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BTN Research

March 28, 2018 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Snap-on Inc. (SNA)- Initiate at SELL

Snap-On (SNA) has been the growing target of criticism for the last couple of years. Short interest is at a noticeably high 17% of the float with onlookers citing problems including slowing growth at the company's flagship tools distribution business, increasing extension of credit to its franchisees and customers, and rising default levels. The stock price fell at the beginning of 2018 as these issues came to the forefront. However, some of the lost ground has been recovered and management was essentially declaring a turnaround in the fourth quarter, boasting of positive franchise sales growth and improving credit quality metrics. However, a closer look at the numbers indicates that the problems are not behind us.

- SNA has rapidly increased its extension of credit to its franchisees over the last several years as evident by growth in its contract receivables balances. Despite this, franchisees posted negative organic growth in 2018. SNA books revenue at the time it sells product to the franchisee which means the company could have essentially financed the stuffing of the franchise distributor channel. The recent weak sales growth could be indicating that the channel has been saturated and it will be difficult to restore growth rates to their historical levels. In addition, the accelerated depreciation for new equipment under the Tax Act likely provided a material tailwind to purchases made by the company's end users, yet organic sales growth remained weak in 2018.

- In addition to extending credit to franchisees, the company also provides financing to end-user customers via its finance receivables portfolio. Finance receivables have outgrown sales for several years. While this reversed in the first two quarters of 2018, the growth in finance receivables days once again resumed in the back half. Yields on the finance receivables portfolio exceed 17%, implying that these customers would have a difficult time getting financing anywhere else and that revenue growth would be considerably slower without the increase in credit extension.

- While the company's low debt levels could conceivably allow it to continue to grow its financing operations, it may be difficult to do so without rising losses in the portfolio. Despite management touting improved loss rates across the whole portfolio in the fourth quarter as evidence of improvement in credit quality, we note that delinquencies in the contract receivables portfolio have more than doubled versus a year ago. Contract receivables allowances as a percentage of receivables are less than 1% versus almost 2% in 2011. A boost of 50 basis points in the allowance for the total credit portfolio would cost over 14 cps in EPS.

- Finance segment operating profits have provided a huge boost to overall profit growth, rising as a percentage of total operating profit by more than 200 basis points in the last four years. Throttling back credit extension would not only mute growth in the core business, it would eliminate growth from the Finance Division as well.

- The company's core automotive service and repair market faces secular headwinds from the increasing complexity of cars forcing more repair work to dealerships and away from "mom-and-pop" shops. In addition, automakers continue to push to make it more difficult for non-OEM diagnostics equipment to be used to service their cars.

Overview of Business

SNA was founded in 1920 to develop its original interchangeable socket set and soon launched its unique mobile van distribution system which it utilized to distribute its hand tools primarily to automotive repair shops. Over the years, SNA has expanded into other specialty tool and diagnostic equipment markets and currently breaks its business down into four reporting segments whose results for the last five years are shown below:

Sales	2018	2017	2016	2015
Commercial & Industrial	$1,051.6	$986.1	$863.0	$895.5
Snap-on Tools Group	$1,613.8	$1,625.1	$1,633.9	$1,568.7
Repair Systems & Information	$1,075.3	$1,075.7	$933.5	$888.6
Financial Services	$329.7	$313.4	$281.4	$240.3
% of Sales				
Commercial & Industrial	25.8%	24.7%	23.3%	24.9%
Snap-on Tools Group	39.6%	40.6%	44.0%	43.7%
Repair Systems & Information	26.4%	26.9%	25.1%	24.7%
Financial Services	8.1%	7.8%	7.6%	6.7%

Operating Profit	2018	2017	2016	2015
Commercial & Industrial	$199.3	$186.5	$168.0	$169.4
Snap-on Tools Group	$264.2	$274.7	$281.1	$256.0
Repair Systems & Information	$342.6	$335.5	$297.8	$273.4
Financial Services	$230.1	$217.5	$198.7	$170.2

% of Operating Profit	2018	2017	2016	2015
Commercial & Industrial	19.2%	18.4%	17.8%	19.5%
Snap-on Tools Group	25.5%	27.1%	29.7%	29.5%
Repair Systems & Information	33.1%	33.1%	31.5%	31.5%
Financial Services	22.2%	21.4%	21.0%	19.6%

Organic growth rates for each segment are shown below:

