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FASTENAL CO

Q1 2022 Earnings Call

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Fastenal Co.

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Fastenal Co.

Holden Lewis

Chief Financial Officer & Executive Vice President

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MANAGEMENT DISCUSSION SECTION

Operator

Hello and welcome to the Fastenal First Quarter 2022 Earnings Results Conference Call and Webcast. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded.

It's now my pleasure to turn the call over to Ellen Stolts of Investor Relations. Please go ahead.

Ellen Stolts

Director of Accounting - Reporting and Reconciliation

Fastenal Co.

Welcome to the Fastenal Company 2022 first quarter earnings conference call. This call will be hosted by Dan Florness, our President and Chief Executive Officer; and Holden Lewis, our Chief Financial Officer. The call will last for up to one hour and will start with a general overview of our quarterly results and operations, with the remainder of the time being open for questions-and-answers.

Today's conference call is a proprietary Fastenal presentation and is being recorded by Fastenal. No recording, reproduction, transmission or distribution of today's call is permitted without Fastenal's consent. This call is being audio-simulcast on the Internet via the Fastenal Investor Relations homepage, investor.fastenal.com. A replay of the webcast will be available on the website until June 1, 2022 at midnight Central Time.

As a reminder, today's conference call may include statements regarding the company's future plans and prospects. These statements are based on our current expectations and we undertake no duty to update them. It is important to note that the company's actual results may differ materially from those anticipated. Factors that could cause the actual results to differ from anticipated results are contained in the company's latest earnings release and periodic filings with the Securities and Exchange Commission and we encourage you to review those factors carefully.

I would now like to turn the call over to Mr. Dan Florness.

Daniel L. Florness

President, Chief Executive Officer & Director

Fastenal Co.

Thank you, Ellen, and good morning, everybody, and thank you for joining our Q1 earnings call.

Before I start, I thought I'd just share a few tidbits from a conversation I had this morning with our regional business unit leaders, our regional vice presidents and our VPs of the business. And I started that by sharing, last evening or late yesterday afternoon, my wife and daughter returned from a weeklong band trip to Florida Marching Band. And as with most high school trips, it involved a – well, if you're coming from Winona, that is, it involves a 26-hour bus ride down last Wednesday and a 26-hour bus ride back. And I saw a bunch of haggard kids and a handful of haggard adults get off the bus yesterday about 4 o'clock. And when we got home that evening, I was watching the video. I don't like to watch myself on video, but it's a necessary evil to make sure you present as good a message as you can and present it in a style that isn't too painful to watch.

And my wife commented on it and I think she probably was commenting, partly and the fact she was kind of tired from the bus ride, she thought it was a pretty under-inspiring video. And she had no problem telling me that and she said, you know, for the last two years, you come home, you talk about things that people are doing at Fastenal, things you see from the leaders and everybody within the organization and how impressed you are. You just had a great quarter and your video doesn't speak to that at all. It sounds like you're in the middle of COVID and it's kind of disappointing.

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And after brushing my pride off, I got in this morning and I let our leadership know just how damn proud I am of the quarter they just put up, but more important than that, of what they've done in the last two years. And all the hard work as we transitioned from tariffs to COVID and worrying about our own human safety and the safety of others to the surge in demand for products, that pivoted into a supply chain globally that completely fell apart and how did we manage through that to support our customers and their needs and, more recently, managing through the chaos, that is inflation.

Frankly, the first bullet on the flip book has the statement good execution. I think there's a typo there. That should say great execution. I think the Fastenal Blue Team did an unbelievable job in the last few years. And I think that extended into this quarter. And I'm really proud to be associated with them.

Even yesterday in our audit committee call, we were picking on Holden a little bit, but he's been kind of crabby lately. And it's kind of refreshing, when you have a really good quarter and your CFO was kind of crabby and he was talking about our cash flow. And he wasn't pleased with it. And I said to him, I said, Holden, take a look at the last six year and look at our growth and look what our operating cash flow to earnings was. In our strongest year, it was at – I think it was at 93%. I think that was first quarter of 2018, might have been 2017. And it costs money to grow a distribution business, and that money is spent in working capital, and that gets amplified when you have heavy inflation like we're seeing right now. So I'm glad you're irritated and irritable. I can't imagine being at least right now when you come home from work. But thanks for what you're doing, but don't be too hard on everybody.

So, flipping to the book here. The net sales grew 20.3% in the first quarter, our pre-tax profit grew 28%. There was some amplifying effects. Last year's weather the in the Texas and Oklahoma area in February hurt our sales, hurt the economy quite frankly. And then we had a mask write-down. But adjusting for those, this is our strongest top and bottom line growth that we've experienced in a decade. It's really been since we were recovering from the 2008, 2009 in the 2011, 2012 timeframe that we saw the growth that we're seeing right now. So I'm really pleased with the performance.

In the last two years, so since the pandemic started, we've put in a lot of energy to deploy technologies and strategies to just improve our efficiency. And that served us really well because the environment has restrained our ability to add labor and energy into the organization. But it hasn't hurt our ability to grow sales and also to continue the branch consolidation process that we started six, seven, eight years ago. So, very, very strong performance there.

The supply chains and labor markets remain tight. However, conditions have stabilized. We're getting more product on the shelf to support the need, which makes the business less chaotic, and we are seeing an uptick in applications coming in. And I'm hearing it mostly anecdotally from our regional leaders. But they're seeing more and more people willing to come back to the workforce and apply for jobs. Part of that is probably a function of our number one recruiting area is four-year state colleges and two-year technical colleges. As they have come back in full force, that group of people are looking for opportunities for their future.

Our international business reached a milestone. In the month of March, we exceeded $100 million in sales for the first time, and next week marks two steps towards normalcy in our world. One is our Customer Expo, our selling event, is returning to an in-person format after two years of not occurring in-person; and that'll be Tuesday, Wednesday next week. And then, next Saturday, we'll hold our annual meeting in-person after two years of the sanitized video or on-air version, which is, frankly, less than satisfying in a community like this where we get a good local turnout at the event.

