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Left-handed spanner

Evan Lorenz writes:

Except for the stock market's U-turn, the cessation of commerce is proving no stimulus to American wealth creation. What mass unemployment and the government's shelter-in-place mandates mean to the auto business and to an iconic American toolmaker are the topics at hand. As to the second, *Grant's* remains bearish on Snap-on, Inc. (SNA on the New York Stock Exchange).

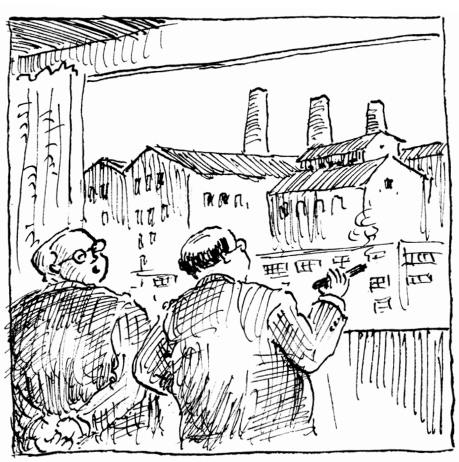
New-car sales in April plunged by 47.7%, to an 8.58 million annualized selling rate, lower than the worst month of the Great Recession but relatively brisk in comparison to the declines of 74.6% and 64.5% logged in Canada and Mexico. In Britain, new-car registrations are running at the lowest annual rate since the postwar retooling year of 1946.

Though 23 states allowed some in-person sales on dealer lots last month, EZ financing, courtesy of the automakers' captive finance units, was the industry's lifeline. In February, according to Edmunds.com, zero-percent loans closed 3.6% of new-car sales. In April, that figure climbed to 25.8%. "Not only are they offering zero-percent financing, they are offering deferred payments for three to six months," Daniel Ruiz, the founder of Blinders Off, LLC, an automotive-research boutique, tells me. "They are offering involuntary job-loss insurance. This is as loose as I've seen lending."

It was another small mercy that in April, for the first time, pickup trucks accounted for more than half of all light-vehicle sales. In flyover country, where lockdowns have been less severe than along the coasts, people like their pickups—and the automakers love to finance them. But while heavy demand raises the possibility of shortages of Detroit's most expensive and most popular vehicle line, container ships full of SUVs, crossovers and sedans continue to ride the hook in waters off California.

Life gets more complicated when business stops, as General Motors Co. can readily attest. Thus, GM's announced intention to restart most of its North American plants on May 18 is colliding with Mexico's announced intention to remain mostly closed. "It's all just-in-time inventory," Charles Chesbrough, senior economist at Cox Automotive, Inc., reminds me, "and you can't really get the whole system up and running here in North America if Canada, the U.S. and Mexico aren't sort of all starting at the same time."

As a rule in business, whether in sickness or in health, everything is interconnected. For instance, weak used-car prices punish new-car sales, since



"Say what you will, J.B., it's just not the same without revenue."

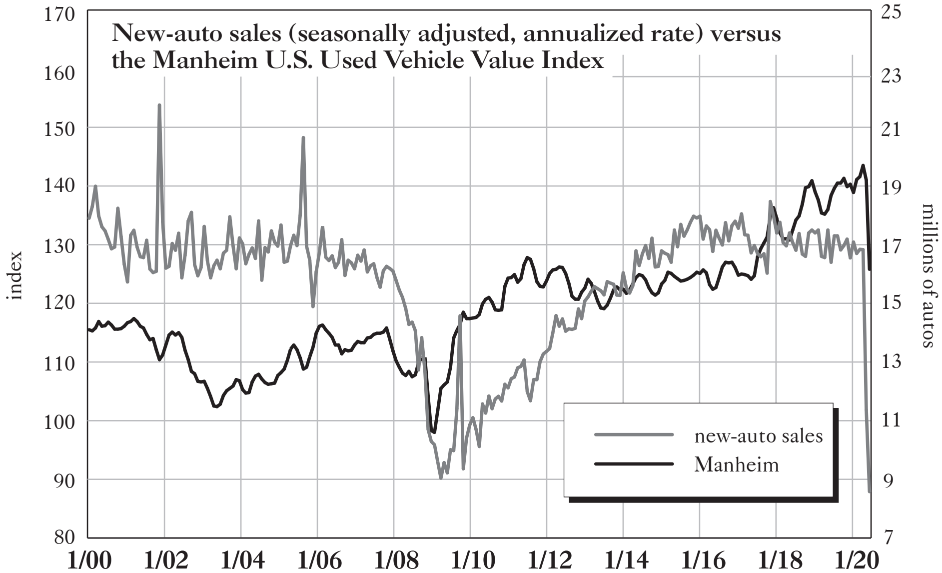
trade-ins facilitate most auto transactions. The 11.2% plunge in used-car prices last month was almost double the 6% dip seen in October 2008, the low automotive ebb of the prior crisis.

