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Snap-on Inc. (SNA) – Update
Maintain SELL

Snap-On's (SNA-$154.11) 6/19 adjusted EPS beat the consensus by a penny. However, we continue to see warning signs in the company's results.

- Contract receivables days of Tool Group sales rose by 5.6 over the year-ago quarter. These balances include financing to franchisees to fund, among other things, purchases of tools from SNA. Past due contract receivables as a percentage of the total fell to 0.83% compared to 1.51% a year ago and essentially flat with the previous quarter. However, the charge-off rate jumped by 11 basis points which helped keep the past-due amount in the quarter down.

- While management noted that finance receivable originations declined due to lower big-ticket sales, days of total sales jumped by 5 versus the year-ago quarter. Past due finance receivables remained stable, but lower provision expense added about 2.3 cps to EPS.

- Inventory days continued to climb, jumping 8 days over the 6/18 quarter. Management blamed the rising inventories on multiple factors including new product introductions, increased project-based activity, and striving to improve service levels. However, the current DSI level in the 140 range has risen steadily from the low 100s seen in 2016. While tools to do not spoil and are not subject rapid obsolescence, we remain concerned that the buildup could lead to reduced production levels which could hurt margins in the future. We also note that the company utilizes FIFO inventory for about 61% of its total inventories and about 35% of US inventories. This makes us less concerned that results are artificially benefitting from expensing older, lower-cost inventory in recent periods.

- Lower pension expense added 3.2 cps to EPS in the quarter due to higher expected return on plan assets and lower amortization of prior loss.

- Lower amortization of intangibles added about 1.4 cps to EPS in the quarter. Gross internally developed software dropped significantly in the 12/18 quarter with a like decline in accumulated amortization although we saw no mention of an impairment or divestiture. At the same time, the average estimated life for internally developed software rose from 4 years to 6 years. The sudden jump in average lives makes it appear as if the company is using a significantly longer amortization period for its more recent internally developed software investments which would provide a mild boost to EPS. For perspective, $160 million of internally developed software amortized over 6 years amounts to $26.6 million in annual amortization expense while the same balance amortized over 4 years results in $40 million in expense.

Contract Receivable Days Still Rising

Contract receivables continued to climb on a days of Tool Group sales basis in the 6/19 quarter, rising 5.6 days over the year-ago quarter. As has been the trend, the increase was centered in long-term contract receivables which can be seen in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Snap-on Tools Groups Sales	$405.8	$410.2	$407.4	$389.8
ST Contract Receivables	$91.5	$92.9	$98.3	$105.6
ST Contract Days	20.6	20.7	22.0	24.7
LT Contract Receivables	$347.5	$345.1	$344.9	$338.1
LT Contract Days	78.1	76.8	77.3	79.1
Total Contract Receivables	$439.0	$438.0	$443.2	$443.7
Total Contract Receivables Days	98.7	97.4	99.3	103.9

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Snap-on Tools Groups Sales	$411.9	$404.7	$409.2	$392.7
ST Contract Receivables	$87.6	$92.0	$96.8	$99.8
ST Contract Days	19.4	20.7	21.6	23.2
LT Contract Receivables	$332.6	$326.1	$322.6	$310.4
LT Contract Days	73.7	73.5	71.9	72.1
Total Contract Receivables	$420.2	$418.1	$419.4	$410.2
Total Contract Receivables Days	93.1	94.3	93.5	95.3

Contract receivables include some financing to independent customers, but a large part includes business financing for the company's franchisees to fund, among other things, purchases of inventory from SNA. Below is the company's definition of contract receivables from its 10-K:

> *"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****."*

Therefore, we view increases in the extension of contract receivables as the company essentially financing its own sales. The average yield on these receivables was 9.1% during the quarter.

Below, we can see that the percentage of total past-due contract receivables was essentially flat sequentially and were substantially down from the year-ago level:

Contract Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
30-59 days past due	0.29%	0.29%	0.38%	0.40%
60-90 days past due	0.23%	0.20%	0.27%	0.31%
>90 days past due	0.32%	0.32%	1.16%	0.85%
Total past due	0.83%	0.81%	1.81%	1.56%
>90 Days and Still Accruing	0.07%	0.09%	0.04%	0.04%

Contract Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
30-59 days past due	0.47%	0.38%	0.28%	0.34%
60-90 days past due	0.21%	0.21%	0.14%	0.17%
>90 days past due	0.82%	0.57%	0.45%	0.41%
Total past due	1.51%	1.16%	0.87%	0.91%
>90 Days and Still Accruing	0.05%	0.09%	0.14%	0.14%

However, the company significantly ramped up its charge-off activity during the quarter. The charge-off rate essentially doubled from a year ago and was a significant increase compared to the previous three quarters as well, which can be seen in the following table:

Contract Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Charge-Off Rate	-0.23%	-0.16%	-0.16%	-0.16%
Recovery Rate	0.05%	0.02%	0.02%	0.02%
Net Loss Rate	-0.18%	-0.14%	-0.13%	-0.13%

Contract Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Charge-Off Rate	-0.12%	-0.14%	-0.14%	-0.17%
Recovery Rate	0.02%	0.02%	0.02%	0.05%
Net Loss Rate	-0.09%	-0.12%	-0.12%	-0.12%

The increase in charge-offs would have made the past due data look better as these receivables would have certainly been counted as past-due if they had not been written off. If we add back the 11 basis point year-over-year increase in the charge-off rate to the 0.83% -total past due figure in the 6/19 quarter, get an adjusted past-due rate of approximately 0.94%, still a marked improvement over the 1.51% from a year ago, but a noticeable deterioration from the 0.83% posted in the 3/19 quarter.