Flipping to page 4 of the book, it's a comparison of the 2020 to 2022 period. And this will be the last quarter that we put this table in because, obviously, as we exit this quarter and enter the new quarter, our two-year comparison falls square into the COVID period. So it becomes less than meaningful. But we thought we'd continue it, as we've done the last three quarters.

I think the only thing that should jump out on here is – at least jumps out for me is the fact that our operating and administrative expenses have dropped from 26.7% of sales two years ago to 25.5% of sales today, as we've worked to make the organization more efficient. And I'm really proud we're able to accomplish this during the distraction of the last two years.

One item that's probably a little bit misleading in here, it shows our gross profit is actually flat in that two-year period. It's actually down slightly. January and February of 2020 were a bit higher. And as we entered the COVID period in March 2020, we started selling bulk quantities of masks and things like that at a lower margin and it actually pulled our margin down to 46.6%. Just trying to express a little full disclosure there.

Flipping to page 5. When people get more confident of where we are today and there's less chaos in the world and you're more comfortable engaging with others, we always felt that our growth drivers would see an uptick and we had to just get through this COVID period. Well, our Onsites saw that uptick. We signed 106 in the quarter, finishing with 1,440. So we're up 12% from the number of active sites we had a year ago.

And we continue to do the healthy business thing. And that is, just like we've done with our branches over the last decade, you challenge every business unit, is that Onsite performing to what you need it to be for both our customer and for us. Sometimes we run into situations where we take a customer that was doing $25,000 or $30,000 a month in sales in a branch and we double that and maybe we even triple that. But we get to the point where we kind of get stuck at a number. Let's say, it's $70,000, $80,000 a month.

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We always have to evaluate what is the best solution there for the customer and for our ability to serve that business. And sometimes, it's pulling it back into the branch. Sometimes it's the case the customer runs out of space for us. Sometimes, and we've seen this in the last six months particularly, we have some customers that are consolidating some of their operations. And we've had a few Onsites that have closed, but we pick it up somewhere else, or it consolidates with an Onsite we have somewhere else. But we think it's a great business and we're really pleased at what we saw in the first quarter with signings. And we're excited about that customer event next week and what it means to keep this thing going.

FMI Technology, it's about bringing better visualization and service ability to the point of use. It started with vending a decade-plus ago and we've expanded with a bunch of other technologies. A year ago, we were signing 74 a day. This quarter, we signed 83 a day. And we ended the quarter stronger than we started the quarter. And for Onsite and for FMI, our goals for the year remain unchanged. So the FMI Technology now represents 35.5% of sales. A year ago, it was 28.7%; and two years ago, it was 26.4%. We're going to keep driving that.

eCommerce, 55.6% growth in the first quarter of 2022. And like our international group, our eCommerce team also hit a milestone. In March, we exceeded $100 million in revenue for the first time. It's not too many years ago, I think it was 2011, when we pointed out the fact that international was now 10% of the company, but still a relatively small piece. And eCommerce was something we dabbled in, but really wasn't a thing. Times have changed in the last decade, and now both of them are $100 million a month businesses.

Finally, if you roll up our FMI Technology and our eCommerce, we talk about our Digital Footprint. We hit 47% of sales in the quarter, 39.1% a year ago; 34.9% two years ago. Our goal is to hit 55% of sales at some point later in the year. And we still believe that long-term that has the potential to be 85% of sales. And we're gearing our supply chain and have been gearing our supply chains to support that kind of business in the future.

With that, I'll turn it over to Holden.

Holden Lewis

Chief Financial Officer & Executive Vice President

Fastenal Co.

Great. Thanks, Dan. So I'll be starting on slide 6. Total sales increased 20.3% in first quarter 2022. If you adjust for the extra selling day in the period, sales increased by 18.4%. Both periods were impacted by adverse weather, and the net effect contributed 50 to 100 basis points to the growth in the period.

I'm not going to recite all the numbers that are on this page because we basically experienced consistent growth across all major product categories, our large and our small customers in most end markets.

The main exception to this, broad-based strength, were government customers, which fell 6.2% year-over-year, but I would point out that they were up nearly 50% from pre-pandemic levels. And I think that really reflects sustained share gains across that customer set. So, as always, our business does not carry a lot of forward visibility, but our field sales force continues to maintain a very positive outlook about their markets.

Pricing contributed 580 to 610 basis points to growth in the first quarter of 2022, reflecting actions taken over the last nine months to offset inflation. Input costs have mostly stabilized at high levels with a few notable exceptions. For instance, higher nickel prices will flow through to stainless steel fasteners while higher oil prices will affect the cost of fuel for our captive vehicle fleet and the cost of overseas shipping services. As described on this page, these are relatively smaller pieces of our business, which we believe we can address through targeted pricing on stainless steel fasteners and surcharges for transportation-related increases. Price contribution should remain high in the second quarter of 2022 before running into tougher comparisons in the second half of 2022.

The last thing I'll say about the marketplace is it is still grappling with supply chain and labor constraints as well as high prices for inputs and products. What is changing is we and our customers are more effectively managing this environment. This is reflected in higher growth driver signings and improving internal supply chain and relatively strong FTE additions in February and March. So, while these disruptions persist, the chaos surrounding them has receded, resulting in a more predictable business environment.

Now to slide 7. Operating margin in the first quarter of 2022 was 21%, up from 19.8% in the first quarter of 2021 and good for an incremental margin of 27.1%. While the absence of last year's write-down of masks favorably impacted the year-over-year compare, even adjusting for this, our incremental margin was a solid 24.4%.

