BEHIND THE NUMBERS
Quality of Earnings Analysis

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Fastenal Company (FAST)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are raising our earnings quality rating of FAST to 5+ (Strong) from the previous 4+ (Acceptable) rating.

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

Summary

FAST reported EPS of $0.37 in the 3/21 quarter, in-line with the consensus target. Our initial rating of 4 (Acceptable) was based on rising DSIs and DSOs, both of which were a reflection of a shift in mix to larger customers and a move to onsite locations. While this trend may continue to be felt somewhat in the future, the company has managed it well, and the ongoing simplicity of its reporting with no non-GAAP adjustments, strong history of returning capital via dividends (special 40 cps paid in the fourth quarter), and high 35%+ pretax return on capital warrant a 5 (Strong) rating.

Items of note in the quarter included:

- Gross margin declined by 120 bps in the 3/21 quarter. This included a $7.8 million write-down to the value of 3 ply-masks in inventory which accounted for about 55 bps of the decline. This penalized EPS by about 1.1 cps. While the company still sells these masks, a glut of supply in the market has pushed prices below a profitable level. The shift to safety products from fasteners also hit margins, but this is improving as the mix began shifting back late in the quarter. Faster growth by larger accounts pressured margins as well as the company having to purchase outside of its traditional supply chain.

- The decline in gross margin was almost offset by a 110 bps decline in SG&A as a percentage of sales. Management attributed this to the leverage of employee, occupancy, and general corporate expenses. Lower fleet maintenance expenses, reduced travel, and easier bad debt expense comps were cited. With daily sales growth of 5.3%, we are skeptical that there was this much improvement from simple leverage and many of these expenses will reverse back in upcoming quarters. However, we would expect the potential improvement in a normalizing gross margin will more than offset this. Management indicated it will raise prices in 2Q to offset expected inflation.

- Inventory DSIs fell to 152 (vs 168 last year) to the lowest level in several years. This was due consolidation of traditional branches, reduction of slow-moving inventory, and the slow signing of Onsite locations in 2020. This should reverse in upcoming quarters as the growth in activity accelerates. A one-day increase in DSI costs approximately $8 million in cash, thus getting inventory back to a more normal mid-160 DSI range could cost over $100 million in cash flow over the next couple of quarters.

- Capital spending is expected to increase to the $170-$200 million range in 2021 from the pandemic-reduced $158 million in 2020. Working capital will also likely consume more cash as inventories rebuild and receivables collections normalize.

- We note that reported EPS benefited from rounding up from 36.53 cents to 37.0. Considering the 1.1 cps unexpected mask write-off, we still view the quarter as having met expectations.

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 Concern)- 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 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 upcoming quarters. 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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