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Virus on the brain

Evan Lorenz writes:

The "full blown" phase of the pandemic is about to end, none other than Anthony Fauci declared a couple of Tuesdays ago, though anyone might have concluded as much by the 277% surge in fourth-quarter revenue by the newly pulsating MGM Resorts International's hotels and casinos along the Las Vegas Strip.

Wall Street seems not to be listening. At least, Mr. Market continues to overvalue many a Covid beneficiary despite deteriorating fundamentals and mounting signs that the pandemic is yesterday's news. In preview, this publication is—once more—bearish on Fastenal Co. (FAST on the Nasdaq).

A pan in the issue of *Grant's* dated Feb. 7, 2014 correctly anticipated 20 months of poor absolute and relative performance in the Fastenal share price (down 16.8% versus a 10.8% gain for the S&P 500; both figures include reinvested dividends).

W.W. Grainger, Inc., another industrial-supply company, responded very differently to a separate *Grant's* analysis in the same bearish vein. Since that essay in the issue dated May 5, 2017, GWW has delivered a total return of 171% versus a 103% gain in the S&P 500—Amazon.com, Inc. didn't prove the margin-lacerating force we expected it to be, and Grainger produced stellar sales growth in 2021. Yet today its shares are considerably cheaper than Fastenal's (as a multiple of enterprise value to trailing Ebitda, 15.4 times versus 20.3 times).

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From a single outlet in Winona, Minn., in 1967, Bob Kierlin's Fastenal Co. has grown into a network of 1,793 freestanding stores, 1,416 customer-sited locations and 92,874 shop-floor vending machines, or bins. And from its start in one country, Fastenal operates today in 25, though 83.7% of last year's revenue was made in America.

As the nameplate suggests, studs, bolts, rivets, concrete anchors, etc. were the founding products, but diversification—first, into tools—began in 1993. In 2021, fasteners produced a third of total sales, followed by safety supplies (21.2%), tools (8.5%), janitorial items (8.2%), hydraulic and pneumatic components (6.4%), material-handling goods (5.6%), cutting tools (5%), electrical supplies (4.3%), welding equipment (3.8%) and "other" (3.7%).

The bull case will take some reciting because Fastenal is exceptionally well-run. In 2020, as the world hibernated, management deftly shifted to making masks, goggles, latex gloves and the like, which delivered a 5.9% revenue bump in that plague year.

Inflation helps, too. "In general, inflationary environments are good for them because of the onsite stores that hold a lot more inventory than Grainger or MSC," Jay Van Sciver, who rates FAST as neutral for Hedgeye Risk Management, LLC, tells me. This benefits the company in two ways: One, Fastenal can sell at today's high prices the inventory it built at yesterday's lower costs and, two, the company is not so vulnerable to supply-chain snafus as its more lightly stocked rivals. Recent results speak for themselves: Between 2019 and 2021, operating margins, as a percentage of sales, increased to 20.3% from 19.8%.

The industrial-supply business is as fragmented as it is mature. Trailing revenues of the three dominant entrants—Fastenal, Grainger and MSC Industrial Direct Co., Inc.—amount to just $22.4 billion out of an industry-wide total of $140 billion. Stealing the little guys' customers is the time-honored way by which the big three outgrow the market.

The current expansive shift to online commerce only expands the opportunity, although company-specific jargon is not always self-explanatory. Thus, online sales are part of what Fastenal calls "digital solutions," a category that includes vending machines and industrial bins, both of which are automatically replenished when stock runs low. The theory behind the practice is that customers so served are likely to stick with Fastenal.

Fastenal has been reciprocally shrinking its conventional store base, to 1,793 at the close of 2021 from a high of 2,687 in 2013. When all is said and done, management projects a count of no more than 1,450.

There's good news, too, on the Amazon.com front. Each quarter, a Wolfe Research, LLC team led by Nigel Coe polls distributors on topics including the threat from the Everything Store. In the fourth quarter, only 19% of respondents said they lost customers to Amazon.com versus "the norm" of 20%–30% over the past couple of years (given persistent supply-chain troubles, Bezos & Co. may be devoting more resources to its consumer division than to business-to-business operations).

Nor can the bears make hay with Fastenal's balance sheet. As of Dec. 31, 2021, net debt summed to $153.8 million, or

High enough?

source: The Bloomberg

11% of trailing Ebitda; Egan-Jones Ratings Co. calls the credit double-A-plus.

