Tools
United States

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Company Update

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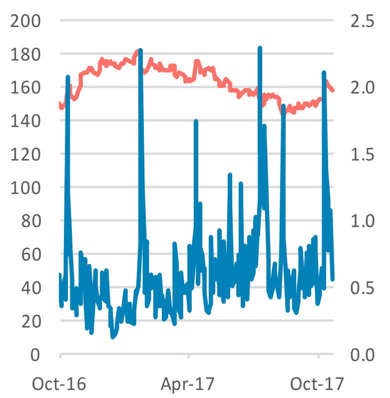
Snap-on Incorporated (SNA US)

Share price	USD 157.09
Market cap (mln)	USD 8,955
P/E	16.11x
S/I	14.26%
Div yield	1.8%
1-year revenue growth	3.3%

Snap-on Incorporated (SNA US) last share price in USD (left, pink) and volume in mln shares (right, blue)



Source: Bloomberg October 31, 2017

Snap-on Incorporated (SNA US)
Channel Stuffing, Not Growth

- **Channel stuffing**
  SNA required franchisees to purchase the new, expensive Zeus diagnostic equipment, effectively stuffing the distribution channel with USD 30 mln of equipment in the quarter.

- **No organic growth**
  Net of sales growth due to acquisitions and channel stuffing there is organic growth of only 0.4%.

- **Provision rates up**
  Provisions rates for default on financial receivables are on target to rise by 50 basis points this year. Contract receivables also set to rise 50 basis point this year. Our research is indicating SNA has increased efforts to artificially suppress delinquency and defaults.

- **Lending fueling sales**
  Increased lending to customers and franchisee financed 85% of the sales increase.

In the Name of Zeus

SNA stock has rallied 4.4% since reporting Q3 results of 8.4% sales growth and net earnings increase of 1.3%. We are surprised as the sales growth was driven by acquisitions for which the company over paid and channel stuffing. Net cash flow from operations fell 14.6% over the same period last year. Provision for bad debts increased despite the company using all its efforts to suppress how bad the growing bad debt situation has become. We expect Q4 to show a deterioration in performance as the acquisition effects roll off, channel stuffing impacts orders in the quarter and defaults continue to rise.

Table 1. Q3 Revenue and Margin by Division

USD mln	Q3 2016	Q3 2017	Growth
Revenue	905.7	982.8	8.5%
Snap-on Tools Group	397.2	392.7	-1.1%
Organic Growth		-6.5	-1.6%
Organic Growth in the US		-20	-5.0%
Repair Systems & Information Group	286.1	333.5	16.6%
Intersegment Revenue (diagnostic equipment sold through Tools)	62.3	73.2	17.5%
Organic Growth		23.7	8.2%
Acquisition Revenue		21.0	7.3%
Channel Stuffing Diagnostic Equipment		30.0	10.5%
Commercial & Industrial Group	289.3	314.6	8.7%
Organic Growth		0.6	0.2%
Acquisition Revenue		22.7	7.8%
Financial Services	71.6	79.0	10.3%
Total Revenue Growth Reported		77.1	8.5%
Total Acquisition and Channel Stuffing Growth		73.7	8.1%
Total Revenue Organic Growth		3.4	0.4%

USD mln	Q3 2016	Q3 2017	Growth
Operating Margin			
Financial Services	70.7%	70.9%	
Repair Systems & Information Group	25.1%	25.0%	
Commercial & Industrial Group	15.1%	15.9%	
Snap-on Tools Group	16.3%	14.3%	

Source: Company Reports, J Capital

Even Snap-on fanboys have panned the Zeus. We think it got at best 50% sell-through.

God of Channel Stuffing

We understand from people close to the franchisee network that Snap-on launched its latest handheld diagnostic device, Zeus, in August by shipping at least two units to franchisees whether they had ordered them or not. On the results call, the CEO said that Zeus was released at the end of August and sold out in September. Well, it certainly left the Snap-on warehouse and went into franchise inventory but it apparently did not sell out to end customers. We believe at least USD 30 mln of Zeus sales were forced and at least USD 40 mln remains in inventory.