We can see below that the provision for bad debt expense doubled in the quarter while the allowance for uncollectible contract receivables remained essentially flat.

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Contract Receivables Allowance %	1.06%	0.97%	1.03%	1.07%
Provision for Bad Debt Expense	$1.2	$0.9	$0.5	$0.4

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Contract Receivables Allowance %	1.08%	1.09%	1.20%	1.16%
Provision for Bad Debt Expense	$0.6	$0.5	$0.0	$0.8

Finance Receivables Days Rising Despite Lower Originations

SNA's finance receivables installment loans mostly to external customers rather than loans for franchisees. Keep in mind that the yield on these receivables averaged over 17% in the quarter, so these customers likely have very little other access to credit to make the purchases.

Consider the company's description of its finance receivables contracts from the 10-K:

"Snap-on's finance receivables are comprised of extended-term installment payment contracts to both technicians and independent shop owners."

Management has emphasized that originations have been down which it largely attributed to slower big-ticket sales in the period:

"Total loan originations of $263.4 million decreased $12.7 million or 4.6%, primarily due to decrease in originations of finance receivables resulting from lower year-over-year Snap-on Tools Group sales of big-ticket items."

However, finance receivables continue to rise on a days sales basis as seen in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Sales	$951.3	$921.7	$952.5	$898.1
ST Finance Receivables	$529.0	$525.9	$518.5	$519.0
ST Finance Receivables Days	50.7	52.1	49.7	52.7
LT Finance Receivables	$1,089.0	$1,077.1	$1,074.4	$1,058.3
LT Finance Receivables Days	104.5	106.6	102.9	107.5

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Sales	$954.6	$935.5	$974.6	$903.8
ST Finance Receivables	$514.4	$512.2	$505.4	$505.8
ST Finance Receivables Days	49.2	50.0	47.3	51.1
LT Finance Receivables	$1,051.3	$1,035.9	$1,039.2	$1,018.6
LT Finance Receivables Days	100.5	101.0	97.3	102.8

We can see that total finance receivables days for the 6/19 quarter increased by 5 days over the year-ago quarter, so while originations may have stalled due to lower sales, the overall balance of receivables continues to outgrow revenues.

Meanwhile, credit metrics for the finance receivables portfolio continues to show improvement as past-due finance receivables remained stable:

Finance Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
30-59 days past due	0.95%	0.85%	1.17%	1.08%
60-90 days past due	0.61%	0.58%	0.73%	0.74%
>90 days past due	0.97%	1.17%	1.23%	1.19%
Total past due	2.53%	2.60%	3.13%	3.00%
>90 Days and Still Accruing	0.75%	0.90%	0.96%	0.94%

Finance Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
30-59 days past due	1.04%	0.82%	1.21%	1.01%
60-90 days past due	0.65%	0.62%	0.87%	0.73%
>90 days past due	1.00%	1.25%	1.26%	1.22%
Total past due	2.69%	2.70%	3.33%	2.97%
>90 Days and Still Accruing	0.76%	0.98%	0.96%	0.98%

..while charge offs slightly declined and allowances were flat:

Finance Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Charge-Off Rate	-0.83%	-0.90%	-0.95%	-0.81%
Recovery Rate	0.12%	0.12%	0.11%	0.10%
Net Loss Rate	-0.71%	-0.78%	-0.84%	-0.71%

Finance Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Charge-Off Rate	-0.90%	-0.98%	-0.96%	-0.80%
Recovery Rate	0.10%	0.12%	0.11%	0.10%
Net Loss Rate	-0.79%	-0.87%	-0.85%	-0.70%

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finance Receivables Allowance %	3.63%	3.67%	3.71%	3.64%

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finance Receivables Allowance %	3.63%	3.63%	3.53%	3.43%

The improvement in finance receivable credit metrics led to a decline in provision expense, as shown in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finance Receivables Allowance %	3.63%	3.67%	3.71%	3.64%
Provision for Bad Debt Expense	$11.9	$12.5	$16.0	$12.1
	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finance Receivables Allowance %	3.63%	3.63%	3.53%	3.43%
Provision for Bad Debt Expense	$13.6	$15.8	$16.0	$12.8

The $1.7 million year-over-year decline in provision expense added about 2.3 cps to EPS growth in the quarter. While it could be argued that the improved metrics warranted a decline in the provision, we nevertheless view this as a non-operational benefit to earnings growth.

