robert Barry

Okay. So, do you expect to be priced cost positive in 4Q?

Thomas Okray

Didn't say that. We'll come back to what we said for the entire year. We expect to be price cost neutral excluding our pricing rate downs that we've done.

Robert Barry

Got it. It just seems a little counterintuitive because the tariff headwinds seemed to be growing.

Thomas Okray

Actually, if you look at the tariffs, how we've experienced them throughout the year, they've been fairly constant. And now that we're starting to lap some of the tariffs, we're seeing improvement there. The other thing is you have to reconcile between stated tariffs and what we're actually able to negotiate in terms of realized tariff. And we've got two buckets we work on. One is our own imported parts which come from largely from China, which are impacted directly. And the other ones are national brands, which we work with our supplier partners. So stated versus actually realized is a factor as well.

Robert Barry

Got it. And so just lastly, so does that mean in that context, maybe seeing price at zero is less of a concern to you given you been able to negotiate some of this deflation?

Thomas Okray

Well, I think what I would say is, where we're at in terms of our share growth where we're at in terms of our share growth objectives and our share growth initiative, seeing flat pricing for the quarter doesn't get us overly exercised as DG mentioned from a volume basis. We grew share quite a bit and at this point where we're trying to get traction on our share gain initiative that doesn't concern us at one quarter we're priced flat.

If you look at the entire year, we're price cost neutral when you adjust for the reset from the strategic write down. And we're happy with that. It's what our objective was at the beginning of the year.

Operator

Thank you. Our next question today is coming from Josh Pokrzwinksi from Morgan Stanley. Your line is now live.

Josh Pokrzwinksi

Hi. Good morning guys.

Donald Macpherson

Good morning.

Josh Pokrzwinksi

Just want to follow up. Given that we're now past -- kind of fully passed the price reset, just any observation with some of those customers what percentage of kind of converted to being more core customers versus those were maybe transactional during the process. So imagine you've got a better grasp on that today than maybe you did six or 12 months ago. How satisfied are you with that? And, I guess, hopefully that is the first question.

Donald Macpherson

So Josh, let me, I will answer the question and interpret it. So, tell me if I'm not answering correctly. We tend to look at with our large customers for sure. We had a lot of relationships that were not transactional relationships before. We still have a lot of those and we've expanded some of those. I think the biggest shift has been with mid sized customers where we now have a whole lot more midsize customers that are buying frequently. Based on the price reset and the price reset was largely to make sure that we were growing across the entire customer base consistently. And so we have liked the results we see with the test customers. You still have a long way to go to acquire and turn those -- many of those customers into regular purchasing customers. But we have made great progress with midsize customers.

Josh Pokrzwinksi

Got it. Yeah, that was a midsize customer question, so yeah, definitely

Donald Macpherson

Sure.

Josh Pokrzwinksi

Right. Yes. Well, large wouldn't make much sense. And then, I guess on the price cost dynamic from here, is there anything that happens as a function of the calendar in terms of customers kind of reevaluating the start a year where the progression kind of post 4Q inflex or diflex one way or another? I think from a cost perspective, there's probably equal measures deflation and inflation, but probably, a bit more deflation on the inputs. But just trying to understand how that conversation evolves over time on the pricing front and if there's anything that changes with the calendar?

Donald Macpherson

Well, we have a long history of working with our customers to -- a lot of our contract customers to lock in prices at the beginning of the year. So, we got through a process that we are going through now to make sure we've got the right competitive prices and that process always happens. So, there's always a sort of beginning of the year sort of reset that happens and you see that in our results historically that that will be the same this year.

Operator

Thank you. Our next question today coming from John Inch from Gordon Haskett. Your line is now live.

Karen Lau

Hi. Good morning. It's Karen Lau dialing in for John. So, I just want to clarify on the 3Q gross margins dynamic. It sounded like given you said price inflation has differentially come down essentially all of that gross margin degradation is coming from product pricing. I guess part of it maybe you can confirm that the 5% of large accounts that still needs to get price adjusted and is that done over the quarter. And then is the rest of the pricing degradation coming from more broad based pricing adjustments?

