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Snap-On (SNA) 3Q'19 Update
Maintain SELL

We maintain our SELL rating on SNA. The company continues to struggle to reignite much in the way of growth as modest organic growth in the US was more than offset by weakness in Europe. Earnings beat the consensus by 3 cps in the quarter but revenue missed the top-line target as the company dealt with negative FX impacts. Our original concerns remain intact and we note the following negative signs in the third-quarter results.

- Management continues to speak of lower originations of finance receivables (credit to end-customers) due to lower sales of big-ticket diagnostic products. The weak big-ticket sales is a concern in itself. Despite the slowdown in originations, finance receivable days of sales continued to rise indicating an increase in the extension of credit for the purchase of hand tools.

- Credit metrics for the finance receivables portfolio remain stable. Allowances were flat as a percentage of gross finance receivables while lower provision expense added about a penny to EPS in the quarter.

- Contract receivables represent credit extended directly to franchisees to fund, among other things, purchases of tools from SNA. Short-term contract receivable days of sales were flat year-over-year, but long-term contract receivable days rose by 3.5 indicating more credit being extended to franchisees.

- Contract receivables credit metrics showed slight sequential deterioration in the quarter with a 7 jump in past due amounts spread evenly across all time frames. Net loss rate rose 4 bps sequentially and 9 bps year-over-year. A jump in provision for bad debt expense cost the company about 2 cps, more than offsetting the boost from the decline in finance receivables provision expense.

- Inventory continued to rise with an almost ten-day year-over-year jump in DSI centered in finished goods, continuing a trend we have cited in past reviews. In the past, management has cited new product introductions and a desire to increase service levels. This quarter, it cited an influx of new orders as well. Regardless, inventories are at historic highs and the risk remains that the company will have to idle production in future quarters at the expense of future margins.

- The trend of lower amortization expense continued into the quarter, adding about a penny to EPS.

Extension of Credit Continues

Finance Receivables

SNA has noted in recent quarters that originations of finance receivables slowed versus the year-ago period, a trend which continued into the current quarter. Management noted in the call "total loan originations of $253.5 million decreased $13.5 million or 5.1%, primarily due to a decrease in originations of finance receivables, resulting from lower year-over-year Snap-on Tools franchisee sales of big-ticket items that utilize extended credit." While originations may have slowed, the rise in credit balances continues to outstrip sales growth

Remember that finance receivables represent credit extended to end customers for the purchase of big-ticket items like diagnostic equipment. The following table shows long and short-term finance receivables on a days of Tool Group sales basis.

Note that in the past we have calculated this on a days of total company sales basis to reflect the possibility that some commercial sales were financed, and this was more conservative given that the non-Tool Group sales were growing faster. However, we believe it is more appropriate to utilize Tool Group sales for the calculation of finance receivable days.

	9/28/2019	6/29/2019	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Tool Group Sales	$385.2	$405.8	$410.2	$407.4	$389.8	$411.9
ST Finance Receivables	$533.5	$529.0	$525.9	$518.5	$519.0	$514.4
ST Finance Receivables Days	126.4	119.0	117.0	116.1	121.5	114.0
LT Finance Receivables	$1,084.7	$1,089.0	$1,077.1	$1,074.4	$1,058.3	$1,051.3
LT Finance Receivables Days	257.0	244.9	239.6	240.6	247.7	232.9

While originations may have slowed, short-term finance receivable days jumped by 4.9 while long-term finance receivable days rose by over 9. Both of these numbers represent decelerations in year-over-year days of sales increases, yet the company's sales growth still appears to be receiving a tailwind from extending more credit. The company's explanation for lower originations indicates that a higher percentage of big-ticket diagnostic equipment is financed compared to other products like wrenches and sockets. Management indicated on the call that sales of hand tools have been especially strong. However, we note that while sales fell by $4.6 million from the year-ago quarter, short-term receivables jumped by $14.5 million and long-term receivables jumped by $25.7 million. The fact that finance receivables growth still outstripped revenue, which had a higher concentration of hand tools sales, seems to be indicating that a larger portion of hand tools sales are being financed than in the past.

