BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Fastenal (FAST) EQ Review

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate earnings quality coverage of FAST with a rating of 3+ (Minor Concern).

We consider FAST to be a high-quality company having reported consistent growth for many years, good overall earnings quality, and a debt-to-EBITDA of under 0.5- all rare qualities for an industrial distributor. However, we believe that gradually increasing challenges to the company's business model are showing up in the numbers and investors should consider their impact on the health of long-term dividend growth.

- Accounts receivable DSOs jumped by approximately 2 days over the year-ago quarter. Rising receivables has been a trend over the last four years driven by growth in the company's international and large national account business. However, management's explanation of the increase in the 2018 10-K became more specific, citing a push by large accounts to extend payment terms as being a trend that has intensified throughout 2018.

- Inventory DSIs at the end of the 12/18 quarter jumped two days over the year-ago quarter which the company attributed to inflation and pre-buying ahead of potential tariffs. However, management has also mentioned that its growth drivers of increasing national accounts, expanding industrial vending machines, and rising number of onsite locations are requiring more investment in inventory.

- We are not in any way predicting a near-term cut to FAST's dividend as the company's core operations are still growing and its low leverage gives it plenty of

flexibility in allocating capital. However, the percentage of free cash flow consumed by the dividend in the last four years has ranged between 79-105%, and capex forecasts for 2019 indicate it could exceed 100% next year as well. This is all before the buyback. This makes the increased working capital drain from receivables and inventories more of an issue.

Accounts Receivable Increasing as Customers Push for Longer Terms

FAST's accounts receivables days (DSO) have been slowly increasing over the last several quarters as shown in the following table:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$1,231.6	$1,279.8	$1,267.9	$1,185.8
Accounts Receivable	$714.3	$772.5	$733.7	$688.6
Sales YOY growth	13.1%	13.0%	13.1%	13.2%
Accounts Receivable YOY growth	17.5%	22.2%	19.6%	19.8%
Accounts Receivable DSOs	52.9	55.1	52.8	53.0

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$1,088.5	$1,132.8	$1,121.5	$1,047.7
Accounts Receivable	$607.8	$632.1	$613.5	$574.7
Sales YOY growth	14.8%	11.8%	10.6%	6.2%
Accounts Receivable YOY growth	21.6%	16.2%	14.2%	7.7%
Accounts Receivable DSOs	51.0	50.9	49.9	50.1

This trend of gradually increasing DSOs actually started in 2015:

Year ended December:	2018	2017	2016	2015
Cost of Sales	$4,965.1	$4,390.5	$3,962	$3,869.2
Accounts Receivable	$714.3	$607.8	$500	$468.4
Accounts Receivable DSOs	51.8	49.8	45.4	43.6

There are two drivers behind this trend of rising receivables. First, the company's national account business is growing faster than small accounts meaning it is dealing with more powerful customers. As evidence of the rising importance of larger accounts, the company is driving growth by opening onsite locations where it maintains a distribution hub on the premises of some of its large accounts while simultaneously closing down nearby public branches. The number of each type of location since 2012 is shown below:

	2018	2017	2016	2015	2014	2013	2012
Sales	$4,965.1	$4,390.5	$3,962.0	$3,869.2	$3,733.5	$3,326.1	$3,133.6
Public Branches	2,227	2,383	2,503	2,622	2,637	2,687	2,652
Onsite Locations	894	605	401	264	214		
Total Locations	3,121	2,988	2,904	2,886	2,851	2,687	2,652

The company has been open about admitting that the greater mix of national accounts was putting pressure on working capital via higher receivables. Consider the discussion in the "Liquidity and Capital Resources" section from the 2017 10-K:

> ***"In 2017, the annual growth in net accounts receivable reflects accelerating growth in sales throughout the course of the year combined with relatively stronger growth of our national accounts and international business.*** *Growth in accounts receivable continued in the fourth quarter of 2017, with the timing of the Christmas and New Year holidays affecting the timing of these customers' payments. Currency fluctuations also impacted accounts receivable in 2017. In 2016, the annual growth in net accounts receivables outpaced the growth in sales. This was not the case through the third quarter, and was mostly a function of conditions in the fourth quarter of 2016. In the fourth quarter of 2015, we collected receivables from our seasonally stronger third quarter, but because demand fell off surprisingly sharply in November and December, our fourth quarter receivables were unseasonably low. In the fourth quarter of 2016, by contrast, we collected receivables from our seasonally stronger third quarter, but because demand was more closely in line with seasonal norms, our receivables in the period were similarly more normal.* ***Over a longer period of time, if we continue to see relatively strong growth in our international business and of our large customer accounts it could continue to create difficulty in managing the growth of accounts receivables relative to the growth in net sales."***

Past explanations have included similar language about the increase in international and national account business making working capital management more challenging. However, the discussion in the 2018 10-K changed to a more specific tone:

> *"In 2018, the annual growth in net accounts receivable reflects accelerating growth in sales throughout the course of the year combined with relatively stronger growth of our national accounts and international business.* ***In addition, two trends emerged among our customer base that increased our net accounts receivable. The first was a push from our customers to contractually increase the period between when they are***

invoiced and when payment is due. The second was customers delaying payments beyond the end of the applicable quarter. <u>We saw these behaviors intensify throughout 2018.</u> *In 2017, the annual growth in net accounts receivable reflects accelerating growth in sales throughout the course of the year combined with relatively stronger growth of our national accounts and international business. Growth in accounts receivable continued in the fourth quarter of 2017, with the timing of the Christmas and New Year holidays affecting the timing of these customers' payments. Currency fluctuations also impacted accounts receivable in 2017."*

While the overall increase in receivables is not a new trend, the specific admission that larger customers are specifically pushing to extend their payment terms and that this intensified in 2018 indicates that this is a new development. As we will discuss in a later section, the increase in working capital is more concerning given the lack of cushion between the dividend and free cash flow. However, it is also worrisome from an operational perspective give that if larger customers can pressure for better payments terms, they could conceivably pressure for lower prices and other concessions as well.