Fastenal changes hands at 20.3 times enterprise value to trailing Ebitda versus an average of 14.6 times in the five years ended 2019. Just 1.8% of the equity float is sold short, though five of the 16 analysts on the case say sell compared with the three who say buy. Management would appear to side with the bears; in the past 12 months, insiders have sold a net 213,628 shares for net proceeds of $12 million.

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Valuation to one side, the bear case starts with the signs of an industrial slowdown—manufacturing clients generate 69% of Fastenal's sales. The manufacturing PMI printed at 55.5 in January, down from 63.4 in July. According to the forward-looking gauges of the Economic Cycle Research Institute, the decline is global and ongoing (*Grant's*, Feb. 4).

Nor is this just any old cycle. As supply-chain snarls infiltrate every corner of the globe, manufacturers are shifting to a "just-in-case" inventory model from the long-fashionable "just-in-time" approach. And the sight of bare grocery shelves is leading consumers, too, to buy while they can, as *The Wall Street Journal* reported on Feb. 7.

"This is the thing that has me most concerned," Ryan Petersen, CEO of freight forwarder Flexport, Inc., remarked last week on the *All-In* podcast. "What's happening is, it's now taking 115 days on average across our customer base from when the factory says, 'Hey, these goods are ready. Come pick them up,' to when they finally get delivered to a warehouse in the U.S. Before the pandemic, it was 50 [days]....When you go to 115, all of a sudden these companies are so much less agile, because you've placed the orders and forecasting demand is so hard and now you are forecasting demand for twice as long a time period."

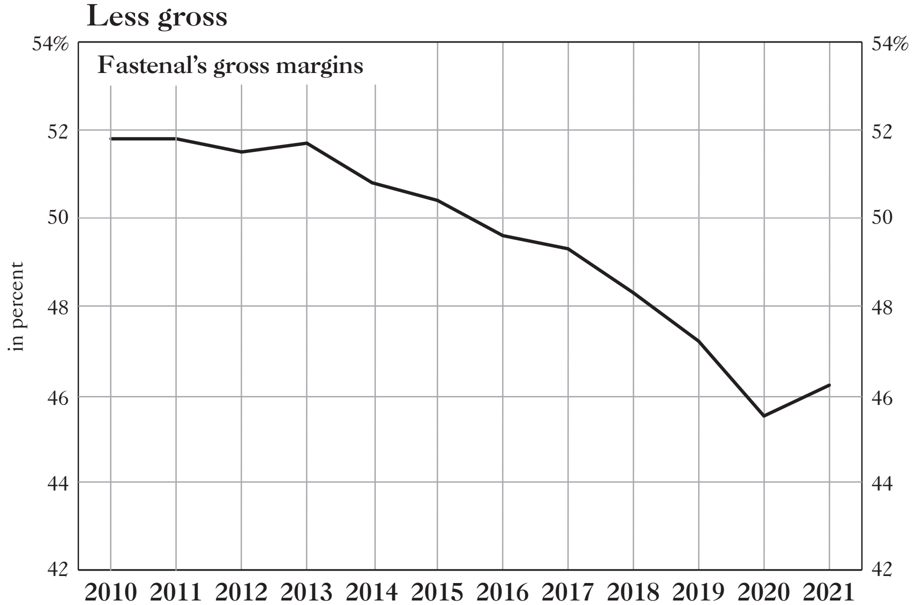
The problem, Petersen continued, is that after you've ordered the goods, newly invigorated and maskless consumers may revert to pre-pandemic purchase patterns (recall that, between the fourth quarters of 2019 and 2021, sales of consumer goods rose by 24.4% while services gained just 5.8%). A pile-up of unwanted inventory would send a new kind of shock wave down the supply chain.

Fastenal may welcome inflation, but not so the rank-and-file American consumer. Listen to John Rainey, CFO of PayPal Holdings, Inc., on the Feb. 1 earnings call: "[W]e've seen weakness around spending in our lower-income cohorts....And this was a cohort that certainly benefited from stimulus in prior periods...and we're seeing the effects of inflationary pricing around that, where there's a more elastic demand curve around that."

To be clear, these concerns of ours are yet conjectural. Fastenal's average daily sales, measured year over year, leapt by 14.9% in January, 16.5% in December and 13.2% in November, and various industrial-management teams have dispensed comparable results on recent conference calls. However that may be, conceded Erik Gershwind, chief executive of MSC Industrial Direct, on the Dec. 22, 2021 earnings call, "we're such a short-cycle business. It's hard to call something for the year."