The percentage of lease-financed new-vehicle sales topped at 30.1% in 2016. Since most leases run for three years, 2019 proved the peak off-lease year, with 4.2 million units returned to the market, according to Black Book. But 2020 won't be far behind, with an expected 4.1 million units slated to return in search of new owners. By offering homebound consumers the option to defer lease returns, OEMs have only slightly delayed the inevitable. "We have projected that at least half a million of those units are going to be pushed to later in the year," Alex Yurchenko, Black Book's senior vice president of data science, tells me.

At the same time, car-rental giants are reeling not only from travel quarantines but also from the consequences of their own bloated balance sheets. It came to light at the end of last month that Hertz Global Holdings, Inc. had missed lease payments on its rental fleet; management must submit a Covid-19-appropriate remediation plan by May 22. Covering its bets, the defaulter, which also operates under the Dollar and Thrifty brands, has retained bankruptcy counsel.

Fleet customers absorb about a fifth of all new-car production, but Hertz, Avis Budget Group, Inc. and Enterprise Holdings, Inc. are busily canceling orders. In the fourth quarter, Hertz was managing a fleet of 686,697 cars. Barring a quick resumption to life as we knew it, that number will have to shrink. Thus, Hertz and its rivals may be adding hundreds of thousands of vehicles to a mar-

Off the road



source: The Bloomberg

ket already heavy with off-lease supply.

One is reminded of the cycle that climaxed in 2002 with 3.45 million vehicles on lease (*Grant's*, Oct. 18, 2019). In 2004, Ford Credit was able to recognize a gain of $768 per leased vehicle. By 2007, it was acknowledging a $1,446 per-vehicle loss. Recession inconveniently followed.

Ordinarily, a collapse even close to the severity of today's would set the stage for a near-term revival, but ultra-easy financing terms could delay recovery. Edmunds finds that 43.9% of new-vehicle sales in April involved a trade-in with negative equity in the average sum of $5,570.70. Five years ago, 30.3% of sales entailed an upside-down trade-in with average negative equity of $4,336.19. Unless lenders agree to roll that deficit into a new loan, consumers may be stuck with the ride they have.

Car loans fared relatively well in 2007–09, Chesbrough notes—people had to get to the office. Now, not a few potential car-buyers are discovering that they can work from home. "And if you're a family with a bunch of smartphones," our informant continues, "that's a $300–$400-a-month payment right there. And if you have to cut costs, can your family live without communication or live without a car?"

Since we identified General Motors Co. and Ford Motor Co. as picks not to click in the Oct. 18 issue of *Grant's*, the stocks have dropped by 37.6% and 46.4% (they were down by half at the March lows). At current prices, we are neither buyers nor sellers but concerned onlookers. GM's triple-B-rated 5¼% senior unsecureds of 2026 change hands to yield 5.8%, or a 550 basis-point pickup over Treasurys. As triple-B bonds are priced at an average 288 basis-point spread, the market has already downgraded GM. Ford's double-B-plus 4.346% senior unsecured notes of 2026 trade at a price to yield 8.2%, a pickup of 790 basis points over Treasurys; on average, double-Bs are priced at a 528 basis-point spread.