Thomas Okray

Yes. It's largely, done, we'll see a little bit in Q4 and then we won't have any in 2020.

Karen Lau

Okay. Yes. It just sounds like I guess given the magnitude of the pricing and gross margin decreased more of that has to do with broader based pricing adjustment. Maybe just follow up on that point. I guess you guys have adjusted pricing since the start of the year, I guess a couple of times. As you go through this exercise, are you seeing sequentially similar, well I guess the ideal volume response that you would hope for or are we -- as you go through, like these pricing exercise, are you starting to see throughout the year like bit of a more diminishing returns.

Thomas Okray

No, I, I think we're seeing good pricing response. Again, I'll go back to -- we see a flat MRO market in the third quarter included in that flat market is a little over 1% in price offset, little bit over 1% in volume deterioration. We were up 2.5%. So that puts us, well above 350 bps. There's also some weather issues related to the hurricanes last year that we didn't put in our prepared remarks and some government lapping differences. So yes, if you look at that, we're very happy with our volume response.

Donald Macpherson

Yes. I would just add that, if you think about some of the pricing dynamic, Tom talked about this. We talked about being priced cost neutral before the reset for the year. We are effectively where we expect to be in aggregate. And we are careful, we made pricing changes all the time, but we're very careful not to disrupt customers with large customers, particularly, we are changing prices around. So, we are a little bit more careful with how many times will change with large customers, but overall we've seen the exact response we expected this year.

Operator

Thank you. Our next question today is coming from Adam Uhlman from Cleveland Research Company. Your line is now live.

Adam Uhlman

Hey, good morning guys. Had a few questions on Zoro. When should we expect incremental investment spend to wrap up? Are we fully lapping that as we head into the first quarter and should expect profitability to recover there early in the year, is going to take a little bit more time.

Thomas Okray

Yes, so we expect that, we expect profitability just to recover some in the first quarter. We did start investing pretty heavily in the first quarter of this year. And it'll just grow -- from profitability to grow from there. So, we will get some improvement in the first quarter's augmentation.

Adam Uhlman

Okay. And then, the 800,000 SKUs that have been added so far this year. And as we add some more going forward, I'm just wondering if you could comment about, if the gross margin profile of the business is changing. How you look at the categories that you're adding in? Is that more of a build out of the existing one or are there new product categories that are getting you into higher or lower margin categories?

Donald Macpherson

Yes. I think that we are -- first of all, we're adding a whole bunch of categories that we haven't had before. So there's a mix of that in new categories and expanding the operating just in categories. In general, we are creating a fairly distinct value proposition for Zoro and Zoro will become less relied on the Grainger supply chain moving forward. And so, most of those products will be drop shipped. So for the financials, the GP is lower when you have drop shipped items. So, was the expense. But, you'll see that impact to GP slightly over time. And, but we expect most of those items that we're adding, if we talk about 10 million over the next three to five years, we expect most of those items to be third-party ship. We're going to be stocking most of those in Grainger.

Operator

Thank you. Our next question today is coming from Chris Dankert from Longbow Research. Your line is now live.

Chris Dankert

All right. Thanks for taking my question. You guys have given some really great color on gross margin. I guess kind of moving down to SG&A, typically we see a bit of a step up into the fourth quarter here, but your reiteration of the guidance suggests maybe you can hold that flat of the fourth quarter. Is that the right way to be thinking about SG&A and just maybe some -- you can have it on the puts and takes that are in that line?

Thomas Okray

Yes. I think just thinking about it the right way. Year-to-date, we're on a total company level where we're 70 bps favorable for SG&A. We expect that percentage to increase for the entire year. We do have a favorable lap related to variable compensation in addition to just a number of other cost productivity ideas and implementation that'll hit in Q4.

Chris Dankert

Got it. Got. Thank you. And then thinking about, some of the rollback of the investment in the other business in Zoro and MonotaRO. I think you guys had called out rolling back the vast majority of that in 2020. Is that still the plan?

