BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Snap-on (SNA) 4Q 19 Update
Maintain SELL

SNA reported earnings in line with expectations in the quarter but missed the consensus top-line target. We note the following items of concern in the quarter:

- We have noted in past reviews that SNA's inventory has been rising for the last several quarters which the company has attributed to new product introductions and higher demand for certain products. The increase in inventory days (DSIs) accelerated in the fourth quarter, rising to over 137 from just over 124 last year. The 13-day increase compares to approximately 10-day and 8-day YOY increases in the 9/19 and 6/19 quarters, respectively. Once again, the company stated that the increase was "*primarily to support the introduction of new products, higher levels of demand across critical industries, including demand for U.S. manufactured hand tools, as well as to improve service levels to our customers."* However, during the call, management also stated about the higher inventory levels: "*I think the biggest increase in inventory actually is new product introduction.* ***And the take-up pace was not as rigorous as we would like for that, and we're confident looking to the future. But as you know, we keep targeting a higher level of sales growth. And when we don't achieve it, the product is there and available but it's in inventory rather than in the sales line."*** After four straight quarters of near 10-day increases in DSIs, we believe the situation has reached the point that investors will be alarmed should the increases not at least moderate significantly going forward.

- With regards to inventory, we would point out that SNA utilized the LIFO method of inventory accounting for 42% of its total inventory as of 12/19, up from 39% a year ago. The company utilizes FIFO inventory for 100% of its international inventory and 32% of its US inventory. If we do start to see inventory balances decline over the next few quarters, the company could enjoy an artificial gross margin tailwind as it begins to match older, lower-cost LIFO layers of inventory against current sales. With almost 5 months of inventory on hand, the impact could be material.

- Short-term contract receivables days of sales were essentially flat year-over-year, but long-term contract receivables rose by almost 3 days. This is consistent with the trend over the last few quarters. Total finance receivables days rose by more than 5 days versus the year-ago quarter. This was an improvement over the mid-teens growth in the previous two quarters. The finance receivables allowance for bad debts fell to 3.65% from 3.71% with lower provision expense adding about 3 cps to earnings. On the surface, the percentage of finance receivables past due was flat, but we note that the percentage of finance receivables over 90 days past due but still accruing jumped to 1.01% from 0.96% last year. This boosted the non-performing finance receivables percentage to 1.73% from 1.69%. While not a huge jump, it is the first YOY increase in some time and this should be monitored in upcoming quarters. Contract receivables fared better with the total past due balance falling to 0.8% versus 1.8%. last year.

- SNA was required to adopt ASU No. 2016-13 under which the company must record an estimate for all credit losses based on "historical experience, current conditions and a reasonable and supportable forecast." This replaced the previous method under which the company only utilized historical loss experience to estimate its credit loss reserves. The company estimated in the 10-K that adoption in 2020 will result in a one-time increase to the allowance for doubtful accounts of $8 million with an offsetting adjustment to beginning retained earnings.

- Lower pension expense again added more than 3 cps to EPS growth in the quarter. The decline has been primarily a result of lower amortization of unrecognized losses along with a higher expected return on plan assets. However, the company stated in the 10-K that it is lowering the discount rate used to calculate pension costs to 3.4% for US plans and 2.1% for international plans from a worldwide rate of 4.2% used in 2019. As such, the company expects pension costs to increase in 2020. To put this in perspective, adjusted EPS rose by just 5 cps in the 12/19 quarter. Removing the pension expense decline in 2020 will take away a key tailwind to recent growth.

- The company disclosed in the 10-K that advertising and promotion expense fell to $47.7 million in 2019 versus $55.6 million and $55.7 million in 2018 and 2017, respectively. Advertising and promotion expense is not disclosed on a quarterly basis, but for the full year, the decline added over 11 cps to earnings.

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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