Gross margin was 46.6% in the first quarter of 2022, up 120 basis points versus the first quarter of 2021. Half of this increase relate to the absence of last year's mask write-down. The next largest contributor was safety product margin, which increased significantly even excluding the effect of the write-down. In the year earlier period, we were still supplying COVID-related supplies to key customers under supply commitments that we had entered into at the start of the pandemic which had lower margin. Those commitments have since expired, and COVID-related product margins have returned to pre-pandemic levels.

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A smaller contributor was a narrower loss on freight service to our branches as strong daily sales growth in freight sales of 37% provided improved cost leverage. Our price/cost remained largely neutral to gross margin in the quarter. Product and customer mix was a roughly 10 basis points negative impact to gross margin with the drag produced by strong Onsite and national account sales having a slightly greater impact than the positive effect of favorable fastener mix.

Our operating leverage was modest in the first quarter of 2022, with an operating expense to sales ratio being 10 basis points better at 25.5%. We achieved 60 basis points of leverage of our occupancy expenses related to a 10% reduction in our traditional branch count and the effect of what has been to this point relatively slow expansion of our vending installed base.

We also achieved good leverage over employee base pay. While we are encouraged by the February and March growth in our FTE employee base, the tight labor market continues to produce FTE growth that is lagging sales. These areas were mostly offset by strong employee incentive payouts, higher profit-sharing expenses, higher healthcare costs, higher travel expenses and, to a lesser degree, rising fuel costs. If you put it all together, we reported first quarter 2022 EPS of $0.47, up 27.8% from $0.37 in the first quarter of 2021.

Now turning to slide 8. We generated $230 million in operating cash in the first quarter of 2022, which is roughly 85% of our net income in the period. Traditionally, first quarter conversion rates exceed net income. However, the combination of robust customer demand, supply chain constraints and high inflation put a premium on product availability and investment in working capital. As a result, we view the lower conversion rate as reflecting our commitment to supporting our customers. As supply chain constraints and inflation rates ease, we expect to see improved conversion rates as we go through the year.

Year-over-year, accounts receivable was up 25.9%. This reflects strong customer demand and an increase in the mix of traditional manufacturing and construction customers, which tend to have longer terms versus the prior year period. Inventories were up 22.6%. Inflation accounted for roughly two-thirds of the total increase. That's significant, but it is a decline from the fourth quarter of 2021 when inflation accounted for roughly 80% of the rise in inventory and that is the result of an accelerating flow of physical products into our hubs, which is improving product availability and fulfillment rates.

Net capital spending in the first quarter of 2022 was $33 million, up from $30 million in the first quarter of 2021, with increased spending for FMI equipment, hub automation and upgrades, and IT equipment. Quarterly capital spending level should pick up through the balance of the year as vehicle availability improves and hub projects advance. As a result, we continue to anticipate 2022 net capital spending in a range of $180 million to $200 million, which is unchanged from the prior quarter.

We returned cash to shareholders in the quarter in the form of $178 million in dividends. And from a liquidity standpoint, we finished the first quarter of 2022 with debt at 10.4% of total capital, down from 12.7% in the year ago period and 11.4% versus the fourth quarter of 2021. Our revolver remains available for use.

With that, operator, we'll turn it over for Q&A.

QUESTION AND ANSWER SECTION

Operator

Thank you. We'll now be conducting a question-and-answer session. One moment, please, while we poll for questions. Our first question is coming from Chris Snyder from UBS. Your line is now live.

Chris Snyder

Q

Analyst

UBS Securities LLC

Thank you, and congratulations on the strong quarter. My question is on price/cost going forward. The company noted that, I think, in the current market, costs are high, but stable, and they're seeing inflation on a select few product lines, where it seems like there is opportunity for incremental pricing. So, I guess, my question is, should we assume relatively unchanged price/cost over the rest of 2022 relative to Q1 levels?

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

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We continue to assume that we're going to be price/cost neutral over the course of the year. If your question is what is the level of pricing we're expected, bear in mind, that, to some degree, as we move into Q2, but particularly as we get into Q3 and Q4, we're going to begin to comp against much higher pricing from a year-over-year standpoint. And so, I think my expectation is that we will still be north of 5% on price in the second quarter, but that you'll begin to see that pricing contribution drop fairly sharply in the Q3 and Q4 period, as our own pricing actions remain fairly stable and runs into last year's tougher comparisons.

Chris Snyder

Q

Analyst

UBS Securities LLC

Appreciate that. Thank you. And then for the follow-up, I wanted to ask around the Onsite model into a potential macro slowdown. I know the company has spoken to Onsite revenue targets per location. I was just wondering, is there any sort of volume commitments that accompany these Onsite agreements that can maybe give the company a naturally higher wallet share of customer spend as their activity declines.

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

When we sign an Onsite, we will have discussions about a target for that facility. And based on the customers' information about their spend, our information about their spend, and sometimes you can do some napkin calculations based on how many employees are there, what types of activities, OEM faster demand, et cetera, there isn't a hard and fast rule that says, hey, you need to be at this number. But it's a partnership. And that partnership says, let's work together to grow the footprint.

What I often see when I visit Onsites is I find a very motivated customer to add wallet share to Fastenal because what does an Onsite represent to them? It represents Fastenal putting personnel and inventory into their business to support their business, which frees up their need to add personnel, frees up their need to add working capital. So, it's a great program for our customer, and it's a way for them to have resources. Resources that we normally would have had working in a branch now are bringing product right to the point of use or doing different things and actively managing, and it frees up resources for them. That's ultimately what gives us our footprint. It isn't a contractual obligation that says, you must do this or else.

Same thing with our vending program and our Onsite program. What we say to the customers, this is what it's about, and we're not going to hold you to a contract. But if you demonstrate that six months into it that you really aren't bought into it, we reserve the right to take our ball and go home. And that's what drives the wallet share ultimately in the business.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

So, Chris, I don't believe that...

