BEHIND THE NUMBERS
Quality of Earnings Analysis

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Snap-on Inc. (SNA)
Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating on SNA of 4+ (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

SNA reported EPS of $3.50 in the 3/21 quarter which was 40 cps ahead of consensus targets with revenue surpassing the hurdle by more than $90 million.

We saw no meaningful quality issues with the quarter. Revenue rose by more than 20% with organic growth of 16.3%. All three segments posted strong organic growth and higher than pre-pandemic levels.

- Despite the 25% organic revenue growth in the Tools segment and 8% organic growth in Repair Systems segment, credit originations rose by just 2.4%. This raised some alarm on the call as credit originations have been used by some as a proxy of sales from franchisees to mechanics and repair shops. (Remember that company automotive tool-related revenue represents sales to franchisees, not to end-users.) However, management indicated in the call that the volume of sales to franchisees approximated franchisee sales to end-users and that the disparity between organic growth and originations is a result of customers utilizing cash for a bigger percentage of purchases. This may be at least in part due to stimulus payments putting more cash in the hands of mechanics and small shop owners. If this is the case, this could be a short-to-medium term positive for future demand as customers have unused borrowing capacity to help fuel future purchases.

- Credit metrics continue to improve as past-due contracts receivables fell to 0.37% of the total while past due finance receivables fell to 2.27%, the lowest in years (except for the June 2020 quarter in which management offering credit deferral for some customers in the pandemic.) Meanwhile, the allowance percentage was 1.9% for contract receivables and 4.4% for finance receivables, both above pre-pandemic levels. Note that lower provision expense boosted EPS by about 10 cps but we assume much of this was anticipated by analysts' models. With reserves still at somewhat elevated levels, we will be watching for any unusual takedowns going forward which could materially boost earnings.

- Inventory days of sales ended the quarter at 130 days compared to 160 in the year-ago quarter and 142 in the 3/19 quarter. If management's assessment that there is not a buildup of inventory at franchisees is correct and demand from end-user remains strong, the company will have to spend cash to rebuild inventories. Note that every one-day increase in DSI takes about $6 million in cash.

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 Concern)- 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 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 upcoming quarters. 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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