	2018	2017	2016	2015	2014
Commercial & Industrial	4.1%	4.5%	0.1%	5.8%	9.5%
Snap-on Tools	-1.0%	-0.4%	5.6%	10.9%	7.6%
Repair Systems & Information	-1.4%	7.6%	4.7%	4.9%	4.9%
Financial Services	5.2%	11.3%	17.1%	11.8%	18.7%
	0.5%	3.4%	2.9%	7.1%	6.9%

Commercial & Industrial Group

The Commercial and Industrial segment serves customers including aerospace, railroads, natural resources, military, heavy-duty fleet and maintenance, and power generation industries. In addition to hand tools and power tools, the company's solutions include specialty tools, tool management, organization solutions, and sourcing services. Products are distributed either directly or through independent distributors.

Snap-On Tools Group

The Snap-on Tools Group sells the company's proprietary line of hand tools, power tools, and equipment to the company's base of franchisees who distribute via mobile vans to vehicle service and repair technicians. The company also generates revenue from initial and ongoing franchise fees which totaled $16.2 million in 2018, up from $15.2 million and $13.9

million in 2017 and 2016, respectively. At the end of 2018, the company had approximately 3,450 routes in the US and 1,350 in international markets.

Repair Systems & Information Group

The Repair Systems & Information Group sells handheld and PC-based diagnostic products, service and repair information products, parts catalogs, business management systems, and point of sales systems to vehicle service shops and OEM dealerships. Products are distributed directly and through distributor channels.

Financial Services

The Financial Services segment provides several financing programs to both franchisees and end-customers including installment sales and lease contracts to customers who need extended payment plans, and business loans and vehicle leases to franchisees.

Weakness in Snap-on Tools Group

One of the most obvious trends seen in table 1 above is the rapidly declining share of sales and profits generated by the company's flagship Snap-on Tools segment. This trend has been going on for years, but as we saw in the above table, organic growth for the segment turned abruptly negative in 2017. The following table shows the organic growth for the segment for the last eight quarters to give a more detailed perspective of the timing of the weakness:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Snap-on Tools	0.4%	0.1%	-1.5%	-2.7%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Snap-on Tools	-3.0%	-1.6%	0.5%	2.5%

We see that the year-over-year declines in organic growth started in the 9/17 quarter. In the conference calls that followed, the company discussed the slowdown and steps it was taking to combat it:

From 12/17 quarter conference call:

> *"Now, let's move to the individual operating groups and their fourth quarter results. The Tools Group. Organic sales down 3% and operating earnings of $67.3 million, representing a margin rate of 16.4%, down 120 basis points.* ***We do believe our actions to reinvigorate the van channel sales will be effective, but they didn't create improvement in the fourth quarter. In the quarter and throughout the year, however, the Tools Group did confirm the strength and the market-leading position of its van network. It wasn't evident in the recent financials, but it was clear in the franchisee health metrics we monitor each period.*** *The franchisees are strong and the turnover is low and that positivity was once again acknowledged by multiple publications, listing Snap-on as a franchise of choice."*

From the 1Q 18 conference call:

> *"We are seeing turbulence, but our van network remains strong. You can see it in the franchisee metrics. The financial and physical indicators, again this quarter, they remain favorable matching the clear optimism we see when we meet our franchisees."*

From the 2Q 18 conference call:

> ***"Now onto the Tools Group. Organic sales down 1.5% reflecting primarily a low single digit decline in the U.S. and essentially flat international results.*** *Operating earnings, $79 million, down 2.1%, an OI margin of 19.2%, lower by 30 basis points but still among the group's strongest.* ***We do believe our actions to reinvigorate the van channel are bearing fruit. Now this quarter didn't create an overall increase, but they did positively affect the U.S. franchise operations.*** *Tool Storage showed some recovery led by the new high margin midrange KCP 1422, and handheld diagnostics also made progress, authoring another increase in software sales as we roll out more Apollo and ZEUS units with the revolutionary intelligent diagnostics feature, the data package sales that accompanies most of those units builds our software "penetration, and software sales did grow again this quarter."*

From the 3Q 18 conference call:

> *“**Now on to the Tools Group. Organic sales about flat, 0.1%, but a return to growth in the U.S. operation, up low single digits. And that return to growth was offset by variation internationally**. That’s the story of the Tools Group. Operating income in the quarter was $59.3 million and that compares to $56.4 million in 2017. The OI margin was 15.2%, an 80 basis point increase. Favorable product mix, higher margin new products, software, the benefits of RCI, and the favorable foreign currency, they made the difference.”*