Chris Snyder

Q

Analyst

UBS Securities LLC

Thank you.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Yeah. I don't believe the Onsite model necessarily diminishes our cyclicality. I mean, we do have a tamped down cyclicality versus any industrials with our MRO exposure and that sort of thing. But I don't think the Onsite does anything in that regard. But the Onsite is a great platform, as Dan indicated, to gain market share. Whether we're in a period where we're growing or a period where the marketplace is contracting, we can gain market share in either environment, but we'll still maintain a cyclical profile.

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Daniel L. Florness
President, Chief Executive Officer & Director
Fastenal Co.

A

I'll add to that. We have relatively low market share. We're always growing. It's just that sometimes it doesn't shine through in the numbers because there is a lot of headwinds.

Chris Snyder
Analyst
UBS Securities LLC

Q

Thank you for all that color. Appreciate it.

Daniel L. Florness
President, Chief Executive Officer & Director
Fastenal Co.

A

Sure.

Operator

Thank you. Next question is coming from David Manthey from Baird. Your line is now live.

David J. Manthey
Analyst
Robert W. Baird & Co. Equity Capital Markets

Q

Yeah. Thanks. Good morning, guys.

Daniel L. Florness
President, Chief Executive Officer & Director
Fastenal Co.

A

Hi Dave.

David J. Manthey
Analyst
Robert W. Baird & Co. Equity Capital Markets

Q

First off, could you discuss your expectations for FTE growth needed to fuel revenue growth this year? And then, Dan, maybe longer-term expectations for labor requirements versus historical trends, especially in light of these automation tools that you've deployed and you will continue to deploy across the company, and that's both customer-facing and internal type technologies.

Daniel L. Florness
President, Chief Executive Officer & Director
Fastenal Co.

A

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I hesitate to throw out a percentage only from the standpoint of, while we've seen a pickup in applications, we still are operating, quite frankly, with fewer employees than we'd like to see. Even if you look at – if I was going to peek through the quarter and point out some positives, some negatives, one negative that would jump out is we didn't implement as many of the Onsites as I'd like to have seen in the first quarter. And I know part of that holdback, sometimes it's just the transition process, but sometimes it's a case of do we have the staffing. And because we have the individual ready to step into that new Onsite, but we have an individual back in the branch ready to step into their spot in the branch. And we add, let's say, we sign and add 100 Onsites a quarter, that pulls employees with it. And we need to have – I said I wasn't going to say percentages. We need to have better than low-single digit percentage growth in that environment when our sales are growing double-digit and beyond. But we'll see how that plays out as we move into the second and third quarter.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

And one nuance about that, Dave, is we tend to look at it less about the FTE and more about what the total labor dollars that we commit. And when we talk about being more productive with labor, we tend to think about are we driving more gross profit dollars for every dollar of labor that we produce in our business. And that's how we tend to think about it.

And to Dan's point, I'm not sure that we have an exact percentage that we would communicate here. It's managed very well by the field. But I think that as an organization, we understand that the growth in our labor dollars on our pathway from where we are today, that $10 billion company and beyond, has to come with labor dollars growing at a slower rate than gross profit dollars. And as an organization, I think, pretty uniform in that objective.

David J. Manthey

Q

Analyst

Robert W. Baird & Co. Equity Capital Markets

Yeah. Thanks, Holden. And maybe we could drill down on that a little bit, because in the first quarter – I know it's just one quarter, but OpEx growth and revenue growth were pretty identical at 20% and you did have this 6% price. So SG&A growth kind of outpaced your unit volume growth by quite a bit. And the question is should we assume that – based on what you just said, that despite the fact that in the generalized inflationary environment, your cost stack is going to be elevated, as we go forward here, you should see better leverage on your OpEx in future quarters?

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

That is the expectation. And here's how I think the setup plays for the rest of the year. If I think about incentive pay, for instance, in the first quarter, it was up about 60% versus the prior year. Again, that's a great thing to be able to talk about because it reflects the performance of the business. I just don't believe that you're going to see that rate of growth as you move into the second quarter, third quarter and fourth quarter, partly because of the comps from the prior year where we really begin to ramp that in terms of our performance in the back half of last year coming out of the pandemic.

And so, I wouldn't be surprised if the rate of growth in incentive pay, as you get those comps, is half in Q2 what it was in Q1, for instance. And I think you have very similar dynamics with healthcare costs and general insurance costs, where the drag that they contributed in Q1, I don't think you're going to see anywhere near that same order of magnitude of drag as you get into Q2, Q3, Q4. Travel and supplies, something which really sort of came down as the pandemic settled in, that was up 50% in the first quarter. I think that's going to be up less than 20% in the second quarter. It could be flat in the back half.

So I think a lot of the lack of leverage that you saw in the first quarter reflects on some levels the comparison versus the prior year. And as we go into the balance of this year and second quarter, third quarter, our volumes should be higher just seasonally, I don't think you're going to have the same degree of cost drag in a lot of areas that we experienced in the first quarter.

So my expectation is that for the balance of the year, we're going to leverage SG&A. Occupancy, I think, will continue to leverage, based on what we're doing on sort of the branch strategies and things of that nature. So, yeah, my expectation is we leverage SG&A in the balance of the year.

Daniel L. Florness

A

President, Chief Executive Officer & Director

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Fastenal Co.

Hey. Dave, I'll just throw a little tidbit in. In prior conversations, you've talked about the shock absorbers in our operating expenses. If you think of what happened a year ago, because I talked about some of the amplifying effects earlier that the weather changed and then the inventory write-down a year ago. There were two things going on in first quarter of 2021 that didn't occur in first quarter of 2022.

