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Unfasten it

For star power in nuts and bolts, look no further than Fastenal Co. (FAST on the Nasdaq). Since its 1987 initial public offering, the company has managed to increase sales and earnings per share at the supersonic compound annual rates of 21.7% and 23.4%, respectively. "I made the mistake of selling it once before. . . ," a major Fastenal shareholder confessed to his investors last spring. "The memory of that sale is still painful." If the following analysis is on the beam, it's the memory of having not sold a bit of FAST that will presently trouble the company's ardent fans.

W.W. Grainger is the top distributor of industrial and construction supplies in America; Fastenal, with $3.3 billion in sales to Grainger's $9.4 billion, is No. 2. Jeff Bezos was three years old when Bob Kierlin scraped together $30,000 to open the first Fastenal store in Winona, Minn., in 1967. Anticipating the Amazon founder, Kierlin coined the phrase, "Growth through customer service"; those four words have become the corporate growth mantra. Fastenal dispenses its products through 2,687 stores, the Fastenal.com Web site, the Fastenal catalog and 33,920 vending machines. The balance sheet is debt-free, and the investor relations' office is mum (this publication, seeking comment, got the silent treatment).

Fastenal sells 1.4 million different products. Fasteners—screws, studs, bolts, rivets, concrete anchors, etc.—account for 42% of sales. You name it—from tools to office supplies to bottled water—makes up the balance. The Fastenal client roster comprises one-half manufacturers and one-quarter contractors (most of the latter in commercial construction).

The "industrial supply" market in which Fastenal operates is roomy enough for MSC Industrial Direct Co., a second pure-play public competitor, as well as the aforementioned Grainger and a host of non-public others. The trio of public companies earned combined revenues of $15.3 billion last year, a drop in the bucket of the guesstimated $150 billion annual sales of industrial and construction products. While that market grows no faster than GDP, Fastenal, MSC and Grainger have outgrown the economy by taking share from small fry.

Since its post-1987 incarnation as a public company, Fastenal has never lacked for a growth initiative. In the 10 years through 1997, store expansion was the driving force, as the number of Fastenal emporia ballooned to 642 from 58. Starting in 1993, the new idea was product expansion, as the once fasteners-only company enhanced its offerings to include tools (in 1993), hydraulics (1996), safety equipment (1999) and office supplies (2010). With more products came a focused initiative to win business from big, national accounts. And now? The new, new thing is vending machines.

Actually, not so new. "The original business plan was to dispense nuts and bolts via custom vending machines,"

Fastenal Co.
(in $ millions, except per-share data)

	2013	2012	2011	2010	2009
Revenue	$3,326.1	$3,133.6	$2,766.9	$2,269.5	$1,930.3
Cost of revenue	1,606.7	1,519.1	1,332.7	1,094.6	946.9
Gross profit	1,719.4	1,614.5	1,434.2	1,174.8	983.4
Operating expenses	1,007.4	941.2	859.4	745.1	686.8
Operating income	712.0	673.3	574.8	429.7	296.6
Non-operating losses (gains)	(1.5)	(0.9)	(0.3)	(0.9)	(0.8)
Pretax income	713.5	674.2	575.1	430.6	297.5
Taxes	264.8	253.6	217.2	165.3	113.1
Net income	448.6	420.5	357.9	265.4	184.4
EPS	$1.51	$1.42	$1.21	$0.90	$0.62
Shares (in millions)	297.7	297.2	295.9	294.9	296.7
Net cash	$ 59.0	$ 80.0	$ 144.8	$ 169.8	$ 189.3
Total assets	2,075.8	1,815.8	1,684.9	1,468.3	1,327.4
Cash flow from operations	416.1	396.3	268.5	240.5	306.1
Cap-ex	(206.5)	(138.4)	(120.0)	(73.6)	(52.5)
Free cash flow	209.6	257.9	148.4	166.9	253.5
No. of stores	2,687	2,652	2,585	2,490	2,369
Vending machines	33,920	21,095	7,453	1,925	567

source: company reports, the Bloomberg

to quote from the Fastenal Web site, "but the technology proved impracticable at the time. Several decades would pass before Fastenal finally popularized industrial vending." In 2009, there were 567 Fastenal vending machines on customer premises; today, there are 33,920. It's not too much to say that the bulls are betting on the success of what the company claims is "the most widely used industrial vending system in the world." Certainly, we bears are betting against it.

The basic bear contention is that the world is changing faster than Fastenal is adapting. "The stock that you hate yourself for selling," we contend, is trading—at 26 times the estimate, mind you—on past glory, not future prospects.