From the 4Q 18 conference call:

> *“Now let's talk about the Tools Group. Organic sales about flat, up 0.4%. But continued growth in the U.S. operations up low single-digits, a positive that was again offset by a decline in international operations including the UK. Operating income in the quarter was $57 million, comparing to $67.3 million in 2017. **The OI margin was 14.0%, a 240 basis point decrease. You can see that in the recent swing to unfavorable currency transaction from a positive position in the prior quarter, in product mix, and in the increased spending to strengthen franchisee support. Those were all the drivers of that margin.”***

We can see from the above discussions that the company has been fighting the slowdown in sales to its franchisees with the introduction of new products along with spending to strengthen support to franchisees which negatively impacted margins in the 12/18 quarter. While comp sales growth turned slightly positive in the last two quarters, bear in mind that this was against very easy comps and hardly signals a clear return to the 5-10% growth seen in the 2014-2016 period.

We also observe that the Tax Act provided bonus depreciation of 100% for qualified equipment placed in service after 9/27/2017 and before 12/31/2022. Qualified equipment is defined as tangible personal property with a recovery period of 20 years or less. We believe it is reasonable to assume that the Tax Act could have provided a meaningful tailwind to spending by many of the company’s customers, yet growth has remained anemic.

In addition, as we will see below, the company’s sales to franchisees have received a boost over the last few years from a rise in financing extended to franchisees.

Franchisee Revenue Recognition

SNA states the following in its 10-K regarding the timing of its revenue recognition:

> *"Snap-on recognizes revenue from the sale of tools, diagnostic and equipment products and related services based on when control of the product passes to the customer or the service is provided and is recognized at an amount that reflects the consideration expected to be received in exchange for such goods or services."*

However, it is important to realize that in transactions with franchisees, the franchisee is the customer and the company books the sale at the time the product is passed on to the franchisee. Consider the following explanation later in the 10-K:

> *"In some cases, the nature of Snap-on's contracts give rise to variable consideration, including rebates, credits, allowances for returns or other similar items that generally decrease the transaction price. These variable amounts generally are credited to the customer, based on achieving certain levels of sales activity, product returns and making payments within specific terms.*
>
> ***In the normal course of business, Snap-on allows franchisees to return product per the provisions in the franchise agreement that allow for the return of product in a saleable condition.*** *For other customers, product returns are generally not accepted unless the item is defective as manufactured. Where applicable, Snap-on establishes provisions for estimated sales returns. Estimated product returns are recorded as a reduction in reported revenues at the time of sale based upon historical product return experience and is adjusted for known trends to arrive at the amount of consideration to which Snap-on expects to receive. Variable consideration is estimated at the most likely amount that is expected to be earned. Estimated amounts are included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Estimates of variable consideration and determination of whether to include estimated amounts in the transaction price are based largely on an assessment of the anticipated performance and all information (historical, current and forecasted) that is reasonably available."*

So, revenue is booked when product is sold to franchisees and allowances for sales returns are recorded. This creates several possibilities for the distortion of economic reality. First, the franchisee sales channel (about 40% of total sales) can be stuffed when franchisees buy product from the company which builds up in their inventory. This will be an important factor as we examine franchisee financing in the next section.

Second, the franchisees can return product to SNA under certain provisions. If SNA does not adequately allow for returns when it books sales, it could result in an over-reporting of revenue. The company discloses its accrued new tool return balance on an annual basis. In 2018, the accrual jumped to $43.7 from $23.9 a year ago, an enormous increase on a 1.5% increase in sales which may indicate the company was catching up on being under-reserved in previous periods.