Inventory DSIs Rose in the Fourth Quarter

FAST's inventory days (DSI) jumped by more than 2 days in the 12/18 quarter as shown in the table below:

	12/31/2018	09/30/2018	06/30/2018	03/31/2018
COGS	$643.8	$664.0	$650.2	$608.2
Inventory	$1,278.7	$1,194.7	$1,163.4	$1,134.9
COGS YOY growth	15.5%	15.1%	15.5%	14.8%
Inventory YOY growth	17.0%	14.1%	11.4%	12.7%
Inventory DSIs	181.2	164.2	163.3	170.3

	12/31/2017	09/30/2017	06/30/2017	03/31/2017
COGS	$557.3	$576.9	$563.0	$529.7
Inventory	$1,092.9	$1,047.0	$1,044.3	$1,007.4
COGS YOY growth	17.1%	12.4%	9.8%	7.0%
Inventory YOY growth	10.1%	8.3%	6.0%	4.4%
Inventory DSIs	178.9	165.6	169.3	173.5

This is not a huge jump, and the fourth quarter DSI numbers is not a historical high. However, this trend is worth keeping an eye on given management's explanation in the 10-K:

> *"Our growth in inventory balances over time does not have as tight a relationship to our monthly sales patterns as does our growth in accounts receivable. One reason for this is cyclical. The lead time for inventory procurement is typically longer than the visibility we have into future monthly sales patterns, so economic downturns can cause a spike in inventory levels, as was seen in the dramatic economic slowdown in late 2008 and early 2009. Inventories may also fluctuate independent of monthly sales patterns based on strategic decisions. For instance, at various times we have increased our relative inventory levels based on new branch openings, expanded stocking breadth at distribution centers and/or individual branches (e.g., CSP), expanded direct sourcing, and expanded Fastenal brands.* ***Our growth drivers, including industrial vending solutions, national accounts, and Onsite and international locations, have also required significant investments in inventory. In 2018, our inventories increased as a result of growth in general demand and successful execution of our growth drivers. Inflation had an increasing impact in the second half of 2018, and our decision to accelerate shipments of product to the U.S. from overseas ahead of potential tariffs resulted in extra inventory of approximately $12.0 in the fourth quarter of 2018. In 2017, the most significant contributor to the increase in inventories was improving business activity and the growth of our Onsite business."***

If we adjust out the $12 million in inventory pre-buys ahead of the tariffs, the year-over-year increase in DSI in the 12/18 quarter drops to about a day. This is hardly dramatic, and we are not at all worried about an unintended buildup in inventory. However, we believe investors should be watching for a sustained increase in inventories eating up more working capital. Consider the cash flow impact of payables for the last four years:

	2018	2017	2016	2015
Cash Use of Inventory	-$193.3	-$76.3	-$80.9	-$47.8

Little Cushion on the Dividend

Let us start by saying we are in no way implying FAST is in danger of a dividend cut. The company's core operations are growing, and its low debt load give it ample flexibility in its capital allocation decisions. However, given that the company's growth initiatives appear to naturally require more working capital, at some point this could factor in to how fast the company can grow its dividend in the future.

The following table shows the free cash flow consumption of the dividend for the last four years:

	12/31/2018	12/31/2017	12/31/2016	12/31/2015
Operating Cash Flow	$674.2	$585.2	$519.9	$550.3
Capex	$176.3	$119.9	$189.5	$155.2
Free Cash Flow	$497.9	$465.3	$330.4	$395.1
Dividends	$441.9	$369.1	$346.6	$327.1
Dividend % of FCF	88.8%	79.3%	104.9%	82.8%
Net Stock Repurchases	$103.0	$82.6	$59.5	$292.9
Cash After Buyback	-$47.0	$13.6	-$75.7	-$224.9

The company's free cash flow can be somewhat volatile given the timing of capex payments. For example, capex was elevated in 2016 due to the rollout of its leased lockers. The rebound in 2018 was due to increased spending on its industrial vending machines and the timing of purchasing new pick-up trucks. Regardless, capex should trend upward as FAST's new growth initiatives will involve more spending on new distribution avenues such as the vending machines and leased locker programs. Management is forecasting 2019 capex to be between $195 million to $225 million. Thus, it is possible that free cash flow will once again not cover the dividend in 2019. As noted above, this is not an immediate problem given the company's low leverage and growth in its core operations. However, an increasing drain from working capital could eat into this cushion over time and impact how rapidly the company can grow the dividend in the future.

Explanation of EQ Rating Scale

Rating	Description
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 recent 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.

Disclosure

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