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Snap-on Inc. (SNA)
Maintain SELL

After a review of the 3/20 quarter, we maintain our SELL rating on SNA. While the company saw some areas of its business such as military, general industry, and trucking holdup well, other areas are facing more pressure. While mechanics are deemed to be essential workers and have been allowed to continue to work during the lockdown, people are driving their cars much less. Transportation data provider INRIX reported that total miles driven (including the increase in long-haul truck traffic) were down 38% for March21-27 versus February 22-28. There is a case to be made that miles driven will rebound quickly when the restrictions are lifted and may receive a boost from people being reluctant to fly. However, there is also a potential for more people to keep working from home and skip the daily commute. The medium and long-term outlooks are unclear.

Regardless of the long-term impact, much of the company's customer base (independent auto shops) has been facing increasing pressure from competition, complexity of new cars driving work to dealerships, plus the longer-term threat of electric cars. The extension of credit continues and there is evidence the customer base is more leveraged than it was during the last crisis. We note the quarter also received some one-time boosts from option accounting.

- Finance receivable days jumped by 35 as the balance rose while sales declined. Originations were up 1.2% which the company attributed to an increase in sales of big-ticket items.

- Management noted during the call that loss rates in 2008-2009 rose to 4%. The allowance for bad debts as a percentage of finance receivables is currently 4.1%. However, total contract receivables and finance receivable days have risen to 202 in 2019 from 100 in 2010. While some of this company-extended credit may have been replacing other sources, the fact that the rates on finance

receivables are in the 17-18% range may indicate that the customers had nowhere else to turn and therefore much of this debt may be incremental leverage on customers' balances sheets. With potentially higher leverage and a decade of mounting secular pressure on their businesses, it remains to be seen if customer defaults will result in more charges for SNA.

- Stock-based compensation expense fell by approximately 9 cps in the 3/20 quarter. Evidence suggests this was due to the stock price decline leading to updated estimates for stock option exercises which resulted in artificially low compensation expense. This will represent a significant headwind in upcoming quarters if the stock recovers significantly and estimates are adjusted the other way. We discuss the accounting in detail below.

- The lower stock price also artificially boosted reported results by causing a larger number of shares to be excluded from the fully-diluted shares count due to their becoming anti-dilutive. This added another 10 cps to the quarter and, like stock-based compensation expense, will reverse when the stock price recovers.

How High Can Finance Losses Go?

We have documented in the past how much of SNA's sales growth has been driven by the extension of credit to both its franchisees (Contract Receivables) and its end customers (Finance Receivables). We will focus this discussion on finance receivables given they are by far the largest component of the company's credit portfolio and they appear to be the most at risk given their high yields (17.7% in the 3/20 quarter). These loans are made to both auto repair shops as well as industrial customers. It is logical to assume that the bulk of these loans are to smaller customers on a tight budget. We doubt major Honda dealerships and Lockheed Martin are paying credit card levels of interest to finance the purchase of their hand tools and diagnostic systems.

Despite the decline in sales in the quarter, the company's extension of finance receivables increased as seen in the following table:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Sales	$852.2	$955.2	$901.8	$951.3
ST Finance Receivables	$514.3	$530.1	$533.5	$529.0
ST Finance Receivables Days	55.1	50.6	54.0	50.7
LT Finance Receivables	$1,101.9	$1,103.5	$1,084.7	$1,089.0
LT Finance Receivables Days	118.0	105.4	109.8	104.5
Total Finance Receivables	$1,616.2	$1,633.6	$1,618.2	$1,618.0
Total Finance Receivables Days	173.1	156.1	163.7	155.2

	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Sales	$921.7	$952.5	$898.1	$954.6
ST Finance Receivables	$525.9	$518.5	$519.0	$514.4
ST Finance Receivables Days	52.1	49.7	52.7	49.2
LT Finance Receivables	$1,077.1	$1,074.4	$1,058.3	$1,051.3
LT Finance Receivables Days	106.6	102.9	107.5	100.5
Total Finance Receivables	$1,603.0	$1,592.9	$1,577.3	$1,565.7
Total Finance Receivables Days	158.7	152.6	160.3	149.7