We expect the company would have a sharp comment on that, if it were the commenting kind. You can go on the Fastenal Web site to hear management's side of the vending machine initiative. It's win-win, says the front office and its sell-side acolytes (of whom exactly one out of 15 has a "sell" rating on the stock). To pick up a roll of electrical tape, a set of earplugs, a shop apron, drill bit, paintbrush or bottle of water, an employee activates the Fastenal-installed machine with his or her personal ID card. The drill bit that just tumbled out and into the employee's hands is unlikely to go home with him after the shift ends. Here's a big selling point, Fastenal says: You, the industrial customer, hold the paid help accountable for the supplies they requisition.

To join the Fastenal vending program, a customer commits to pay a \$40-per-month user fee and to spend \$2,000 more per month on Fastenal-provided products than it would otherwise do. Fastenal installs the big blue machines, stocks and restocks them, trains the users and furnishes around-the-clock tech and software support. We are, Fastenal bills itself to prospective vending customers, "the machine behind the machine."

We call attention to the fact that revenue growth has decelerated. The top line rose by 6.1% in 2013. It expanded by 13.3% in 2012 and 21.9% in 2011. Nor is Fastenal alone; you see the same trend at Grainger and MSC.

"Sales to customers who have at least one Fastenal vending machine on their premises have been steadily rising," colleague Evan Lorenz observes, "to 36.6% of sales in the fourth quarter of last year, up from 15.7% of sales in the fourth quarter of 2011. Take the company at its word: Assume that each new vending customer booked the required minimum increment of \$2,000 in monthly purchases. This would imply that growth in sales, measured year-over-year, to the non-vending-machine portion of the Fastenal customer base has been negative for five consecutive quarters, including a decline of 3.7% in the final quarter of 2013."

On the aforementioned Fastenal video clip, management talks about the "huge" investment it made in vending machines. Will that investment bear fruit? A short-seller of Fastenal shares to whom Lorenz spoke contends that the evidence—such as it is—warrants skepticism. Exactly what kind of products do the Fastenal machines most commonly dispense? Management doesn't say, but our short-seller, through his own channel checks, surmises that the top-selling item is bottled water, followed closely by earplugs and eyewear. None is a high-value SKU.

Who or what is to blame for the slowdown in revenue growth? Evidently, not America's macro economy. The Institute of Supply Management's Purchasing Manager Index (a datum of which Fastenal thinks highly enough to feature in its earnings releases and 10-K reports) registered 56.5 in December, up from 56 in September and 52.5 in June. Maybe the distributors' very efficiency is part of the problem. Grainger reports that prices for its American product sales fell by1% in the fourth quarter and will rise by no more than 1% in 2014. In 2011 and 2012, those prices rose by 3% per annum.

Anyway, a slowdown there is. Fastenal's earnings warning on Dec. 20 was only the second such amber light since the 1987 IPO. Fourth-quarter sales and earnings, when they were released on Jan. 15, missed even those downgraded Street expectations. It was the fifth quarter in a row to feature a miss in top-line growth.

Fastenal's commitment to the vending machine underscores its preference for the physical world over the virtual one—maybe, too, it reflects the difficulty of hiring and retaining good salespeople. Thus, it was Grainger, not Fastenal, that developed a line of tools offered for sale online and nowhere else. That innovative niche, called Zoro Tools, grew by 150% in calendar 2013 (no doubt from a low base), Grainger says.

"Just how deeply Fastenal is anchored to planet earth is evident in the sheer number of its retail stores," Lorenz points out. "There are 2,687 Fastenal outlets and they generate about \$1.25 million of sales a year. Grainger's 710 stores and MSC's 103 stores produce annual revenue of about \$13 million and \$25 million, respectively. Web-based sales tell much the same story. In the three months to Nov. 30, e-commerce generated 46% of MSC's sales. Grainger says that 35% of its American business comes via the Internet. Fastenal provides no such figure, but sell-side guesses put the figure only as high as 15%."

As any former bookstore owner can attest, the Internet is a retailing force to be reckoned with. "The value proposition with Fastenal was always that they could deliver you one screw or one widget in a day," Lorenz's unnamed Fastenal bear remarks. "They had the distribution centers and the branch stores. They are really, really good at customer service. We've seen that all the smaller distributors are able to do this, too, now—not just the other two publicly traded distributors. That's because of e-commerce and FedEx/UPS. We've seen a shift over the past five years where the key levers of Fastenal's growth have been—not disintermediated—but have been under assault from some kind of competitive threat."