Trend of Increased Franchisee Financing

In addition to extending traditional trade receivables to its customers, SNA also offers financing to its customers and its franchisees through its wholly-owned finance subsidiary. The company describes the program in its 10-K as follows:

> *"Snap-on also generates revenue from various financing programs that include:* ***(i) installment sales and lease contracts arising from franchisees' customers and Snap-on customers who require financing for the purchase or lease of tools and diagnostic and equipment products on an extended-term payment plan; and (ii) business loans and vehicle leases to franchisees.*** *The decision to finance through Snap-on or another financing source is solely by election of the customer. When assessing customers for potential financing, Snap-on considers various factors regarding ability to pay, including the customers' financial condition, debt servicing ability, past payment experience, and credit bureau and proprietary Snap-on credit model information, as well as the value of the underlying collateral.*

Elsewhere in the 10-K, the company provides a more detailed definition of contract receivables versus and finance receivables:

> ***"Snap-on's finance receivables are comprised of extended-term installment payment contracts to both technicians and independent shop owners (i.e., franchisees' customers) to enable them to purchase tools and diagnostic and equipment products***

on an extended-term payment plan, generally with average payment terms of approximately four years. *Finance receivables are generally secured by the underlying tools and/or diagnostic or equipment products financed.*

Snap-on's contract receivables, with payment terms of up to 10 years, are comprised of extended-term installment payment contracts to a broad base of customers worldwide, including shop owners, both independents and national chains, for their purchase of tools and diagnostic and equipment products. Contract receivables also include extended-term installment loans to franchisees to meet a number of financing needs, including working capital loans, loans to enable new franchisees to fund the purchase of the franchise and van leases, or the expansion of an existing franchise. *Contract receivables are generally secured by the underlying tools and/or diagnostic or equipment products financed and, for installment loans to franchisees, other franchisee assets."*

The company does not break out how much of contract receivables represent loans to franchisees, but given various comments, and characteristics of the loans (9% yield for contract receivables vs. 17% for finance receivables) indicates to us that the bulk of the contract receivables are loans to franchisees.

The following table shows the calculation of contract receivables days of Snap-on Tools Group revenues for the last five years:

	2018	2017	2016	2015	2014
Snap-on-Tools Group Sales	$1,613.8	$1,625.1	$1,633.9	$1,568.7	$1,455.2
ST Contract Receivables	$98.3	$96.8	$88.1	$82.1	$74.5
Days of Sales	21.9	21.4	19.4	18.8	18.4
LT Contract Receivables	$344.9	$322.6	$286.7	$266.6	$242.0
Days of Sales	76.9	71.5	63.2	61.2	59.9
Total Contract Receivables	$443.2	$419.4	$374.8	$348.7	$316.5
	98.9	92.9	82.6	80.0	78.3

We see that the company rapidly expanded its contract receivables balances over the last few years with a marked acceleration in 2017 which corresponds to the slowdown in sales

to franchisees. In addition, we can see that the bulk of the increase in contract receivable days is in long-term financing. We can also see in the table below that the trend of increasing contract receivable days continued on a quarterly basis throughout 2018:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Snap-on Tools Groups Sales	$407.4	$389.8	$411.9	$404.7
ST Contract Receivables	$98.3	$105.6	$87.6	$92.0
ST Contract Days	22.0	24.7	19.4	20.7
LT Contract Receivables	$344.9	$338.1	$332.6	$326.1
LT Contract Days	77.3	79.1	73.7	73.5
Total Contract Receivables	443.2	443.7	420.2	418.1
Total Contract Receivables Days	99.3	103.9	93.1	94.3

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Snap-on Tools Groups Sales	$409.2	$392.7	$413.8	$409.4
ST Contract Receivables	$96.8	$99.8	$82.4	$84.5
ST Contract Days	21.6	23.2	18.2	18.8
LT Contract Receivables	$322.6	$310.4	$299.4	$292.6
LT Contract Days	71.9	72.1	66.0	65.2
Total Contract Receivables	$419.4	$410.2	$381.8	$377.1
Total Contract Receivables Days	93.5	95.3	84.2	84.1

Keep in mind that from SNA's perspective, for franchise sales, the customer is not the shop that buys a wrench but rather the franchisee who stocks the wrench. Therefore, SNA has essentially been extending credit to its own customers to buy its products.

This financing can take the form of working capital loans, business loans or vehicle leases. We found the following quote from the 3Q 17 conference call interesting:

> *"Secondly, we're expanding the space on the vans. One of the reasons you see, in a lot of cases, you can see it reflected in franchise finance, is that the* ***van drivers are buying or leasing bigger trucks, 20-foot trucks, not the 16-foot trucks, giving them more retail space.*** *And we believe these kinds of things -- better product, more space and then we're working on helping them with their time so they have more time to sell. That's what wins for us."*

If franchisees are using their contract financing to lease or buy bigger vans which they then stock with more SNA products, it is very concerning that we have not seen a bigger jump in organic sales growth to franchisees.

