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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Fastenal (FAST) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating to 4+ (Acceptable) from 3+ (Minor Concern)

We see FAST's reporting as being of high quality. Our original rating was based on deteriorating working capital ratios which reflected changes in the company's market and strategy. While the improvement in these ratios in the 6/20 quarter was admittedly artificial, we are nonetheless taking the opportunity to upgrade our rating to 4+ (Acceptable). We remind clients that our earnings quality ratings do not consider valuation or macro factors. Several questions are facing FAST in the short run including how quickly manufacturing will rebound and how much of their recent surge in safety-related products will become permanent.

- Our original rating of 3+ (Minor Concern) partly reflected the fact that FAST's larger customers were becoming a bigger part of FAST's sales mix and were pushing for extended payment terms. This resulted in rising receivable DSOs and pressure on cash flow growth. However, DSOs were essentially flat in the 12/19 quarter, rose a day in the 3/20 quarter, and declined 1.4 days in the 6/20 quarter. Management indicated that $75 million of the YOY increase in receivables was due to COVID demand and it expects those to be collected in 3Q. We would not read too much into the DSO decline in the quarter as it was largely the result of the elevated sales and not an indication of a sudden improvement in collections. However, we have never seen the company's rise in receivables as an artificial boost to sales growth, but rather a shift to larger customers that the company cannot control. We note that any sustained shift in safety sales to a new customer base could result in an overall improvement in collections.

- On the subject of receivables, FAST's accounts receivable allowances fell as a percentage of gross receivables to 1.3% from 1.4% in the previous several quarters. The allowance percentage was in the 2% range two years ago. We are not concerned about this given that it would take less than a penny per share to boost the allowance back to 2%. Also, like sales, receivables are due from larger national accounts with onsite locations which are conceivably better credit risks.

- Our other red flag for FAST was rising inventory balances to support its expanding onsite locations. Headline DSI in the 6/20 quarter fell by more than 16 days versus last year. However, the DSI ratio was distorted by a jump in cost of sales driven by a shift to lower margin safety products, lower safety margins from last-minute outsourcing to meet demand, increased rebates, and deleveraging of fixed costs. The 240 bps drop in gross margin was more than offset at the operating line by a reduction of costs, but the unusually high cost of sales deflated the DSI calculation. If conditions normalize in the next few quarters, we would not be surprised to see a slight increase in DSIs driven by the expansion of onsite locations for larger corporate accounts. Still, we are going to use this as an opportunity to raise our earnings quality rating to a 4+ (Acceptable) given that the trend towards rising DSI is indicative of a business strategy and not the unexcepted buildup of product.

- On a non-earnings quality-related matter, we had to pass along this piece of wisdom voiced by CEO Dan Florness in the conference call:

  "The other suggestion I gave to the folks… was maybe shut off the TV and get off social media. There's more garbage there than value, unfortunately. Talk to each other, talk to your customer, solve problems. That's the task of the day."

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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