In the first quarter of 2021, 55% of our branches were growing. By the second quarter, that has expanded to 70%; and it's kind of hung at that 70-ish number in the second, third and fourth quarter. In the first quarter, 75% of our branches and Onsites were growing. That has a massive impact on the incentive comp paid locally to our branch and Onsite employees because we believe it's harder to grow than it is to maintain; and there's a premium for growth. So that was part of that 60% expansion in incentive comp that we saw from a year ago.

The other thing that happens is we have a big chunk of people that are paid off of earnings growth. Earnings, the rate of just the raw earnings and earnings growth, that $8 million write-down a year ago hammered those programs. But a year later, it amplifies those programs.

So when I look at the 60% increase over first quarter last year in the incentive comp, it's amplified by those two hammering events. In fact, from Q1 to Q2, our incentive comp increased 32%. And so, that changes the comp picture dramatically. And that was 130 basis points of operating expense decrement Q1 to Q1.

David J. Manthey — Q

Analyst

Robert W. Baird & Co. Equity Capital Markets

Yeah.

Daniel L. Florness — A

President, Chief Executive Officer & Director

Fastenal Co.

Probably got way into the weeds there, but I thought I'd just share a little insight on that.

Holden Lewis — A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Yeah. The impact of that write-off actually is an important perspective to have.

David J. Manthey — Q

Analyst

Robert W. Baird & Co. Equity Capital Markets

Yes. It's very helpful, guys. Thanks very much.

Daniel L. Florness — A

President, Chief Executive Officer & Director

Fastenal Co.

Thanks, Dave.

Operator

Thank you. Next question is coming from Michael McGinn from Wells Fargo. Your line is now live.

Michael L. McGinn — Q

Analyst

Wells Fargo Securities LLC

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Hey. Good morning. Thanks for the time.

Daniel L. Florness
A

President, Chief Executive Officer & Director

Fastenal Co.

Good morning.

Holden Lewis
A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Good morning.

Michael L. McGinn
Q

Analyst

Wells Fargo Securities LLC

Good morning. So, I guess, higher level, if you watch the news, a recession is imminent and it doesn't seem to be a case with almost 90% of your top 100 national accounts growing. I guess, of those top accounts, how many are growth-constrained that maybe shape your outlook for sales, given the tougher comps as we approach the back half of the year? And maybe any update on what you think your market share take rate is in an environment where fasteners are the fastest-growing category? And it's been a while since we've seen that for you on a sustained basis.

Daniel L. Florness
A

President, Chief Executive Officer & Director

Fastenal Co.

What do you mean by growth – going back to question one, what do you mean by growth constraints in our largest customers?

Michael L. McGinn
Q

Analyst

Wells Fargo Securities LLC

Yeah. Components where you're not necessarily playing right now and they're trying to deliver longer cycle backlog-driven product, but can't get it out the door for reasons that are beyond your control.

Daniel L. Florness
A

President, Chief Executive Officer & Director

Fastenal Co.

So other supply chain disruption other than what we're supplying?

Michael L. McGinn
Q

Analyst

Wells Fargo Securities LLC

That's correct.

Holden Lewis
A

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Chief Financial Officer & Executive Vice President

Fastenal Co.

Okay. Got it. I'll just fall back on some of the commentary from our regional vice presidents. And I'll say that, in general, they believe that getting products is still a challenge, but easier than it was six months ago. And that's not just for our products, that's for other products within the supply chain. And so, in general, I think that our customers are figuring out how to navigate that sum.

So relative to six months ago, do I think that production rates have gotten better and the ability to navigate some of this disruption has improved? It feels that way to us just, again, based on some of that commentary. So I'm not going to tell you that there aren't issues around ships and things like that that you hear about. But I think that for the most part, our customers are more successfully navigating those issues than was the case six months ago. And so, perhaps that what you're concerned about in the marketplace probably is not as dramatic today as it was. That's all anecdotal, by the way.

Michael L. McGinn

Q

Analyst

Wells Fargo Securities LLC

Got it.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Does that answer the question?

Michael L. McGinn

Q

Analyst

Wells Fargo Securities LLC

It does, yes. So I wanted to go back to kind of gross margin. I see the strong results here, and you mentioned price/cost neutral. It just feels like during – when you're comparing that to pre-COVID levels, you should have seen some sort of national account mix erosion given your model, but that's – it seems like something more is going right here for you guys. And I'm just wondering, I think flat or slightly down was the prior framework and understanding everyone's a little gun shy to guide that line item. But I guess, what's your outlook now on the gross margin side of the equation?

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Well, a couple things to think about. One, the 46.6% in the first quarter of 2020 and the 46.6% in the first quarter of 2022 was a little bit misleading. As Dan alluded to, if you look at only January and February, because in March, the back half of March, we already started to see a lot of low-margin product getting shipped to deal with the pandemic.

If you look just at January and February of 2020 versus 2022, the gross margin in January and February 2020 was 47.1%, and in January and February of 2022 was 46.5%, right. So that decline you would have expected to see. If you take out a month that was beginning to get affected by the pandemic, you would have seen it, okay. So, that's one element.

The other thing I think you have to be a little bit careful of is there is more that drives our gross margin than just price/cost and product, customer mix, right. And I think about things like mix within mix. When we talk about product and customer mix, we're really looking at large categories against one another. But within safety, there may be a mix within mix element where we're improving our margin on the COVID product specifically. That doesn't necessarily get captured in the customer product mix between categories.

There's also things like – we've done a great job with exclusive brands over the course of the pandemic. If I look at the mix of exclusive brands in Onsites, two years ago, it was 10%. This quarter, it was 12%. Exclusive brands to vending, two years ago was 21.5%. This quarter, it's 24.5%. So, that's something which can actually mitigate the product and cost impact to some degree that has happened. And EBs are great because it's lower cost to our customers and it's a higher margin to us.

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And then I would also point out that you're looking over a two-year period. All through last year, we talked about organizational leverage, which wasn't a big factor in Q1, but it was a bigger factor last year, and that's related to the cycle. So, there's more than just those two pieces that affect our gross margin trend certainly over a multiyear period of time. Did that add some color to that?

