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SNA - Snap-On Inc at RBC Capital Markets Global Industrials

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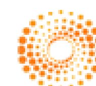

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PRESENTATION

Matt McConnell - *RBC Capital Markets - Analyst*

We're going to get started here. We're thrilled to have Snap-on with us this afternoon. And just by way of introduction again, I'm Matt McConnell with RBC. We have Aldo Pagliari, CFO of Snap-on; has been with the Company for 12 years and has been CFO since 2010. Maybe we'll start with just a very quick overview of the Company, two or three minutes, and then we'll just jump right into fireside chat type questions.

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Snap-on, Company founded in Milwaukee in 1920 so we've been around 94 years. Most people recognize it as a company that serves the working men and women in the auto repair space. To that end, it delivers products through mobile vans and it calls on truly professionals. We don't cater to DIY, we don't cater to consumers, we don't cater to big box, and that's been kind of the legacy of the Company. What I've just described makes up about 37% of the Company. There are other two segments that make up the remaining 63%. One of them is immediately adjacent to the mechanic; it is a different type of customer, that's the repair shop owner and manager. So if you go back in 1920, the repair shop owner and manager and the mechanic were probably one and the same where you had an owner/operator so to speak.

In today's day and age, a repair shop manager could be somewhat at an OEM dealership who's managing as many as 90 bays and 100 mechanics. It could be a chain of stores such as Goodyear or Bridgestone or Pep Boys, things such as that. And his needs are far different from the mechanic. The mechanic owns their tools, performs their work as an entrepreneur, and is attached to the product in terms of their possession of it. The repair shop owner manager's more making the durable goods decision, probably a five-year life cycle, he needs to see somebody at a different pace with a different level of technical knowledge. And then finally, the other segment that we have, commercial industrial, caters to just that.

Outside of the auto repair segment, you have things such as the aviation, oil and gas, mining, power generation, natural resources, technical education, military. These are all areas with their own unique requirements, unique set of problems to be solved so Snap-on has an array of divisions focused on catering to that segment of the business. So, that largely describes the three major operating segments of the Company. And then just to make life a little bit more interesting, we have a Financial Services captive business unit that 95% of which is spent serving the Snap-on Tools segment, the mobile van distribution; but it does make Snap-on kind of intriguing because it is not every day that you find a mid-cap with a captive credit company and that portfolio is not insignificant, it's about $1.3 billion and again, that's kind of intriguing to understand.

Matt McConnell - *RBC Capital Markets - Analyst*

Great, thanks. That's very helpful to get us started. And maybe you can touch briefly on your go-to-market strategy that's so unique and the kind of advantages that that creates with respect to customer knowledge and maybe even a new product development process. How are those related?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

One of the advantages that we do have is we access the workplace in a very unfiltered manner. First off, we could talk about the mechanic workspace, the auto repair segment. You have around the world 4,800 franchisees vans directly contacting the workplace each and every week, talking to the mechanics in the US for example 1.3 billion mechanics that are performing that work, and hearing unfiltered from them what has to be done to make their life easier, what problems do they need to solve. So the secret recipe is not just purveying a product, it's actually purveying a solution.

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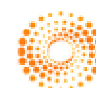

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And the more you focus on professionals, the more they have an appreciation of what goods and services you have to offer and as a result, they pay a fair price for that. Also when you get into the other segments, we have hundreds of direct sales people that work for Snap-on as well as a combination of distributors around the world.

We have hundreds of direct sales people, thousands of distributors accessing the repair space whether it be the flight line, whether it would be the shop floor, whether it be the oil rig. You get up close and personal what are the requirements of the day and you take those back home to your R&D center, your engineering team, or your product development specialist and you find out that while innovation has always been a part of Snap-on's life and culture, innovation doesn't mean as maybe what we're hearing today with Apple releasing the new iWatch or an iPhone or whatever they're developing. In the world of Snap-on, innovation does not have to be groundbreaking. It just has to make work easier that you cater to an audience that's truly professional. If they can appreciate how this product or service is going to make their job five minutes less, they immediately can start to see the benefits of having a relationship with Snap-on as the purveyor of the product or service.

Matt McConnell - *RBC Capital Markets - Analyst*

Great, that's helpful. And then the age of the auto fleet is obviously a pretty important driver for your tool. So how has that changed in your developed markets over the past 5 to 10 years and then we'll touch on emerging markets next?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

The math here works in our favor in terms of the mature market. The average age of vehicles in the US is about 11.5 years old and continues to age and if you look at the mathematics behind it, it will continue to trend upward. Now if you look at the number of scrap vehicles versus the number of new vehicles being produced even though new vehicle production will be quite significant this year, it's not enough to offset the fact that there already is an installed base of 250 million vehicles and they're all going to get one year older. So, that will creep up. As vehicles get older, they're not only better, they last longer there's just more of demand for products and services that that need.