Zeus costs USD 16,500 for equipment (USD 12,000), three years of software updates (USD 5,000), warranty, and three years of data. We think the product may have flopped; it certainly has been panned by Snap-on fanboys,[1] who are withering in their criticism of the high price for a device that is comparable in capabilities to a Samsung tablet that costs USD 1,500.

Given that there are around 3,300 franchises, each of which were required to purchase two units wholesale at USD 12,375 each (gross margin on diagnostics is 25%), then sales in the quarter would have been elevated by USD 81.75 mln for the Zeus devices. We estimate that maybe at most half were sold while at least USD 40 mln are still in inventory. That should depress sales next quarter.

Zeus sales are reported in the Repair Systems and Information Group but mainly sold via Snap-on Tools. So the high growth reported in RSI sales was likely a result of the channel stuffing.

[1] See these three Youtube videos:
https://www.youtube.com/watch?v=sDd4RO4YpA0 and
https://www.youtube.com/watch?v=v2uwauP9MFY and
https://www.youtube.com/watch?v=sDd4RO4YpA0

Desperate to juice sales, the company has been forcing franchisees to buy new trucks as a condition of franchise renewal on the five-year anniversary.

New toolbox a flop

Management admitted on the earnings call that orders at the Snap-on Franchise Conference were down on previous years. Orders had already been soft at the end of Q2 due to a decline in tool box sales, and management expected orders to pick up at the SFC, when a revamped tool box offering was being launched. It flopped. Although management claimed toolbox orders were up and other items were down, we doubt that, since inventory increased from 65% of sales to 72% from Q2 to Q3. That is why SNA had to force purchases of Zeus and why contract receivables (loans to franchisees) increased by USD 31 mln in the quarter. Contract receivables normally jump in Q3 due to higher orders at the SFC, but this year the increase was higher than last year, while orders at the SFC fell. This is evidence that Zeus sales were just channel stuffing.

Forced truck upgrades

On the earnings call, the CFO claimed contract receivables were up, as franchise dealers were upgrading their trucks. We heard from dealers who reached the five-year anniversary of their franchise contract that they had been forced to upgrade trucks from serviceable and adequate 16-foot trucks to new, 20-foot trucks in order to renew their franchise agreements. The new trucks cost USD 125,000 truck and were financed with SNA Credit loans. This is killing off the secondary market for 16-foot trucks. Truck-sales sites show that second hand sales of Snap-on's 16-foot truck have been falling.

SNA is forcing the new trucks on franchisees to increase contract lending. This also pushes out more inventory, as larger trucks require 20% more inventory to fill them up.

We believe this SNA practice could lead to lawsuits, as some state and federal laws may regard this as an unreasonable condition of renewal.

Table 2. Provision for Contract and Finance Receivable

USD mln	Q3 2016	Q3 2017	2016	2017 Est
Provisions for Finance Receivables YTD Q3	30.4	38.6		
% of total Finance Receivables	3.1%	3.5%	4.3%	4.8%
Provisions for Contract Receivables YTD Q3	6.1	7.9		
% of total Contract Receivables	1.6%	1.9%	2.0%	2.50%

Source: Company Reports, J Capital

Provisions for bad debt relentlessly rising

Provisions for defaulting finance receivables are on track to increase 50 basis points to 4.8% by the end of the year. Contract receivables will also rise 50 basis points for the year.

We are hearing increased reports of Snap-on Credit using recency and loan restructuring to under report delinquency and default of loans. We have heard examples where a 119-day debt of USD 1,000 is about to go into default. The franchisee can then call Snap-on Credit and get verbal approval of a USD 100 payment, making the loan current and putting the USD 900 at the end of the contract for an extension fee of USD 30, adding USD 930 to the end of the contract. We believe this is a breach of consumer law, as consumer credit contracts cannot be altered orally in many states and according to federal consumer credit laws.

We have heard also that SNA is hiding delinquency by making dealers responsible for 100% of any unpaid balance. Snap-on Credit invents a reason to claim that the contract was fraudulent and, if the dealer refuses, Snap-on Credit adds the deficient amount to the dealer's tool bill. If the dealer does not pay the tool bill, then that dealer goes on "tool hold," meaning it can no longer get tools for orders or for warranty replacements. That ruins the franchisees' standing with customers.

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