Now come Google *and* Amazon. In April 2012, Bezos & Co. unveiled AmazonSupply.com, a venture that grew out of the 2005 acquisition of Small Parts, an online vendor serving the medical supply and research fields. In keeping with the spirit of the Everything Store, AmazonSupply limits itself to no such narrow field as all things medical; "all things" seems rather to describe the ambitious new venture. From 500,000 items two years ago, AmazonSupply today sells 750,000 items "with more being added every day." Point-to-point comparison of AmazonSupply to Fastenal isn't easy—the two sell things that, with regard to brand and description, don't always match up. They do in the case of the DeWalt 18-Volt, Half-Inch Cordless XRP Drill/Driver (manufacturer's part number DCD940KX). AmazonSupply sells it for \$199.00, Fastenal for \$288.99. This isolated comparison may or may not be representative; we don't know. What's indisputable is that Fastenal faces competition that didn't exist a few short years ago.

Google Shopping for Suppliers, a business-to-business sales venture, only began beta testing a year ago. Google sells no items itself, rather it connects manufacturers and consumers. So conjoined, the latter may buy direct from the former. To the single original menu item of electrical components, the service has added mechanical components and test and measurement products. Shopping for Suppliers might conceivably prove a rowdier, more disruptive force in the industrial products market than even AmazonSupply. "After all," Lorenz observes, "Grainger, MSC and Fastenal have gross margins ranging from the mid-40s to the low 50 percent range; manufacturers selling directly to customers can choose to capture this margin themselves or reduce their prices relative to the distributors with which they already trade. For the privilege of being verified by Google, and therefore earning a higher search ranking, vendors pay $1,000 per annum."

We imagine that Fastenal would wave away the Google and Amazon ventures on the ground that neither yet measures up in quality of service (specifically, of inventory management service). The marketplace seems to be warming to the upstarts nonetheless. Robert W. Baird & Co. conducts a quarterly survey of the industrial supply chain. In the Jan. 14 canvass, Baird analyst David J. Manthey tells Lorenz, respondents addressed the new online purchasing channels: Would you, Mr. or Ms. Industrial Products Manufacturer, allocate more resources to established distributors like Fastenal or to digital-only newcomers like AmazonSupply? According to Manthey, 80% said they intend to stick with the tried and true, 20% to toss more business Amazon's way. "That one-fifth of Fastenal's market is prepared to direct more resources to a sales channel that didn't even exist two years ago can't exactly be music to Fastenal's ears," Lorenz points out.

"If you read the industrial distributor blogs and magazines," our secret Fastenal bear continues, "they talk more and more about AmazonSupply and Google. What's happening is that the smaller distributors are getting disintermediated. Amazon is taking share from the smaller distributors. What's important here is that Fastenal used to take share from the smaller distributors. Perhaps Amazon isn't taking share from Fastenal, but they are eating the bait all around them." It won't be GDP growth alone that will lift Fastenal to the 11.2% revenue growth the Street is expecting in 2014—the company must continue to do what it used to do when the competition was softer and the field less crowded than either is today.

"Finally," Lorenz observes, "there's the question of margins. It ought to concern a Fastenal bull that tomorrow's sales may be less profitable than yesterday's or today's. For now, those margins are top-flight. Thus, over the past 12 months, Fastenal posted a 51.7% gross margin compared to 43.8% for Grainger and 45.7% for MSC. Product mix explains much of the difference. 'If you look at fasteners as a category,' Manthey tells me, 'the gross margins tend to be in the mid-50s at least, maybe a little bit better depending on the mix. Everything else that Fastenal sells is probably in the upper 40s. When you mix it all in a blender, you get 51% or 52%.' So it's of more than passing interest that fasteners, as a percent of Fastenal's sales, fell to 40.6% in the fourth quarter last year, down from 48% as recently as the fourth quarter of 2010. To date, Fastenal management has done a good job of compensating for this evolution away from fasteners. But as Fastenal's sales mix comes to resemble Grainger's and MSC's, so should Fastenal's equity valuation converge on its public competitors. To wit: not 26 times the estimate but 18.3 times as in Grainger's case, or 20.4 times in MSC's."

We now take the liberty of imagining the remarks of a guileless Fastenal spokesman who comes to the phone to speak the literal truth. He is responding to a question from Lorenz about insider sales and purchases of Fastenal shares. "Yes," this strikingly candid PR person replies, "it's true that insiders have purchased 8,785 shares in the year to date at a cost of $404,479 (an average of $46.04 a share). But don't forget that, last year, they sold a net 315,431 shares for net proceeds of $15.3 million (an average net price of $48.61). Why the selling? Well, let me only say that I think you guys at *Grant's* are on to something." This is just our imagination, of course.

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