Michael L. McGinn

Q

Analyst

Wells Fargo Securities LLC

It did. Appreciate the time. Thank you.

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

A couple structural changes, and Holden alluded to the EB component. And again, that's expanded nicely in our vending offering. That subset of business has expanded nicely the exclusive brand component in the last two years as well as our preferred partner component in the last two years. And some of that, we believe, is going to continue to get amplified by things like our LIFT initiative where we are picking and supporting the product needs for our vending platform out of a handful of facilities and our push to our branch to turn that on is you need to have a more standardized offering in the vending machine to make it work in that type of supply chain.

The second one is we talk about the consolidation of branch locations and what it does for occupancy. What we never talk about is the consolidation of locations and what it does for our trucking network. If I'm going out to – if it's two years ago and there's a bunch of trucks that are leaving at 8, 9, 10 o'clock at night, going out and delivering the branches throughout the night, and we're going to 1,800 locations. And two years later, we're going to 1,600 locations, but those 1,600 locations are doing more revenue than the 1,800 did two years ago. That's a more efficient network. And all those things come into play and they keep – the mix punches us in the gut and it affects our gross margin downward. And we have to keep clawing back up these little incremental gains, and we find them in places like that.

Operator

Thanks. Our next question today is coming from Tommy Moll from Stephens. Your line is now live.

Tommy Moll

Q

Analyst

Stephens, Inc.

Good morning, and thanks for taking my questions.

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

Good morning.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Good morning.

Tommy Moll

Q

Analyst

Stephens, Inc.

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Dan, I wanted to start by going back to your introductory slide. You mentioned some technologies and strategies all around efficiency, talked about restraining labor adds without hurting sales, supporting gross margin, branch consolidation, et cetera. Can you give any more context on what some of those efficiency-driven measures have been and what inning we're in in terms of the deployment there?

Daniel L. Florness — A

President, Chief Executive Officer & Director

Fastenal Co.

Okay. So, we talk a bit about the Digital Footprint. And so, within that Digital Footprint, if I went back two years ago when COVID had started, we probably had around, I don't know, 5%, 6% of our sales where we used – it's an MC device, but it was to go out and scan bins. But we didn't really use that to be more efficient upstream in how we pick the product, how we supported that. Today, that roughly 6% has expanded to about 12% of sales in the March month that's gone through what we can now call FASTStock, that's our mobile technology on a platform that we have written that interfaces directly with our point-of-sale system and of equal importance with our distribution center network.

And so, not only are we gathering using technology twice as much of our sales, but we're using that upstream, where in the past, that doubling would have been – we've been writing on yellow notepad and getting orders and pulling it in. And then those orders transmit earlier in the day. So, when they transmit earlier in the day, our distribution center can start picking that product to support them at 10 o'clock in the morning when they scan the bin, not at 4 o'clock in the afternoon when they get back to the branch and they dock their MC device and transmit all that. And it allows us to think differently about how we operate.

Same thing with our FASTBin and FASTVend platform. FASTBin is a relatively new thing, and that's where we put in an environment where you have OEM fasteners and there's a Kanban system. Somebody has to go out and get the bins. Somebody has to go out and figure out what we need for replenishment. What we do today is where we've implemented the bin technology, when that bin is empty, the person that emptied it puts the bin up above the shelf, and there's an RFID chip in it, and there's an RFID reader that's saying, hey, bin number 242 is empty, it's hungry, it needs to be fed. And that transmits right through our point-of-sale system to our distribution center.

And that's where LIFT becomes important in the future because we'll support more and more of that, especially with standard product in a highly efficient distribution model. But even if it's done locally, where it's – because it's more special for that OEM need, we're gathering the information, the need electronically when it occurs, you have fewer surprises, but you also remove the cost of that data collection. And then you can service that information for your customer much more readily and you become a better supply chain partner. And so, that as a percentage, when I start adding that up, just the FMI component has grown dramatically from two years ago, and there's no data collection effort going on.

Holden Lewis — A

Chief Financial Officer & Executive Vice President

Fastenal Co.

I would probably add to that. I mean, if you see the growth in our web, for instance, right, I mean, you're having better than 50% growth at a VDI within that and that creates certain efficiencies for us when you're seeing that much growth there. The web component is also growing north of 50%, and that's allowing us to address certain types of customers in a much more efficient way for us. So I think the growth that you're seeing there also introduces some of that.

And then, some of the strategic things that we're doing, right, the LIFT is still a relatively small component, but we're getting aggressive with it and we're growing it faster and we'll continue to do so. That's going to bring efficiencies into the field in terms of how they supply the vending and, frankly, the FMI as well over time, right. And so, that's going to bring efficiencies to how we use our time. And I would say the things we've talked about with regards to our branches also is trying to bring efficiencies and focus to how we prioritize there. So, it's really a combination of the technologies Dan talked about and some of the strategies, all of which are really aimed at what we talked about earlier, which is making sure that our labor productivity goes up over time.

Tommy Moll — Q

Analyst

Stephens, Inc.

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Thank you, both. That's helpful. As a follow-up, I was looking through my notes from last quarter, and I think the framework that you laid out for the full year this year was gross margin maybe down as much as 50 basis points for the full year versus full year last year, but incremental margins in the 20% to 25% range. You've come out of the gate pretty strong here in the first quarter. So, really just to boil it all down. Is it fair to assume that both of those ranges that you talked about a quarter ago based on what you know now could be positively biased?

Holden Lewis
A

Chief Financial Officer & Executive Vice President

Fastenal Co.