Inventory Is Still Climbing Rapidly

We remain concerned about the company's rising inventory levels which continued into the 6/19 quarter. Inventory days increased by 8.3 days over the year-ago level:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Total Inventories	$725.8	$707.0	$673.8	$690.6
COGS	$477.5	$450.1	$495.1	$444.2
DSI	138.7	143.3	124.2	141.9
	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Total Inventories	$668.3	$678.8	$638.8	$649.9
COGS	$467.5	$463.9	$509.0	$455.0
DSI	130.4	133.5	114.5	130.3

In addition, the increase was focused in finished goods, which increased as a percentage of total FIFO value inventories on both a year-over-year basis and sequentially:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finished Goods %	77.2%	76.8%	76.7%	76.2%
Work in Process %	6.7%	7.0%	6.9%	7.0%
Raw Materials %	16.1%	16.2%	16.4%	16.8%
	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finished Goods %	76.1%	76.5%	75.9%	76.8%
Work in Process %	6.8%	6.7%	6.9%	6.8%
Raw Materials %	17.1%	16.8%	17.2%	16.3%

Management indicated that the increase in inventory was 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." When asked about the increase on the conference call, management provided more color:

> *"The biggest increase is if you look at our divisions,* ***the biggest increase is inventory associated with the Snap-on Tools Group, our European-based hand tools operation and industrial.*** *Those are the ones that have been adding by the way the most, I'd say, across the range of most new products.* ***We have new product additions, it's certainly one of them. The industrial, more specifically, has been pleasantly engaged in more project-based activity in assembly of kits, and they've been compiling more inventory to service those customers. As an example, the U.S. military being a significant one.***
>
> ***And we're trying to improve our service levels,*** *where when you have such a variety of SKUs that we offer across the board and you're somewhat dealing with an environment where people can use discretion to buy, maybe a little bit of an impulse element in there as well. Last thing you want to do is not being able to meet demand because you don't have the inventory on the shelf. So we are willing to err on the side of having adequate levels of inventory across those broad number of SKUs. And at least you got a couple of product ramp ups that are occurring. So for example, we're developing new leaps in some of our factories, and that requires some ramp-up investment. And our inventories are [indiscernible] as well. We're getting it a little low, we're trying to take advantage of the situation where we can and buy smartly. And that divestments is what drives the -- the operating variance, David, it's about $52 million. If you look year-over-year, you're taking out the effects of currency and acquisitions to give you a number."*

Investors should remember that the inventory on the company's balance sheet represents unsold tools in its warehouses, not the inventory on franchisee trucks which is owned by the franchisee.

We understand the explanation of new product launches and assuring service levels. However, the current DSIs are in the 140 range, but they have steadily increased from the low 100s in 2016. Sales of diagnostic systems and bigger ticket commercial and industrial systems have grown faster in the last few years than the company's flagship mechanics hand tools which could account for some of the increase in the dollar value of inventory.

Nevertheless, the buildup in inventory is a concern. These tools do not spoil and are not subject to rapid obsolescence. Nevertheless, the buildup could lead to reduced production levels which could hurt margins in the future.

We also note that the company utilizes FIFO inventory for about 61% of its total inventories and about 35% of US inventories. This makes us less concerned that results are artificially benefitting from expensing older, lower-cost inventory in recent periods.

Lower Pension Expense Adds 3.2 CPS

We note that pension expense fell by $2.3 million during the quarter due to higher expected return on plan assets and lower amortization of prior loss. This added about 3.2 cps to EPS growth in the quarter.

Decline in Amortization Adds About 1.4 CPS

SNA's amortization expense fell by $1 million (1.4 cps) in the 6/19 quarter. While a small boost, it nonetheless accounted for more than 10% of the reported increase in adjusted EPS.

SNA discloses gross balances, accumulated amortization, and weighted average assumed life of each segment of its intangible assets. The following table shows this data for the last five quarters for the internally developed software component of intangibles:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Gross Internally Developed Software	$161.2	$158.0	$156.6	$182.9	$181.1
Accumulated Amortization	$120.3	$117.9	$116.6	$142.9	$139.8
Net Internally Developed Software	$40.9	$40.1	$40.0	$40.0	$41.3
Weighted Average Amortization Period (years)	6	6	5	4	4

We found it interesting that there was a sharp decline in gross internally developed software in the 12/18 quarter offset which was matched by a similar decline in accumulated amortization. At the same time, the weighted average assumed life for internally developed software jumped from 4 years to 6 years. The company did not mention impairments or divestitures which would have accounted for the sudden drop in internally developed software so we are uncertain of the nature of the decline. Regardless, the sudden jump in average lives makes it appear as if the company is using a significantly longer amortization period for its more recent internally developed software investments which would provide a mild boost to EPS. $160 million amortized over 6 years amounts to $26.6 million in annual amortization expense while the same balance amortized over 4 years results in $40 million in expense.

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