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Which brings us to Snap-on, maker of tools for auto mechanics, miners, aerospace workers, farmers, truckers and public servants. Snap-on outfits garages with equipment, both digital and old-school, to diagnose aging or damaged vehicles. Accustomed to adversity, the Kenosha, Wis.–headquartered company came into the world during the sharp 1920–21 business-cycle downturn—and now it's facing another.

The Tools Group, one of three Snap-on product segments, brings in $227 million in operating income, 23% of the total, but its overall contribution to the bottom line is much bigger. Supporting the Tools unit is Snap-on Credit (SOC), which lends both to franchisees and to the mechanics who buy from those familiar Snap-on vans. At the end of the first quarter, contract receivables (loans to franchisees) summed to $447.6 million, finance receivables (loans to the patrons of the company vans) to $1.6 billion. The mechanic who applies for credit to buy a toolbox likely has a subprime credit score, and Snap-on prices such loans accordingly: As of the first quarter, the rate was 17.7%.

If you lump together SOC's trailing operating income ($240.7 million) with that of the franchised vans and the aforementioned contribution of the Tool Group, you've accounted for 47.8% of total operating income before corporate overhead.

The bull case for the Kenosha centenarian begins with valuation. Snap-on trades at 10.3 times trailing earnings, 7.5 times trailing enterprise value to earnings before interest, taxes, depreciation and amortization and the shares offer a 3.5% dividend yield. The dividend is no Johnny-come-lately. Snap-on has paid without interruption or reduction since 1939, a period encompassing a world war, the galloping inflation of the 1970s, the dot-com crash, the Great Recession and, now, the Great Bug. "This isn't our first encounter with deep difficulty," Snap-on chairman and CEO Nicholas Pinchuk reminded listeners on the April 21 earnings call.

America's cars, too, have been around the block. While they're harder to repair than ever (much to the satisfaction of Copart, Inc.—see the prior issue of *Grant's*), people are also driving them longer. Average age on the road was 8.8 years in 1999, 10.3 years in 2009 and 11.8 years in 2019. You'd suppose that Snap-on-equipped auto mechanics would be making hay.

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At a glance, there's nothing to fear in Snap-on's corporate credit profile. The March 28 balance sheet shows net debt of $922.5 million or 0.9 times trailing Ebitda; in the first quarter, operating income covered interest expense by 17.2 times. The single-A-minus-rated Snap-on 3¼s of 2027 change hands at $106.58 to yield 2.2%, a 184 basis-point pickup over Treasurys, only slightly wider than the peer-group average.

When we said our piece on Snap-on four years ago, the analysis centered on the credit book (*Grant's*, June 3, 2016). It had shone in the prior slump—losses in 2009 totaled only 3.9%—but we speculated that next time could be different, and so we reason again. For one thing, until mid-2009, CIT Group, Inc. had shared in credit management with the Snap-on finance people. (Yes, CIT did fail in 2009, but defective loans to mechanics were not the reason.) For another thing, since 2010, financing receivables have grown at a 10.9% compound annual rate and contract receivables at 10.2%, each more than double the 4.2% annual rise in Tools Group sales.

A third issue is loss recognition. In March, Norne LLC produced research to show that Snap-on Credit appears to allow customers to roll past-due credits into new loans in ways that flatter reported credit quality. All a customer behind on payments needs to do is finance a tool purchase worth $300 or more.

Capitol Forum tackled this issue with a 2018 critique of management's use of the "recency" approach to loan-loss recognition. By that method, a delinquent customer making a partial, "qualifying" payment on an overdue bill restores the loan to current status. The sterner, conventional "contractual" method deems no delinquency cured except by payment in full. Federal Reserve regulators discourage banks from employing the alternative.