Total finance receivables days of sales rose by more than 14 days versus the year-ago quarter due to long-term finance receivables rising while sales declined. The company noted that:

> *"Total loan originations of $255.6 million increased $3.1 million, or 1.2%, primarily due to a 1.1% increase in originations of finance receivables, and a 2% increase in originations of contract receivables, principally franchise finance. In the United States, extended originations were up 2% larger reflecting higher franchisee sales of big-ticket products."*

Clearly, the increase in finance receivables days of sales was not a result of a slow runoff of existing receivables but rather more from an increase in organizations. While the first two months of the quarter were strong, sales reportedly fell off in the last four weeks as the COVID-19 quarantine took hold, implying that the growth in the first two months was a result of an unusual, credit-fueled big-ticket activity.

We can already start to see the shutdown's impact on credit statistics in the finance receivables portfolio, although they are not severe at this point:

Finance Receivables	3/28/2020	12/28/2019	9/28/2019	6/29/2019
30-59 days past due	1.07%	1.16%	1.07%	0.95%
60-90 days past due	0.68%	0.71%	0.67%	0.61%
>90 days past due	1.23%	1.26%	1.19%	0.97%
Total past due	2.98%	3.13%	2.92%	2.53%
>90 Days and Still Accruing	0.97%	1.01%	0.93%	0.75%

Finance Receivables	3/30/2019	12/29/2018	9/29/2018	6/30/2018
30-59 days past due	0.85%	1.17%	1.08%	1.04%
60-90 days past due	0.58%	0.73%	0.74%	0.65%
>90 days past due	1.17%	1.23%	1.19%	1.00%
Total past due	2.60%	3.13%	3.00%	2.69%
>90 Days and Still Accruing	0.90%	0.96%	0.94%	0.76%

Total past due finance receivables as a percentage of the total rose by almost 40 basis points. Meanwhile, loss rates also crept up:

Finance Receivables	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Charge-Off Rate	-0.94%	-0.90%	-0.77%	-0.83%
Recovery Rate	0.12%	0.11%	0.11%	0.12%
Net Loss Rate	-0.82%	-0.79%	-0.66%	-0.71%

Finance Receivables	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Charge-Off Rate	-0.90%	-0.95%	-0.81%	-0.90%
Recovery Rate	0.12%	0.11%	0.10%	0.10%
Net Loss Rate	-0.78%	-0.84%	-0.71%	-0.79%

After a string of improving quarterly net loss rates, the 3/20 quarter saw a slight 4 bps deterioration. The company did not disclose charge-off and recovery data in the 2008-2009 SEC filings so we cannot make an exact “apples-to-apples” comparison. However, management was asked about the 2008 loss rates on the conference call:

Analyst:

> “Got it and last question, just remind us what – just going back to '08 through 2010, what the 60 day delinquency numbers went up to from a percentage standpoint and the losses – the total losses in the portfolio on a trailing 12 month basis. Thanks.”

Aldo Pagliari:

> "Scott. I don't have the exact delinquency numbers in front of me. But they would be not so dissimilar to what you're seeing today. **But the losses went up about 100 basis points. I think I mentioned earlier on the call, they hit a peak in a negative sense in Q4 of '09, and then moved from around 3% over the portfolio to around 4%**. And then they declined back to below 3% until recent times, so that gives you a range I guess or a feel for what it might be like."

In the table above, the quarterly loss rate of 0.82% corresponds to an annual loss rate of approximately 3.3% and loss rates eventually hit 4% in the Great Recession. Management also noted it would be quick to help struggling shops by extending the terms and providing other concessions.