In the next section, we will take a look at the credit metrics for the contract receivables portfolio.

Contract Receivables Metrics Deteriorating

SNA attracted some negative attention in late 2017 from increasing loss rates in its finance receivables portfolio which we will discuss in a section below. Management is touting recent improvement in its finance portfolio delinquency rates. However, management's quarterly disclosure shows the delinquency rates for its finance receivables (which it refers to as "extended credit") as well as delinquency rates for the total portfolio. The finance receivables balance is roughly four times the size of the contract receivables balance, so the credit metrics of the finance receivables dominates the total portfolio figures. As we will examine in the next section, while credit metrics of the finance receivables portfolio are improving on the surface, this could have been helped by their recent rapid growth. Meanwhile, the credit metrics for the contract receivables portfolio are getting worse by the quarter despite growth in the portfolio outstripping sales to franchisees.

Delinquency data for contract receivables is shown below:

Contract Receivables Metrics	12/29/2018	09/29/2018	06/30/2018	03/31/2018
30-59 days past due	0.38%	0.40%	0.47%	0.38%
60-90 days past due	0.27%	0.31%	0.21%	0.21%
>90 days past due	1.16%	0.85%	0.82%	0.57%
Total past due	1.81%	1.56%	1.51%	1.16%
>90 Days and Still Accruing	0.04%	0.04%	0.05%	0.09%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
30-59 days past due	0.28%	0.34%	0.36%	0.29%
60-90 days past due	0.14%	0.17%	0.21%	0.26%
>90 days past due	0.45%	0.41%	0.44%	0.52%
Total past due	0.87%	0.91%	1.01%	1.07%
>90 Days and Still Accruing	0.14%	0.14%	0.18%	0.13%

Total percentage of past due contract receivables more than doubled from the 12/17 to the 12/18 quarter and jumped 25 bps sequentially. Similar deterioration can be seen in the percentage of non-performing loans and loans on non-accrual status:

Contract Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Performing	98.66%	98.95%	98.94%	99.27%
Nonperforming	1.34%	1.05%	1.06%	0.73%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Performing	99.46%	99.47%	99.4%	99.4%
Nonperforming	0.54%	0.53%	0.6%	0.6%

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Contract Receivables Non-Accrual Status %	1.30%	1.00%	1.01%	0.64%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Contract Receivables Non-Accrual Status %	0.40%	0.41%	0.41%	0.47%

Another item to consider is that the number of franchisees has remained essentially flat. While SNA does not break out the exact number of franchisees, it does give an approximate route count in its 10-Ks which disclose the following:

approximate route count	2018	2017	2016	2015
US	3,450	3,500	3,500	3,500
International	1,350	1,400	1,400	1,300
Total	4,800	4,900	4,900	4,800
Franchise Fees Collected	$16.2	$15.2	$13.9	$12.1

These numbers are approximate and the decline in routes in 2018 was likely exaggerated by rounding. The flat-to-down trend in the number of franchisees indicates that the debt per franchisee is increasing rather than debt being extended to open new franchised routes.

We are also puzzled by the increase in franchise fees. The company charges an initial franchise fee when a franchise is established as well as an ongoing monthly fee. The fee revenue has been growing materially while the number of franchisees is not even holding

steady. This implies either the company is regularly raising its fees, or possibly turnover among its franchisee base.

The skyrocketing rate of delinquencies, non-performing rates and non-accrual contract receivables are very concerning and not at all indicative of improving health in the portfolio. It appears that SNA has been supporting its franchisees through aggressive extension of loans and increased spending to support the franchisees. It is quite reasonable to think that this money was used by franchisees to increase their inventory levels and lease new trucks which required even more purchases of the company's products to stock. Despite this, organic growth in sales to franchisees grew by less than half a percentage point in the 12/18 quarter despite being up against a very easy comparison. To top it all off, it appears a rapidly increasing percentage of franchisees are having trouble staying current on those loans.

Increase in Customer Financing

As discussed above, the company extends credit directly to its franchisees which is included in its contract receivables balances. However, the largest part of its finance portfolio is its finance receivables which mostly represent loans directly to customers including franchisees' customers.