The extent to which inflation is behind resurgent revenue growth is another question. Fastenal's management

Less gross



source: company reports

attributes 4.4 to 4.7 percentage points of the 12.8% gain in fourth-quarter revenue to price markups. And yet, it came out during the earnings call, daily sales of fasteners exploded by 24.2% and price increases accounted for 20 percentage points of that burst.

Applying this math to the overall company, it follows that price hikes in fasteners alone contributed 6.1 percentage points to revenue growth. Which would imply that the other two-thirds of Fastenal's products saw price deflation—though that appears unlikely.

If the numbers don't jibe, it would not be the first time that management miscalculated its non-GAAP metrics. First-quarter figures showed that digital sales (online, vending machines and bins) amounted to 34.8% of the total; the second-quarter press release said no, hold on—wait a minute—make that 39.1% of the total. Would management care to clarify? Management, after lengthy deliberation, declined to come to the phone.

Looming competition counts as another strike against FAST's treetop valuation. Peruse the 10-K reports on file at the Securities and Exchange Commission for Fastenal, Grainger and MSC, and you will find no reference to Affiliated Distributors, a cooperative of more than 800 independent suppliers of manufacturing, construction and industrial goods that pool their resources and buying power. Last year, AD members reported sales of $58.5 billion, or more than two-and-a-half times the public trio, and growth of 30%, which is not quite five times the 6.4% that Fastenal posted in full-year 2021.

A countervailing strength is Fastenal's focus on digital vending for its high-ticket clientele. In the fourth quarter, daily sales to such national customers rose by 19.9% and those to non-national accounts by 7.6%. It would be no good thing for the Fastenal bulls if vibrant growth at the national level began to move closer to the non-vibrant growth at the non-national level. (Subtract a 6% inflation rate from a 7.6% growth rate, and you're not left with much.)

In other words, growth in new digital contracts with national-grade customers is key. At the start of last year, Fastenal guided for 300–350 such signings but cut the estimate, on Oct. 12, to 285–325. At the midpoint, the revised figure implied 75 new onsite customers in the December quarter. Yet, just 44 new onsite contracts turned up in the fourth-quarter financial results. The discrepancy matters because, in the five years ended 2021, onsite-generated sales grew at a compound annual rate of 19.8%, other sources at just 2.6%.

All of Fastenal's growth initiatives, including diversifying into new products, are margin-dilutive, because fasteners—in their thousands of different shapes and sizes—are unusually profitable. Thus, it's no accident that, from 2012 through 2022, as the proportion of sales derived from fasteners declined to 33% from 44%, overall gross margins fell to 46.2% from 51.5%. While the onsite strategy may breed customer loyalty, such sales have lower margins than Fastenal's legacy branch network. On the Jan. 19 earnings call, management guided for a 40 or 50 basis-point contraction in gross margins in 2022.

While Fastenal touts its digital strategy, its peers are the ones with the online bragging rights. On the fourth-quarter call, management said that FAST ended the year with 15% of sales online. "That number would be north of 50% for some of their larger competitors," Coe, who rates FAST a sell for Wolfe, tells me. This also may explain why Grainger reported stronger growth last quarter—up 14.2% year over year versus 12.8% for Fastenal—which was driven by a 25% surge in sales to smaller customers, a segment in which Fastenal lags.

"This is an exceptionally expensive stock," Coe winds up, referring to FAST. "The distribution market is transitioning more towards e-commerce, and Fastenal's true e-comm exposure is quite low compared with competitors. The onsite strategy of putting vending machines and onsite customer stores seems to be delivering below expectations. Our concern is that the growth contribution from these onsite efforts could be lower going forward."

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Fastenal at a glance

all figures in USD millions except per share data

	2021	2020	2019	2018	2017
sales	$6,010.9	$5,647.3	$5,333.7	$4,965.1	$4,390.5
operating income	1,217.4	1,141.8	1,057.2	999.2	881.8
net income	925.0	859.1	790.9	751.9	578.6
earnings per share	1.60	1.49	1.38	1.31	1.00
shares	577.1	575.7	574.4	574.3	576.7
cash	236.2	245.7	174.9	167.2	116.9
debt	390.0	405.0	345.0	500.0	415.0
total assets	4,299.0	3,964.7	3,799.9	3,321.5	2,910.5

source: company reports