If memory serves, I think the 50 basis points might have related specifically to mix as opposed to the overall gross margin. But I think the expectation was that gross margin would sort of lean down over the course of the year. I would tend to agree with you that the first quarter was a good start to the year on gross margin. And would it surprise me if that improves the overall annual picture a little bit and pushes us closer to something that's flat for the year? Yeah, that wouldn't surprise me. And I want to give some credit because one of the reasons I think that we came out stronger this quarter really does relate to the job the field is doing on freight revenue.

Freight revenue in the first quarter is up 37%. And it was at a dollar level that we haven't seen before. And that really allowed us to narrow the losses that I otherwise expected to see. I mean, I expected the losses related to our branch freight to be about $3.5 million higher than they turned out to be. And I think that that relates to real efforts on the part of the field and strategies that we put in place to try to improve that freight profile, and I expect it to sort of carry through for the rest of the year. So, that's probably the piece that provided more upside relative to my expectations in the first quarter. And the good news is I think that that's going to sort of carry through for the rest of the year as well.

Tommy Moll
Q

Analyst

Stephens, Inc.

Appreciate it. I'll turn it back.

Operator

Thank you. Next question today is coming from Chris Dankert from Loop Capital. Your line is now live

Chris Dankert
Q

Analyst

Loop Capital Markets LLC

Hi. Morning. Thanks for taking the questions, guys.

Holden Lewis
A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Good morning.

Chris Dankert
Q

Analyst

Loop Capital Markets LLC

I guess, first off, and I know this question is going to be very difficult to parse so I appreciate that upfront. But I guess, looking at the fastener growth, I mean, it's pretty staggering. Is there any way to parse on a relative basis how much pricing versus restocking versus core demand is contributing there? I'm not looking for an exact number, but just can you give us a flavor for how those kind of three pieces might be contributing?

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Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Yeah. And actually, if I could just add one more thing to my prior question, I won't count it against you. I want to make sure that when I think about gross margin being flattish or in that ballpark for the year, make sure you're including the write-down from last year because I'm comparing against that number including that number, just so we're all on the same bases.

To your question about fastener margin, we haven't necessarily broken it out by product line in that fashion. What I would tell you is the inflation that exists in fasteners is probably twice or more that of what we're seeing in the non-fastener lines. And even though we might be a touch below neutral on the fastener line from a price/cost standpoint, in order to achieve that, it's fair to assume that the pricing component would be greater for fasteners than it is for the non-fastener piece. And so, I think there's probably a bit more balance between product and price as it relates to the fastener side of the ledger.

Chris Dankert

Q

Analyst

Loop Capital Markets LLC

Got it. That's really helpful. Thanks so much on that. And, I guess, kind of bigger picture zooming out a bit. As kind of supply chain start to normalize slowly here, how do we think about how some of these competitive dynamics shift, which certainly have been taking share by just having inventory availability, what changes on that front? And then, I guess, how do we think about your inventory levels versus customer inventory levels? So just any kind of big picture, how do we think about Fastenal in the context of a normalizing supply chain here?

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

I don't know if we know the answer to that on the competitive shift, Chris. The reality of it is we've performed well in the last two years because we figured out how to find product and we figured out how to get product. And sometimes that meant spending money. That was painful for us. We're a pretty frugal organization. And sometimes that meant spending money to move stuff that was kind of expensive in our way of thinking. And, heck, even today, the cost of taking a container across the ocean is ridiculous. But that doesn't change that. It is what it is.

But I think the memories – memories sometimes are short; painful memories often aren't. And a lot of businesses that went through a really ugly period and they found a friend in Fastenal. I think they remember that because, again, that's a painful memory. Holden has talked about, on prior calls, the number of customers that didn't buy from us before COVID that discovered who Fastenal was because of a pain point they had during COVID. And a lot of that is government and healthcare-centered organizations, but it's a lot of other businesses too.

But that's a $50 million a quarter business for us now. It's a $200 million business within Fastenal that didn't exist two years ago. And I don't think supply chain becoming a little bit less chaotic hurts that business. I think that's a customer segment and that as is realized what a lot of our traditional industrial construction customers have realized for years that Fastenal does a pretty nice job supporting their supply chain needs.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

The other thing I might add to that is we've also talked in prior quarters about how we tend to get sort of obsessive about growth drivers Onsite. If those aren't going well, what's that mean for market share, et cetera? And what we've commented before is we meet the customer where they're at. And for the last couple years, our Onsite signings have been relatively low, but we've been able to gain share through other means because customers are asking us for different things.

I think we should all be encouraged by the fact that as the environment does perhaps become a little less chaotic and, therefore, a little easier for everyone to navigate and maybe that changes the dynamics a little bit, by the same token, we just signed a record number of Onsites. And so, if one element begins to normalize, I think that we're going to have, coming up from behind, those Onsites growing in the mix at a faster rate driving market share from our more traditional growth drivers at the same time. So one might normalize a bit, but I think the other one comes up.

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Chris Dankert

Analyst

Loop Capital Markets LLC

Q

That's really, really excellent color. Thank you, both. And again, congrats on the quarter here.

Holden Lewis

Chief Financial Officer & Executive Vice President

Fastenal Co.

A

Thank you.

Daniel L. Florness

President, Chief Executive Officer & Director

Fastenal Co.

A

Thanks.

Operator

Thank you. Our next question is coming from Jake Levinson from Melius Research. Your line is now live.

Jake Levinson

Analyst

Melius Research LLC

Q

Good morning, everyone.

Daniel L. Florness

President, Chief Executive Officer & Director

Fastenal Co.

A

Good morning.

Jake Levinson

Analyst

Melius Research LLC

Q

Morning. It certainly sounds like most of your end markets are firing on all cylinders here. But any particular positive or negative surprises you guys saw in the quarter, as you look across the different verticals? Or just curious what you're hearing from the field?

Holden Lewis

Chief Financial Officer & Executive Vice President

Fastenal Co.