The following table shows the calculation of finance receivables days of Commercial & Industrial Group and Repair Systems & Information Groups sales for the last five years:

	2018	2017	2016	2015	2014
Commercial & Industrial Group Sales	$1,051.6	$986.1	$863.0	$895.5	$952.1
Repair Systems & Information Group Sales	$1,075.3	$1,075.7	$933.5	$888.6	$870.4
	$2,126.9	$2,061.8	$1,796.5	$1,784.1	$1,822.5
ST Finance Receivables	$518.5	$505.4	$472.5	$447.3	$402.4
ST Finance Receivables Days	87.8	88.2	94.7	90.3	79.5
LT Finance Receivables	$1,074.4	$1,039.2	$934.5	$772.7	$650.5
LT Finance Receivables Days	181.9	181.4	187.3	155.9	128.5
Total Finance Receivables	$1,592.9	$1,544.6	$1,407.0	$1,220.0	$1,052.9
Total Finance Receivables Days	269.6	269.7	281.9	246.2	208.0

Total finance receivables days have risen almost 90 days in the last five years, indicating a rapid increase in the use of customer financing to support sales growth. While total finance

receivable days were flat sequentially in 2018, when we look at them on a quarterly basis, we see the year-over-year increase resumed in the last two quarters:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Commercial & Industrial Group Sales	$270.0	$255.7	$267.1	$258.8
Repair Systems & Information Group Sales	$275.1	$252.6	$275.6	$272.0
	$545.1	$508.3	$542.7	$530.8
ST Finance Receivables	$518.5	$519.0	$514.4	$512.2
ST Finance Receivables Days	86.8	93.2	86.5	88.1
LT Finance Receivables	$1,074.4	$1,058.3	$1,051.3	$1,035.9
LT Finance Receivables Days	179.9	190.0	176.8	178.1

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Commercial & Industrial Group Sales	$273.2	$250.8	$236.5	$225.6
Repair Systems & Information Group Sales	$292.2	$260.3	$271.1	$252.1
	$565.4	$511.1	$507.6	$477.7
ST Finance Receivables	$505.4	$505.8	$496.5	$484.7
ST Finance Receivables Days	81.6	90.3	89.3	92.6
LT Finance Receivables	$1,039.2	$1,018.6	$998.6	$966.3
LT Finance Receivables Days	167.7	181.9	179.5	184.6

The following table shows delinquency data for the finance receivable portfolio:

Finance Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
30-59 days past due	1.17%	1.08%	1.04%	0.82%
60-90 days past due	0.73%	0.74%	0.65%	0.62%
>90 days past due	1.23%	1.19%	1.00%	1.25%
Total past due	3.13%	3.00%	2.69%	2.70%
>90 Days and Still Accruing	0.96%	0.94%	0.76%	0.98%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
30-59 days past due	1.21%	1.01%	0.99%	0.80%
60-90 days past due	0.87%	0.73%	0.63%	0.59%
>90 days past due	1.26%	1.22%	0.94%	1.12%
Total past due	3.33%	2.97%	2.57%	2.50%
>90 Days and Still Accruing	0.96%	0.98%	0.72%	0.84%

While the year-over-year increase in delinquencies reversed in the 9/18 quarter, note that the improvement corresponds to the increase in finance receivables that started in the 9/18 quarter. This likely improved the delinquency metrics by virtue of simply including less seasoned receivables in the mix. Similar trends are seen in the non-performing and non-accrual detail below:

Finance Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Performing	98.31%	98.30%	98.49%	98.26%
Nonperforming	1.69%	1.70%	1.51%	1.74%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Performing	98.25%	98.24%	98.49%	98.34%
Nonperforming	1.75%	1.76%	1.51%	1.66%

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Finance Receivables Non-Accruals Status %	0.73%	0.76%	0.76%	0.75%
	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Finance Receivables Non-Accruals Status %	0.79%	0.80%	0.79%	0.82%

SNA has clearly utilized increasing customer financing to drive growth in revenue from external customers. In addition, the company's Financial Services segment has become an increasing percentage of total profits as shown in the following table:

	2018	2017	2016
Operating Earnings Before Financial Services	**$726.0**	**$664.6**	**$662.4**
Adjustment for Legal (benefit)/Expense	-$4.3	$45.9	
Adjustment for Currency	-$4.4	$8.6	$21.5
Adjusted Operating Earnings Before Financial Services	$717.3	$719.1	$683.9
% of Total Adjusted Operating Earnings	75.7%	76.8%	77.5%
Operating Earnings From Financial Services	**$230.1**	**$217.5**	**$198.7**
% of Total Adjusted Operating Earnings	24.3%	23.2%	22.5%
Total Adjusted Operating Earnings	$947.4	$936.6	$882.6

