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Snap-on Inc. (SNA) 2Q'20 Update
Maintain SELL

We maintain our SELL rating on SNA.

- The percentage of past-due contract receivables (credit franchisees) fell to 0.76% at the end of the 6/20 quarter from 0.83% a year ago and 0.90% in the 3/20 quarter. However, this was artificially enhanced by the company extending low-interest rate loans to help out its franchisees. We estimate that the past-due percentage would have doubled to about 1.9% of the portfolio if just 25% of the low-interest loan amount had gone past due. SNA has a history of supporting its franchisees in tough times which is admittedly good business practice. This may work out well in the long run assuming miles driven does bounce back above historical trend with people shifting from flying, cabs, and ride-sharing and back towards driving their own cars.

- Past due finance receivables (credit to franchisees' customers) as a percentage of the portfolio fell to 1.74% from 2.53% in the year-ago quarter and 2.98% in the 3/20 quarter. However, collections fell to $167 million from $192 million in the year-ago quarter as the company allowed some customers to delay their payments. Loans on forbearance rose to 2.5% of the portfolio at the end of the quarter compared to a historical norm of 1%. We estimate if these amounts had been allowed to be marked as past due, the past due percentage would have risen to 3.25%.

- As noted above, helping out customers in times of trouble makes sense. However, one of our biggest concerns is the stability of its small auto shop customers who have been taking a beating for years as the market shifts to dealerships, larger chain shops, and now towards electric cars. We again remind clients that the yield on the company's finance receivables is over 17%- these are already not financially healthy customers. We will continue to watch for signs that they are having trouble getting current on loans over the next couple of quarters.

Contract Receivables

Contract receivables are loans made to franchisees for equipment and working capital. On the surface, credit metrics improved significantly in the quarter:

Contract Receivables	6/27/2020	3/28/2020	12/28/2019	09/28/2019
30-59 days past due	0.25%	0.39%	0.32%	0.33%
60-90 days past due	0.15%	0.20%	0.19%	0.22%
>90 days past due	0.36%	0.31%	0.32%	0.35%
Total past due	0.76%	0.90%	0.84%	0.90%
>90 Days and Still Accruing	0.06%	0.09%	0.11%	0.04%

Contract Receivables	06/29/2019	03/30/2019	12/29/2018	09/29/2018
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%

However, these figures benefitted artificially from the company issuing approximately $20 million in low-interest loans to franchisees to support their businesses through COVID. This resulted in contract receivables originations increasing by more than 20% in the period and also drove down the average yield on the portfolio to 8.2% from 9.1%. The company has a history of supporting its franchisees during tough times which makes good business sense. For perspective, however, if we assume the $20 million in low-interest loans were not made, and just 25% of that amount became past due, it would have driven the past-due rate on the contract receivables portfolio to about 1.9%, double the rate seen in the year-ago quarter. Miles driven are expected to rebound and even rise above historical trend as people avoid flying, cabs, and ride-sharing due to the virus. If this happens, we may see business at local repair shops pick up and franchisees may be able to service this debt. However, investors should be watchful for signs that the COVID impact permanently impaired an already stressed small repair shop customer base.

Finance Receivables

Finance receivables represent mostly loans made to franchisee customers. As with contract receivables, the headline credit numbers in the finance showed significant improvement in the quarter:

Finance Receivables	6/27/2020	3/28/2020	12/28/2019	9/28/2019
30-59 days past due	0.55%	1.07%	1.16%	1.07%
60-90 days past due	0.29%	0.68%	0.71%	0.67%
>90 days past due	0.90%	1.23%	1.26%	1.19%
Total past due	1.74%	2.98%	3.13%	2.92%
>90 Days and Still Accruing	0.70%	0.97%	1.01%	0.93%

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%

However, these numbers also saw an artificial benefit in the period. Finance receivable originations declined by 8.5% in the quarter. However, consider the following quote from the conference call:

> *"Collections of finance receivables in the quarter of $166.8 million compared to collections of $191.6 million during the second quarter of 2019. This year's quarter reflected the* ***greater use of deferred payment plan sales programs and short-term payment relief or forbearance to some of our franchisees qualifying customers.***
>
> *Similar to the trends elsewhere in our business, we saw the greatest number of requests for payment relief on extended credit or finance receivables in April. This lessened in May, and* ***as of the end of June, forbearance was granted for approximately 2.5% of the portfolio. Historically, those accounts having forbearance terms are below 1% of the finance receivable portfolio."***

So, the company avoided marking loans as delinquent by modifying the payment terms and allowing franchisee customers to put off making payments until later. Again, this may prove to be good business in the long term if miles driven bounce above the historical trend and customers can catch up on their payments in upcoming quarters. But to again put this in perspective, past due finance receivables were $30 million at the end of the 6/20 quarter. If we assume that the incremental 1.5% of the portfolio placed in forbearance at the end of the quarter compared to the historical norm had been allowed to be marked as delinquent, we estimate it would have almost doubled the past-due balance to 3.25% of the portfolio versus last years second-quarter level of 2.5%.

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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