Donald Macpherson

Yes. That's still the plan, Chris. That is, if you think about it, a number of the investments have been system investments. So, we're going live with the new product information system for example, we get through those this year and those do not repeat next year. So, we have most of the investments behind us. We have added people analytics talent, marketing talent that will remain obviously but a lot of the investments are kind of one-timers if they're going to be gone this year.

Thomas Okray

And as you saw in the charts, we're really happy with the sales growth of both Zoro and MonotaRO. MonotaRO constant currency, local currency basis was up over 23% and Zoro was up big double digits. So, very happy with that.

Operator

Thank you. Our next question today is coming from Justin Bergner from G. Research. Your line is now live.

Justin Bergner

Good morning, DJ. Good morning Tom. Just quickly on Zoro, did I hear you say earlier in the call that Zoro is currently running unprofitable below breakeven?

Donald Macpherson

No. They actually made money in the quarter just not as much as they will make on a ongoing run rate basis.

Justin Bergner

Okay. And does any of the investment -- price investment or is this all mainly on the SG&A side?

Donald Macpherson

It's both. There are promotional spending, which we're undertaking when are adding new SkUs and going into new verticals.

Donald Macpherson

Okay. On a dollar bases most of it is expense as opposed to price of that.

Justin Bergner

Okay, great. My other question was just around the -- I guess price action you took that affected price cost in the third quarter. Was that price action taken in the second quarter such that you kind of expected the results that you ended up just reporting or was some of that taken in the third quarter? And was that all sort of to correct for some of the pricing you took in the earlier part of the year? It was some of that more in response to current market conditions.

Donald Macpherson

It's taken in the second quarter.

Operator

Thank you. Our next question today is coming from Nigel Coe from Wolfe Research. Your line is now live.

Nigel Coe

Yes. Good morning. Why don't you just come back from the gross margin sequential guidance he gave and certainly, when you go back in history, there's a very profound seasonal uplift in 4Q. Can you remind us though what drives that? Is it a mixed impact? Because normally revenues are slightly down. So, just curious what drives that.

And then, the second part of that question is with the task list three 25% rolled in from may onwards and then that's from September, I think you talked about 10% of your U S sales industry [indiscernible] school. I'm just curious why we're not incrementally shrink pressures come from prep and preps are set by other deflation meeting text. But maybe just address that as well, please.

Thomas Okray

Okay. Well, let me take the first one and I might have to get you to repeat the second one where it was, it was breaking up on our phone here. There are many levers that we can pull in terms of, in terms of gross margin for Q4, why is it historically goes up. Traditionally I think what we've seen is, we've seen cost inflation work its way, work its way down throughout the year, and we have better opportunities in terms of related to pricing terms in terms of vendor rebates, customer support, those types of things, which are quarter-end settlements. And we count those as costs, obviously.

Our pricing environment is fairly static throughout the year as DG mentioned with the, the big pricing happening throughout the year. So the main driver in Q4 is really our vendor volume rebates and our customer rebates settlements that we have in Q4.

Donald Macpherson

And if I can get you to, repeat the second question, please.

Thomas Okray

Yeah, I'm, it's pretty just about the impact of the tariff. So the step up from 10% to 25% on the list, three tariffs which would it early May. And then, I think previously close to 10% of your U.S. sales are less three, 10% or less forward. So I'm just wondering why we're not facing some inflationary pressures. Going into Q4 full that would need to be offset with price.

Well, we've got part one and part two, which arguably are a lower amount of our cogs, which are laughing in Q4. So, we'll see less of an impact there. Q3, you're right. Is moving from 10% to 25% or did move from 10% to 25% in May. Again, I will take you back to the actual stated info tear off number versus realize, we are experiencing much less than the stated tariff number on an actual basis. So, it's hard to just look at what's stated and, look at the actual results. You really have to focus on the actual realized results.

And our team's doing a very good job of working with our supplier partners to mitigate those increases.

Nigel Coe

Okay. I'll leave it there. Thank very much.