The total reported operating income has not only been boosted by the increase in extension of credit to franchisees and external customers, but also by the growth in finance segment

profits. This could easily reverse should the company have to throttle back on growth in the portfolio, or if bad debt expense were to rise. The following table shows the reserve percentages for finance receivables and contract receivables:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018	12/30/2017	09/30/2017
Finance Receivables Allowance %	3.71%	3.64%	3.63%	3.63%	3.53%	3.43%
Contract Receivables Allowance %	0.96%	1.03%	1.13%	1.09%	1.08%	1.23%

Despite the rapid increase in delinquencies, contract receivables allowance for bad debts as a percentage of receivables has been declining. Investors should remember that in 2011, the contract receivables allowance percentage was 2.4% and finance receivables allowance percentage was 3.7%. For perspective, if the allowance percentage for the whole finance portfolio increased by 50 basis points, it would cost about 14.5 cps in charges.

Granted, SNA's debt load is manageable at just over 1 times EBITDA, so leverage is not an immediate barrier to continuing to extend credit. However, if the credit portfolio continues to deteriorate and losses mount, it will begin to limit the company's ability to spur the top line with continued credit extension without causing obvious problems. To put this in perspective, in the 12/18 quarter Commercial and Industrial revenue plus Repair Systems & Information revenue fell by over $20 million versus the year-ago quarter. However, finance receivables jumped by more than $35 million in the same time frame which implies that the revenue decline could have more than doubled without the increase in credit extension.

Headwinds to Growth for Independent Repair Related Services

As the bulk of the company's business relates to automotive service and repair, investors should be aware of the challenges facing these markets. The Bureau of Labor Statistics (BLS) predicts that the number of automotive service technicians will grow by 6% between 2016 and 2026. This is roughly in-line with the average growth in other occupations. However, the BLS also notes:

> *"The number of vehicles in use is expected to continue to rise. More entry-level service technicians will be needed to perform basic maintenance and repair, such as replacing brake pads and changing oil, on these vehicles.* ***New technologies, however, such as electric vehicles, may limit future demand for automotive service technicians and***

mechanics because these vehicles will be more reliable and thus require less frequent maintenance and repair."

The increasing complexity of cars is causing more car owners to seek service and repairs at dealerships rather than mom-and-pop service shops. This phenomenon is documented in the attached 6/18/18 article of *Auto News.* Also, consider this 9/5/17 article from Quartz entitled The Connected Car of the Future Could Kill off the Local Auto Repair Shop. We found this quote very interesting:

> *"Some worry that eventually, services like GM's Onstar could share data they receive from connected cars with local GM dealers, who offer repairs and maintenance service, but they won't necessarily share this type of information with Dykstra or the other 180,000 independent auto repair businesses in the United States, which could leave them at a disadvantage. Or worse, manufacturers will move data that shops need to fix cars, some of which is currently accessible by the OBD port, to these new connected systems, where it will be less accessible to independent businesses."*

Likewise, for years automakers have been moving towards making the software in their cars more difficult to access through encryption and seeking to have their code copyright protected. This trend will likely continue under the guise of protecting cars from being hacked, but it will also make it more difficult for makers of third-party diagnostic tools to make and sell universal diagnostic equipment. The result will likely be even more pressure for owners to get their cars fixed at the dealership, thus bypassing suppliers like SNA.

It is also important to realize that a mechanic employed by a mom-and-pop shop often is required to provide his own tools. The larger the shop or dealership, the more likely it is it will be able to provide a full range of its own tools. As business shifts to these larger shops, it is likely putting more pressure on the Snap-on franchisees who sell to mechanics at smaller shops.

Another obstacle to growth is the fact that most of these tools last a very long time. Once someone buys a socket set, they will not need to replace it anytime soon.

> *'Dealerships will send you a message that says 'your oil sensor says that your oil is ready' and we have a bay open at this time, come on in,'" says Greg Potter, the executive manager of the Equipment and Tool Institute, a trade association of automotive tool and equipment manufacturers. "It's a good idea, a good model. But very difficult to compete with."*

That would impact not only repair service businesses like Dykstra's, but also the companies that sell these shops parts and tools, *which together with repair shops that aren't associated with a dealership are called the "aftermarket."*

Disclosure

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