But even more important than the age of the vehicles, one of the bigger tailwinds helping a company like Snap-on is the continued change in the vehicle. As vehicles change, it never really obsoletes the need for the tools and services that are rendered today. It usually forces people to supplement what they have. So as cars change, the need for additional tools change and you see that happening in the marketplace. You switch gears and now look at a developing market like China, China certainly has been the largest market for new car sales for the last about three or four years. I think they're expecting 21 million, 22 million vehicles. So as robust as the US is this year, China's still far and away bigger than that.

However, the average age in China of vehicles is only about four years old, mostly still under warranty and actually with the new vehicle construction this year being so large, the dynamics are such that the math will probably drive down the average age of vehicles a bit. So in emerging markets not just in auto repair, but also when it comes to machine tools and other things, you have a lot of new equipment in the marketplace. People have not yet thought as strategically how am I going to serve the aftermarket requirements in an emerging market. If you find the pun in afterthought when it comes to the aftermarket because people are more concerned about new cars build or new vehicle sale or new equipment sale and aftermarket still remains an opportunity. So as a result, I don't think we've seen yet the repair wave of activity that emerging markets are going to offer in the future.

Matt McConnell - *RBC Capital Markets - Analyst*

And so how do you prepare and position Snap-on for that? So you have a very kind of mature sales effort in the US, footprint all that. Where are you in the process of creating that somewhere like China where the repair effort is not there quite yet, but it certainly will be?

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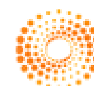

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Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Well, the biggest changes that I've seen 12 years with Snap-on is 12 years ago we had two sales offices and 13 employees in Asia, we had an office in Beijing and one in Singapore. Today we have 30 sales offices and five factories, about 1,500 employees, and more than 700 distributors, and we're probably still just scratching the surface. How the markets evolve in Asia remains to be seen and I suggest they're actually impossible to predict. So, what does one do in that case? That means that what you know for certain is that you'll need to have physical capabilities on the ground that serves that market, you'll need to have product that's adaptable or Asianised for that market, you'll need to have people that understand the culture and how people buy, how people do things, how do they affect their repairs, and that means you just need to have physical. Again while we have 1,500 employees, I think again the market is such that we'll still have a lot of upside opportunity. So the answer to your question is to continue to invest in those markets, build up our capabilities, and be prepared that when the repair wave comes we have an infrastructure that can meet its needs.

Matt McConnell - *RBC Capital Markets - Analyst*

And do you have a sense of where the sweet spot is with respect to the age of the installed base for four years in China? How far away might we be from a much more substantial level of repair activity?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Well, if you look at mature market statistics, again I'm not the source on this, but I think there's enough published data; it seems as if the amount of dollars spent for vehicle repair is at its height in years six 6 through 10. And as a mature market ages, it seems like that that might move up the curve a bit again because they are making vehicles better, they last longer, people are willing to invest in the product. If you look at again vehicles that are newer and the repairs are still largely warranty related. So, it seems like the sweet spot for maximum dollars spent in the United States as an example 6 to 10 years; whether it would be exactly like that in China, we don't know yet, but odds are that it will be something akin to that.

Matt McConnell - *RBC Capital Markets - Analyst*

So you guarantee your products for life and it's challenging to see how you get replacement sales in a dynamic like that, but how quick is the new product cycle? I know cars are getting more sophisticated and that does require a mechanic to re-buy your equipment. But do your tools wear out where they need to be replaced or is it all like from more sophisticated vehicles coming online?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Occasionally a Snap-on tool will wear out and will be replaced or will be repaired, but that's not anywhere near a significant percent of the business that we have each and every day. So, what happens is that the vehicles become more sophisticated. As items change, you need a wider array of tools to solve your problem. For an example, average mechanic has about 16 ratchets in their tool cabinet. Now I can argue you don't need 16 different ratchets in the tool cabinet to do the repair, but each one has its purpose and its functionality. So if you can impress, again I go back to a professional mechanic, the nuance of why this particular tool can allow you to access as an example a very tight space and all of a sudden he doesn't bust knuckles on the skin of the automobile or he doesn't drop the tool; where he can get the job done in five minutes less, there's a return on that product and they like to build on of their array of equipment.

As you introduce hybrids and electric cars, you don't obsolete the need for the mechanical tools because they still have wheels that go around just like on the bus yet you still need to have diagnostic products that deal with what's the voltage in the car, do I need to have insulated tools that work on the car, do I need to have a lifting device to remove the heavy battery; all of these are ancillary tools that they will add on. And at the same time what's a little bit unique in the segment that caters to the mechanic is that remember these technicians own their own tools. In the markets where the van model works, the technician owns their own tools. As a result, there is a bit of an emotional content. So if you've convinced the mechanic to have the lime green tool storage cabinet, eventually it comes to why not have the line of lime green colored handled screwdrivers to go along with it.

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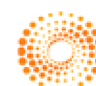

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Because you have that personal ownership aspect of it, people will invest in their appearance to again create a halo effect of professionalism in what they do. They'll invest in tool cabinetry, they'll invest in diagnostic products, they'll invest in the big screen display to give their repair shops sometimes status and authenticity that you might expect at the OEM dealership that you might not have expected in the aftermarket space. So again, all of these opportunities to upsell bring new tools to life. New tools give you the reason to have an engaging conversation with a client each week, but oftentimes a new tool sale leads to what else do you have at Snap-on that could help me with my problem.