A

Not really. When 92% of your top 100 are growing, there's not many that's not. Even areas, I would say, like oil and gas and areas that have been a little bit sluggish, they're not necessarily where everything else is, but they're doing better. But I think the marketplace is pretty uniformly strong, Jake. It's hard for me to define many areas of significant weakness. And again, we don't have a lot of visibility into the future, but the field still remains pretty optimistic about how things are playing out.

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Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

The only thing I'd add to that is, Europe is a relatively small piece of our business. The last few years, that business has been on fire; I mean, growing 40%, 50%, 55%. And right now that business is growing in single digits because we have customers that are either impacted because of what's going on in Ukraine or they're impacted by – might be supply chain disruption, but it's probably linked to what's going on in Ukraine. And so, that's impacted our business there.

Just each week, I have about a half dozen conversations with district leaders within Fastenal, where they talk about their business. And in the last week, I had a couple of conversations with folks down in the Carolinas. And one of them had a customer that supplies a product that goes into packaging for medical products, where one of their larger customers is in Russia. And that business is in a standstill right now. And so, I've heard – but that's really small anecdotes in the scheme of the business. Your comment about generally a robust environment is spot on.

Jake Levinson

Q

Analyst

Melius Research LLC

That's great color. I appreciate it. That's all from me today. I'll pass it on. Thank you.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Thanks.

Operator

Thank you. Our next question today is coming from Ken Newman from KeyBanc Capital Markets. Your line is now live.

Ken H. Newman

Q

Analyst

KeyBanc Capital Markets

Hey. Good morning, guys. Thanks for taking the question.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Good morning.

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

Good morning.

Ken H. Newman

Q

Analyst

KeyBanc Capital Markets

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I just wanted to clarify the operating leverage comments you made earlier in the call, and sorry if I missed it. But I mean, just given your comments on potentially flat gross margins inclusive of the mask write-down for the year, like, Holden, you were talking about expectations for better SG&A leverage through the remainder of the year. Should I just take all of that to mean that you expect incrementals could stay in this mid-20% range or higher for the remainder of the year?

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

Our goal has always been to achieve a 20% to 25% and to expand our margin a little bit from where we are, and that remains our goal. I'll let you model it however you model it based on what you've heard so far. I think we've given you enough to play with. But we feel good about how the business is performing today. And we'll see how the macro environment plays out the rest of the year, but we feel pretty good about how things are playing out.

Ken H. Newman

Q

Analyst

KeyBanc Capital Markets

Understood. And then, for my follow-up, obviously, I think COVID is unfortunately a normal part of the operating environment now. But I'm curious if you could just talk through any of the impacts that you may or may not be seeing from the recent lockdowns in China. Particularly, I'm just curious about your ability to secure inventory or your outlook on the margin progression for the rest of the year as it relates to your suppliers within Asia.

Daniel L. Florness

A

President, Chief Executive Officer & Director

Fastenal Co.

Well, first off, so on the call this morning, one thing I didn't touch on, I did touch on the fact that our leaders in both our sourcing operation and our sales operations in China, they're based in Shanghai and, obviously, they're experiencing a pretty ugly lockdown right now. And I first let them know that we are here to support and really impressed with what you're doing locally. Our team has become – especially the sourcing side of it, but both sides have become quite agile of operating in a remote fashion.

Fortunately, there was enough warning that they were able to set up that ability to do that again. And I feel better about it. The fact that we have more inventory on the shelf right now because there will be disruptions from this. There's no question. We're not immune to that and nor is anybody else. But sometimes the old adage possession is nine-tenths of the law, the fact that we have inventory on the shelf or inbound at a pretty high level, even though Holden doesn't like the cash flow impact of that, he does like the fact that they're to support our business. But we have a sizable presence in Shanghai and we're worried about our team.

Holden Lewis

A

Chief Financial Officer & Executive Vice President

Fastenal Co.

And when we talked about the supply chain being fairly predictable at this point, there are components to that. What I will say is you are seeing – the time it takes to get product from a port in China through to our hubs has actually begun to shorten. However, the time that it takes to sort of put in a PO with a manufacturer overseas and then get it to the port, that actually has begun to lengthen. And I suspect that's a little bit of what you're seeing the impact of COVID over there. So, there's a little bit of a difference there. But as Dan indicated, I think the fact that we've been purchasing and floating over so much product over the past six, nine months and that's now really beginning to hit the hubs nicely, that's going to provide us a fairly decent runway of insulation from some of that.

Ken H. Newman

Q

Analyst

KeyBanc Capital Markets

Got it. That's helpful. Thanks.

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Daniel L. Florness

President, Chief Executive Officer & Director

Fastenal Co.

Thank you. I see we're coming up on the hour. And so, I'll close with a philosophical talk for you. And that is – so, a year ago, Holden, what was it, about $8 million that we wrote off on inventory?

Holden Lewis

Chief Financial Officer & Executive Vice President

Fastenal Co.

Yeah.

Daniel L. Florness

President, Chief Executive Officer & Director

Fastenal Co.

We wrote off $8 million of inventory. And our leader of the supply chain team as well as quite a few members of the supply chain team were at pains when we wrote that off. And they were quite apologetic about it. And I looked at them and I said, I said, no, here's what we did. We made a conscious decision stock up on product to support our customer needs and our new customers' needs. Even factoring that $8 million write-off in, if I had to do all over, I'd do it in a second. And I believe it will build a better business for us in the future.

If we've never had gotten that business in the prior year and let's just say we had an $8 million write-off the year ago, but that $8 million write-off would have translated into a $200 million business within Fastenal that now exists because we were willing to do that, that didn't exist before. We're not an acquisitive organization, but I would have spent $8 million in a second for $200 million of annual business within Fastenal. Thanks for your time today, everybody.

Holden Lewis

Chief Financial Officer & Executive Vice President

Fastenal Co.

Thank you.

Operator

Thank you. That does conclude today's teleconference and webcast. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.

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