We are not concluding that the current situation will play itself out like the Great Recession, but remember that many of these customers are small independent shops that have been struggling from competition, more reliable cars, and a move towards getting cars serviced at dealerships due to increasing complexity. In addition, SNA's own financials provide a clue that many of these customers may be considerably more leveraged than they were ten years ago. The following table shows total outstanding contract and finance receivables on a days of sales basis for the last ten years:

	2019	2018	2017	2016	2015
Sales	$3,730.0	$3,740.7	$3,686.9	$3,430.4	$3,352.8
ST Finance	$530.1	$518.5	$505.4	$472.5	$447.3
ST Contract	$100.7	$98.3	$96.8	$88.1	$82.1
LT Finance	$1,103.5	$1,074.4	$1,039.2	$934.5	$727.7
LT Contract	$360.1	$344.9	$322.6	$286.7	$266.6
Total Finance and Contract Receivables	$2,094.4	$2,036.1	$1,964.0	$1,781.8	$1,523.7
Days of Sales	202	196	192	187	164

	2014	2013	2012	2011	2010
Sales	$3,277.7	$3,056.5	$2,937.9	$2,854.2	$2,619.2
ST Finance	$402.4	$374.6	$323.1	$277.2	$215.3
ST Contract	$74.5	$68.4	$62.7	$49.7	$45.6
LT Finance	$650.5	$560.6	$494.6	$431.8	$345.7
LT Contract	$242.0	$217.1	$194.4	$165.1	$119.3
Total Finance and Contract Receivables	$1,369.4	$1,220.7	$1,074.8	$923.8	$725.9
Days of Sales	150	144	132	117	100

This highlights one of our original concerns with the company which is the degree to which sales growth has been driven by extending more credit to its customers. Some of the credit extended by SNA could very well have been replacing other forms of borrowing and therefore does not represent new leverage on the customers' balance sheets. However, given that these customers are paying 17-18% in interest to SNA to finance equipment indicates that they likely could not have received this credit anywhere else. Therefore, we believe it is a logical conclusion that a decent part of the new credit does represent incremental leverage for customers meaning that even if the economy returns to normal relatively quickly, loss rates on the portfolio could meet or exceed those experienced in the Great Recession.

SNA did increase its provision expense for finance receivables by $3.8 million in the 3/20 quarter along with an additional $5.2 million related to the adoption of ASU No 2016-13 which requires the company to forecast credit losses on a forward-looking basis rather than using just historical trends. However, it also only attributed $2.1 million of the incremental increase to the impact of COVID-19. (Massive revenue losses for a period of months leading to only $2.1 million on a $2 billion portfolio seems a little unrealistic.) The provision expense brought the allowance for bad debts to

4.1% of the finance receivables portfolio at the end of the 3/20 quarter which is presumably on par with losses suffered in the 2008-2009 time period. Still, with the higher degree of leverage and the possibility of miles driven being suppressed for some time we would not be surprised to see higher than expected expenses out of the credit portfolio over the next couple of quarters.

Stock-Based Compensation Down Sharply

SNA enjoyed a sharp decline in stock-based compensation expense in the 3/20 quarter as seen in the following table:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Stock-Based Comp Expense	$1.1	$5.1	$4.6	$6.8

	3/28/2020	12/28/2019	9/28/2019	6/29/2019
Stock-Based Comp Expense	$7.3	$4.6	$8.0	$7.9

The lower stock-based compensation expense added about 9 cps to EPS growth in the period. This is a phenomenon we expect to see a lot in the next couple of quarters due to the sharp price declines in most companies' share prices. To help in understanding the mechanics behind the sharp decline in stock-based compensation we present a quick review of stock option accounting.

When a company issues stock options to employees, it estimates the intrinsic value of the option at the time of grant. Calculating the intrinsic value is usually done utilizing the Black-Scholes option pricing model which requires many complex estimates including the volatility of the stock price over the contract period as well as estimates for the rate of forfeiture and exercise of options. The intrinsic value is then capitalized and amortized over the expected time over which the options are expected to be outstanding. Changes to these assumptions can significantly impact the periodic options expense. For a simplified example, let's say a company issues stock options in Year 1 with an estimated intrinsic value of $300 which is to be amortized over 3 years. The original assumptions include the expectation that 80% of options will be exercised over that time period. Over the first two years, actual experience matches the original expectations and there are no changes to the original intrinsic value estimate. The company recognizes $100 of stock option expense each

year. However, at the end of year 2, there is an unexpected decline in the company's stock price, driving many of the unexercised options out of the money. The company now estimates only 60% of the options will be exercised over three years, reducing the intrinsic value of the original options grant to $225. Since $200 million has already been expensed, there is only $25 million of unamortized option expense left to be recognized in Year 3 resulting in a sharp drop in stock-based compensation expense.