Credit metrics for finance receivables remained stable in the quarter. Past-due finance receivables as a percentage of the total were flat or down versus the year-ago figures across all time ranges as were non-performing finance receivables and the charge-off rate. The allowance for bad debt percentage remained flat at 3.6% while lower provision expense added about a penny per share to EPS growth in the period.

Contract Receivables

A similar trend can be seen in contract receivables. Contract receivables primarily include credit extended to franchisees for working capital loans (purchases of tools from SNA), funding new franchises or van leases, and expanding existing franchises. The following table shows long and short-term contract receivables on a days of Snap-on Tool Group sales basis:

	9/28/2019	6/29/2019	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Snap-on Tools Groups Sales	$385.2	$405.8	$410.2	$407.4	$389.8	$411.9
ST Contract Receivables	$102.7	$91.5	$92.9	$98.3	$105.6	$87.6
ST Contract Days	24.3	20.6	20.7	22.0	24.7	19.4
LT Contract Receivables	$348.6	$347.5	$345.1	$344.9	$338.1	$332.6
LT Contract Days	82.6	78.1	76.8	77.3	79.1	73.7
Total Contract Receivables	451.3	439.0	438.0	443.2	443.7	420.2
Total Contract Receivables Days	106.9	98.7	97.4	99.3	103.9	93.1

While short-term contact receivable days were essentially flat year-over-year, long-term contract days rose by 3.5, indicating a continuing trend of more credit being extended to franchisees to purchase tools from SNA.

Past due contract receivables improved versus last year's third quarter with total past due receivables falling from 1.56% of the total to 0.90%. However, the 0.90% represented a slight sequential deterioration from the 6/19 quarter's 0.83% with the deterioration spread across all past due time frames. The net loss rate on contract receivables also rose to 0.22% from 0.18% in the 6/19 quarter and 0.13% in the 9/18 quarter. While not a dramatic decline, this warrants close attention in upcoming quarters.

The company increased its allowance for bad contract receivables slightly, requiring $1.5 million in incremental bad debt expense which cost the company about 2 cps in earnings.

Inventory Continue to Climb

SNA's inventories continue to climb faster than sales resulting in another almost 10-day year-over-year jump in DSI as shown below:

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Total Inventories	$753.5	$725.8	$707.0	$673.8
COGS	$453.7	$477.5	$450.1	$495.1
DSI	151.5	138.7	143.3	124.2

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Total Inventories	$690.6	$668.3	$678.8	$638.8
COGS	$444.2	$467.5	$463.9	$509.0
DSI	141.9	130.4	133.5	114.5

One can also see in the following table that the bulk of the increase in DSI was once again centered in finished goods:

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Finished Goods DSI	130.9	119.0	122.5	106.3
Work in Process DSI	11.2	10.5	10.6	10.3
Raw Materials DSI	42.3	41.8	41.0	40.9

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Finished Goods DSI	120.2	110.7	113.6	97.1
Work in Process DSI	10.7	9.5	9.8	9.7
Raw Materials DSI	42.1	39.4	39.3	36.4

Management indicated in the conference call that the increase in inventory was *"primarily to support higher levels of demand across critical industries, including demand for U.S. manufactured hand tools, new products as well as to improve service levels to our customers."*

Management also implied the increase in inventory was to match orders it received in its industrial division:

> *"Second, what makes it – the order is taken to the SFC, we're well above the sales that we had in terms of the quarter. So while orders don't necessarily equals sales, we like having stronger orders coming out of the SFC and that's why we feel pretty good that the inventory we have built as a home to go to as we roll through the future quarters."*

We continue to view the inventory increase with skepticism given how long it has been going on. If these orders do solidify in the coming quarters, we should see the buildup in DSIs level off. However, if the company must idle production to stem the increase, it will put pressure on future margins.

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