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October 31, 2019 | www.btnresearch.com

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Fastenal (FAST) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3+ (Minor Concern).

- Accounts receivable days fell by about 1 day in the 9/19 quarter. However, the quarter ended on a Monday this year versus a Sunday last year, allowing one more day for collection. Management stated in the call that after adjusting for the extra day of collection, DSOs would have been up about a half a day. This compares to approximate 2-day year-over-year increases in each of the last two quarters. We noted in our original review that the shift in the customer base to larger national accounts has resulted in the company getting paid more slowly. The company noted in the call that "customers continue to aggressively pursue longer payment terms and withhold payment at quarters-end. We expect growth in our working capital assets to be more modest in the fourth quarter than it was in the third producing another strong cash flow quarter." This will likely remain an issue for the foreseeable future but for now management appears to be minimizing the cash flow drain.

- FAST is also growing its mix of onsite locations which requires a larger investment in inventories. Inventory days of sales jumped by 5.6 days on a year-over-year basis in each of the last two quarters. In the 10-Q, management attributed the increase to an increase in the installed base of vending machines and onsite locations, to increase support levels, and from inflation and tariffs. More color was added in the conference call:

"Inventories were up 13.4% in the third quarter of 2019. Nearly half of this growth related to inventory to support new Onsites. The remainder relates to higher hub inventories. We planned for growth in inventory to slow meaningfully in the fourth quarter as actions taken earlier in 2019 to reduce overseas purchasing in response to slower demand begins to be felt."

We will be watching to see if the inventory increase comes under control in the fourth quarter.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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