Operator

Thank you. Our next question today is coming from Patrick Baughman from JPMorgan. Your line is now live.

Patrick Baughman

Hi, DG. Hi, Tom. Thanks for taking my question. Just on the Zoro business, if you could put a finer point on -- you said it's making money, is it making money this year. Is it kind of like a mid single digit type operating margin? I know MonotaROs in the low double digits. Just have a better sense of what the runway is there over the next several years. What the base is this year.

Thomas Okray

We are not going to go into specific breakout of Zoro, let's leave it. It's making a small amount of money this year.

Patrick Baughman

Okay, fair enough. And then, how should we think about the Louisville facility coming on line in the fourth quarter here. And then, into next year brought from I guess, what are your expectations from the market. Our growth or cost perspective and you mentioned supply chain favorability that you expect in the fourth quarter. I know that's part of it. Are respect some just curious any color on that?

Donald Macpherson

I think, I would answer that two ways. One is long-term [indiscernible] facility provides capacity and helpful capacity in a couple of ways. That first thing does it, it allows us to stock probably 200,000 more items in the network, because it's a very good pack up for Chicago, Greenville, New Jersey and even Dallas for some degree. It allows us to stock more items, add more breadth, which provides better customer experience.

And typically that does drive growth. The other thing it does its next to the report. So, gives you [indiscernible] for sale items, before moving items in the network to get a customers who needs them and that's [indiscernible] customers.

We are working through exactly how to bring the building up. We're starting to receive in the fourth quarter and we'll talk more about that at the end of the fourth quarter in terms of what we're using the building for exactly next year and how we're bringing that building up. It's huge and it's going to take a couple of years to get to full capacity for sure that we're going to leverage that building to provide better service to customers next year and improve our cost structure as well. So we'll, talk about that at the end of year.

Operator

Thank you. Our next question is coming from Michael McGinn from Wells Fargo. Your line is now live.

Michael McGinn

Thanks a lot for the time. If I could switch gears to more of a long-term fundamental question regarding the endless assortment model? Having visited your new New Jersey DC, there was a distinct concerted effort on what shows up in a red box versus what shows up in a blue box. I'm just wondering, long-term, what kind of thresholds are you putting on the third-party market and maintain branding? Are they going to get national account freight pricing? How does that feed into your supplier rebate discussions longer-term, if you can just answer those quick questions, would be great.

Thomas Okray

So, we will have, as we build out the endless assortment, we will have partners that provide distinct over branding whether or not it's an acid box or a label is, is probably up for discussion at this point still. But, the idea is, we will make sure we became this overall branding. Zoro will have more ownership for its own state. It will still leverage free contracts that we have at Grainger and leverage some things at Grainger, but in general it will be more independent. The value proposition will be independent and the business was more independent.

Michael McGinn

And the growth of that business, does that feed into the general Grainger supplier rebate conversation or is that something separate?

Thomas Okray

For stuff that we stopped jointly? It definitely will or stuff that we don't it will not.

Operator

Thank you. We reached end of our question-and-answer session. I'd like to turn the floor back over to DG Macpherson for any further closing or comments.

Donald Macpherson

Terrific. Thanks. Thanks for joining us this morning. I'll just reiterate what we feel are really important about our expectations moving forward. In our U.S. business, we feel that scale really, really matters and gaining share is incredibly important. And so our expectation is that we are going to grow revenue 340 basis points fashion in the market. We feel like we have a great opportunity to do that with a relatively stable gross profit and continuing leverage on the SG&A line going forward. In Canada, we have improved the customer experience. We are re-engaging customers in a positive way. And if we can get volume back into the business, which is our entire focus right now, we're going to be in a place to drive profitable growth.

We're excited about being able to serve them all the investments we're making, even in Zoro excited about the growth path there. And we feel really, really good about a lot of the initiatives we have and the customer experience we're providing. So appreciate the time today and look forward to talking to you soon. Thanks.

Operator

Thank you. That does conclude today's teleconference. You may disconnect your line at this time and have a wonderful day. We thank you for your participation today.