BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

April 29, 2019 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Fastenal (FAST) EQ Update -3/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3+

*For an 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)

While we have no major concerns with FAST's overall earnings quality, working capital ratios continue to reflect the pressure that the company's growth strategy is putting on cash flow. FAST's CEO summed up the problem well during the quarterly conference call:

> *"We've talked about this in the past. Our business as it continues to grow with larger customers and with international customers, sometimes* ***we get caught in a situation where you have a customer that's doing some window dressing at the end of a year, end of a quarter, and they frankly stop paying with two, three, four weeks left in the quarter, and it makes for a challenging situation.***
>
> *Our solution here is to constantly be engaged in discussion with our customer about our value proposition to you is a better supply chain.* ***We take inventory off your balance sheet, don't do this to us at the end of the quarter, because what it ultimately does, it puts us in a position where we can't fund inventory, because there's trade-offs.***
>
> *If we know if we're going to have an extra $5 million of receivables, we have to squeeze that somewhere else and that doesn't serve our customer and we need to be engaged in that dialogue and challenge.* ***If you want to do window dressing, do it with somebody else's payable, not with ours.*** *And – but we did produce a stronger cash flow in the quarter and allowed us to pay a higher dividend and reduced that a little bit."*

In short, growth is coming from large national accounts, international markets, and the expansion of industrial vending machines and onsite locations. Larger customers and international customers are pressuring the company for better payment terms which is boosting FAST's investment in receivables while the new distribution channels are requiring larger investments in inventory. The erosion in working capital metrics continued in the 3/19 quarter with accounts receivable DSOs rising 2.3 days to 55.3 and inventory days jumping 2.2 days to 172.5.

Management explained the increase in receivables in the 3/19 10-Q as follows:

> *"Growth in net accounts receivable in the period was also impacted by the timing of customers' [payments late in the quarter, a trend that began in the fourth quarter of 2017 and has intensified since that time period. Based on the aging of our receivables, there has been no erosion in the quality of our receivables."*

Management also stated in the conference call with regard to receivables:

> *"AR grew 15.2% in the first quarter of 2019, with customers continuing to aggressively push payments out past quarter-end. As has been the case in past quarters, we are not seeing any meaningful change in hard-to-collect balances. Reducing these annual growth rates will be an area on which to improve over the balance of the year."*

We will continue to monitor working capital trends going forward.

Gross Margin Continues to Slide

Gross margin fell 100 bps in the 3/19 to 47.7%. This is another side effect of the company's growth strategy as larger national account customers pressure for better prices and sales continue to shift to lower-margin, non-fastener products. The company also saw pressure from increased shipping costs and lower rebates from efforts to reduce inventory. For now, the move to onsite locations and vending is allowing for operating expense leverage as operating and administrative expense as a percentage of sales fell by 110 bps. We will focus on these trends more in future reviews.

Explanation of EQ Rating Scale

Rating	Explanation
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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.