In none of Snap-on's public filings does management clarify its accounting approach to credit delinquency; Norne and Capitol Forum have had to deduce it, as have we. Nor did the company respond to my calls and emails. It may or may not be pertinent to Snap-on that when Signet Jewelers Ltd., which definitely employed recency accounting, sold its subprime credit book to CarVal Investors and Castlelake, L.P. in 2018, it netted 72 cents on the dollar, a deep and jolting discount to the par-or-better outcome that some bulls said they were expecting (for the back story, see *Grant's*, June 3, 2016).

Since we last visited Snap-on, growth in the Tools Group has hit a wall. Excluding acquisitions and currency movements, sales expanded by 7.6% in 2014, 10.9% in 2015 and 5.6% in 2016. They fell by 0.4% in 2017, 1% in 2018—and grew by just 0.9% in 2019. Whom to blame? We point a finger at the competition.

"I'm 51 years old," Jeff King, who runs the "Den of Tools" YouTube channel and discussion site, tells me, "and I can remember a time when 'made in Japan' was looked at as junk, and then it transitioned into, 'This stuff is pretty good.' Then it was 'made in Korea' was junk, and now it is actually pretty good.

"When you see 'made in Taiwan,' a lot of people say, 'It could be junk, but it could be some of the new, nicer stuff,'" King goes on. "We're seeing a lot of these businesses—what I'm calling tool-truck alternatives—coming out with stuff that is generally made in Taiwan, because it is in this sweet spot between cost-effective but also being at a [quality] level that people expect in the trades. I think GearWrench was the first company to really go after this market. Many others have followed: Harbor Freight with their Icon line, the new hand tools from Ingersoll Rand. We're seeing all these different brands that are coming in at half or less the price of the tool truck [i.e., Snap-on] and delivering 80%, 90%, 110% of the quality."

Harbor Freight, which was once better known for its prices than its quality, repositioned itself four years ago, King relates: "They used to just be introductory, cheap tools, but they are now doing this good, better, best. The good stuff is still the cheap stuff they had before. The better stuff is like your DIY consumer level and the best—Icon line—is one of these tool-truck alts./made-in-Taiwan categories that approaches the level of quality of Snap-on." And, usually, at half the price or less.

It seems hardly coincidental that Snap-on's tool sales stopped growing as Harbor Freight came into its own—in the context, let it not be forgotten, of the longest economic expansion in American cyclical history. And now Harbor Freight is advertising a new customer-credit facility at the low, low APR of zero for up to 36 months. It's exactly 1,770 basis points cheaper than the aforementioned SOC lending rate.

Snap-on can't relish the option of slashing prices to match the ascendant, half-off competition. As it is, according to the corporate franchise documents, Snap-on sells to its franchisees at discounts to list price of between 10% and 43.9%. Say that the franchisees pay a third less than the end customers. Now, then, the Tools division itself earns a 14.4% operating margin. To compete with the van alternatives, the company would have to eliminate not only its franchisees' margins, but also its own.

Last fall, Harbor Freight dropped a note into its tool catalog to hammer the point home: "The Snap-On FJ300 Jack is a good example," Eric Smidt, the founder and CEO began. "A couple of years ago, we learned that an independent factory in Asia made the jack. The factory sold it to a middleman, who sold it to Snap-on, who sold it to the tool-truck franchisee, who then sold the jack to the customer. Today, the jack sells for $726.25. At every step along the way there's a markup. So, by the time the customer buys the jack, the price has increased four times or more.

"The same factory makes the Daytona Super Duty 3 Ton Steel Jack for Harbor Freight," Smidt continued. "The Daytona has the same performance, features and durability as the Snap-on. But because we work directly with the factory, we can pass the savings on to you and sell it for $209.99 (and as low as $189.99 with a coupon)."