While SNA does not give any detail about the decline in stock compensation expense, the evidence indicates that something similar to the above example is at play. SNA discloses the amount of unamortized stock-based compensation for the various compensation types (stock options, performance share units, and stock appreciation rights) at the end of each quarter as well as the expected average amortization period. This is disclosed in the following table for the last three quarters:

	3/28/2020	12/28/2019	9/28/2019
Unamortized Stock Option Expense	$22.6	$15.6	$19.4
Average period (in years)	2.2	1.4	1.7
Implied Quarterly Expense	$2.6	$2.8	$2.9
Unamortized PSUs	$10.2	$7.3	$12.0
Average period (in years)	2.2	1.6	1.8
Implied Quarterly Expense	$1.2	$1.1	$1.7
Unamortized SARs	$4.0	$0.0	$3.2
Average period (in years)	2.2	1.5	1.7
Implied Quarterly Expense	$0.5	$0.0	$0.5

We see at the end of the 12/19 quarter that the implied quarterly amortization for the three major stock-based compensation expense components based on then-current expectations totaled $3.9 million ($2.8M +$1.1 M). However, stock compensation expense was only $1.1 million in the 3/19 period which was almost certainly due to the stock price decline reducing the estimate for stock option exercises on previous grants which lowered their estimated intrinsic values. However, at the end of the 3/19 quarter, the expected quarterly amortization was back up to $4.3 million as expectations for awards granted in the first quarter would incorporate current stock prices.

We should point out that while this dynamic worked in the company's favor this quarter, it is likely to work against it in a few quarters if the stock price recovers

significantly and forces an increase in the estimate of the percentage of options that will ultimately be exercised.

Removal of Anti-Dilutive Shares Adds Another Artificial Boost

We discussed above how SNA's sharp stock price decline in the first quarter led to lower stock compensation expense. Another related side effect to lower stock prices is an increase in the number of option-related shares that are qualified as anti-dilutive. When a company calculates its diluted share base every period, it adds the number of dilutive securities to the outstanding share base. This includes potentially exercisable options under share-based compensation plans. However, if a security is anti-dilutive (its exercise would increase EPS), it is excluded from the diluted share count. Out of the money options under share-based compensation plans are anti-dilutive and therefore excluded from the diluted share count. The following table shows the components of the diluted share count for the last five quarters:

	3/28/2020	12/28/2019	9/28/2019	6/29/2019	3/30/2019
Weighted Average Diluted Shares	55,048,368	55,400,000	55,656,942	56,040,484	56,305,157
Antidilutive Shares Excluded	2,304,236	1,215,695	1,223,983	1,223,467	1,233,467
W/Average Shares Adj. for Antidilution	57,352,604	56,615,695	56,880,925	57,263,951	57,538,624
Growth in Reported WA Shares	-2.2%	-2.1%	-2.9%	-2.3%	
	-0.3%	-1.2%	-2.0%	-2.3%	
Non-GAAP Net Income	$143,200,000				
Reported Non-GAAP EPS	$2.60				
Non-GAAP EPS Adjusted for Antidilution	$2.50				

We see that there was a large spike in antidilutive shares in the 3/20 quarter as a result of the company's stock price decline. If we add the excluded shares back to the diluted share count, we see that rather than a 2.2% decline in diluted shares, the 3/20 quarter saw only a 0.3% decline. The exclusion of the additional shares resulted in a 10 cps increase in reported diluted EPS. Like the stock option expense above, this could reverse in upcoming quarters if a stock price recovery results in the shares related to these options being added back to the weighted average share base.

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.

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