Over the past four years, Snap-on franchisees have failed at rates just above or below 6%, according to the company's arithmetic. However, the calculation derives from the total number of driver routes, whereas some drivers take on more than one. Recalculating failure by the number of franchise owners who quit

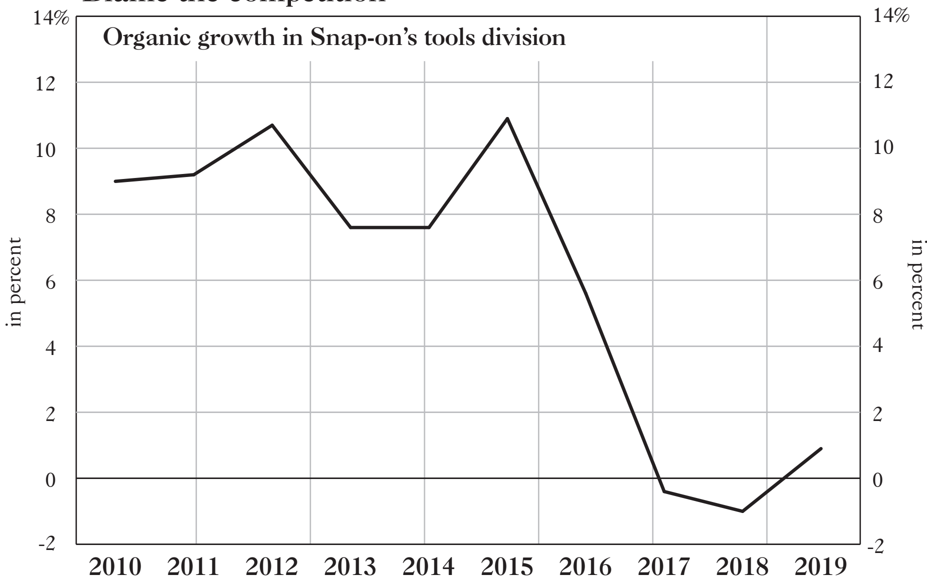
Snap-on, Inc. at a glance
all figures in $ millions

	TTM*	2019	2018	2017	2016
sales	$3,660.5	$3,730.0	$3,740.7	$3,686.9	$3,430.4
operating profit	908.6	962.3	956.1	882.1	861.1
interest expense	47.9	49.0	50.4	52.4	52.2
net income	652.8	693.5	679.9	557.7	546.4
cash	185.8	184.5	140.9	92.0	77.6
debt	1,108.3	1,149.8	1,132.3	1,186.8	1,010.2
contract receivables	447.6	460.8	443.2	419.4	374.8
financing receivables	1,616.2	1,633.6	1,592.9	1,544.6	1,407.0
total assets	5,564.3	5,693.5	5,373.1	5,249.1	4,723.2

* For the 12 months ended March 28, 2020.

source: company reports

Blame the competition



source: company reports

the system, Norne finds that the drop-out rate worked steadily higher, to 11.8% in 2019 from 8.9% in 2016.

The trend is problematical for a service model founded on franchise trucks paying their customers weekly visits. A franchisee's departure complicates, for instance, the essential work of warranty service. Some of the tool-truck alternatives will ship replacement parts on receipt of photographic proof of the broken original, no questions asked. Snap-on franchisees seem to have no uniform policy in this regard; the customer takes pot luck.

Miles driven regulates the demand for auto repair. Now that cars, like their owners, are sheltering in place, State Farm, Chubb Auto Insurance and Berkshire Hathaway, Inc.'s GEICO are discounting or refunding insurance premiums. Job losses, too, are weighing on the demand for preventive maintenance. Nearly a third of respondents to a May 1–3 survey by Cox Automotive said that, for the time being, they'll do without.

The decline in repair volumes will hit the income of the mechanics and, perhaps, make them more price-sensitive when (or if) they next buy tools. And if they find that they are unable to service their tool-incurred debt, it won't be the company alone that bears the loss. To improve underwriting quality through the alignment of interests, Snap-on accepts responsibility for only 75% of credit losses; franchisees are on the hook for the remainder. If things get hairy enough, it seems reasonable to expect further weakening in the Snap-on customer-service network.

With six buys, five holds and no sells, the Street is friendly enough towards Snap-on. Nevertheless, with 13.8% of the stock sold short, not everyone is well disposed. For its part, management seems to be lining up with the bears. Over the past 12 months, insiders have unloaded 95,067 shares for proceeds of $15.6 million.

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