Matt McConnell - *RBC Capital Markets - Analyst*

And can you touch on the balance sheet and just your use of cash priorities? I know the dividend track record is quite important to Snap-on, but you could comfortably maintain that and also have the option for acquisitions or maybe more aggressive buyback. So, what's your preference on capital allocation?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

To look at Snap-on, you have to take the time to remember the credit company and the credit company is the use of cash and has been our largest user of cash year-to-date and the credit company's grown actually about $92 million in the first six months so it's been our biggest user of cash. So, this is something I call-out and we publish non-GAAP supplemental statements each and every quarter so people can understand that nuance. On top of that, we're a fairly working capital-intensive company. If you look at our working capital as a percent of revenue is about 26% to 27% and we believe it's been a good investment because we've gotten fairly attractive organic growth rates. So again to support organic growth, you have to be prepared to invest in the working capital. Dividend, you mentioned has been uninterrupted and not reduced since 1939 and so odds are Snap-on is not going to reduce its dividend.

Today, that's a demand of about $105 million annually for the current dividend at the current rate. Then we engage in share buyback to offset dilution. CapEx is slightly more than depreciation and amortization so that's our CapEx picture. That leaves us actually with a lot of fire power to go after the right M&A type of transactions at this point in time. If you look at Snap-on, we believe we have balance to capacity if we needed to borrow and M&A is certainly something that we take a hard look at so long as it's coherent and consistent with the type of activities we do today. We're not looking to diversify the Company, we're not looking to transform the Company to something it isn't, and if it's something close to the DNA structure that we have today, things that we do already you might call it bolt-on type transaction. Those are the type of M&A opportunities that we seek.

Matt McConnell - *RBC Capital Markets - Analyst*

So these are mainly product line acquisitions, either something that you don't want to develop internally or you buy brands. What's the preference when you do seek a bolt-on acquisition?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

I think we'd start with the product. What is the product there? Is it a make or buy decision? Why don't we develop that internally? That's the fundamental question that I think we would always ask ourself. But what would be very attractive is a company or brand that has panache or relationship with customers similar to what Snap-on experiences. If you believe the acquisition brings customers to you, you get more than just a product, you actually get a relationship. That would be attractive for a company like Snap-on because we do value the relationships with our customer base.

Matt McConnell - *RBC Capital Markets - Analyst*

And given the strength of those relationships, how do you think about pricing from a very high level at Snap-on? How do you price your new products? How do you make sure you're kind of getting the value of what you're bringing to the table to your customers?

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Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

If you've ever had a chance to price a Snap-on product, you'll find that they're not inexpensive. For example, the tool storage cabinets that I mentioned, probably the average price point with nothing in it just the tool storage cabinet itself is about a $10,000 investment. If you look at the average mechanic, he probably has about $40,000 invested in tools and tool storage cabinet. If you think of the net worth of a mechanic or the net annual take-home pay, it's probably almost equal to a year's take-home salary. Not many businesses where people invest this level in themselves that come to work each day. So when it comes to pricing, Snap-on is actually viewed as the price leader. We're cognizant of each and every new product in terms of what does it bring, what are the arguments, what are the products, what are the features and benefits, how does it compare against ourself, how does it compare against the competition, what's the right price point to introduce for that? And again in a world where there's inflation, there is none to speak of today; but when you have to deal with inflation, Snap-on is actually in a position that we feel we can price for in an inflation and have done so in the past.

Matt McConnell - *RBC Capital Markets - Analyst*

And partly related to that, you've actually made some pretty good progress on the margin side over the past five to seven years, now you're in the mid-teens. I know a lean company would never say they've reached their margin potential. So give us a sense of where can you drive margin expansion from here? You've had a nice run. What are the highest priorities and maybe some of the trigger points that can keep margins expanding?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Even though we've had some success, if you look at Snap-on's margin since 2007 to 2013, [notably] similar sales. Sales were up maybe about $200 million in that time period, margins expanded 450 basis points. We think that if you had an analogy for baseball game, we're probably in the top of the fourth inning and the reason for that is Snap-on first came to the lean party a little bit later than others. We didn't probably surgically attack the problem until the early 2000s, 2003, 2004 when other companies maybe had started on this back in the 1990s. So opportunity one, we started late. And because we have such a complex product line, we know who we are in that we offer a wide variety of professional customers, a wide variety of solutions. So we have more than 65,000 parts and products that we offer. To deal with that, you need to have ability to have rapid change over in the factories, good management in the warehouses.

All of these complexities offer continuous opportunities to keep looking at how do you do things today and is there a better way to do it tomorrow. We find that this lean journey, as you said, is never-ending and each time we attack a problem, we find if we go back to the same problem six months later, there's still other costs that can be taken out. The same logic applies behind the scenes in the back office. How do you make processing of payables and collections more time effective, cost effective? How do you increase capacity without having to add resources? That's another opportunity that presents itself. So even today, we believe in a flat sales environment, we still expect of ourselves to be able to increase margins. But then if you add any type of volume over and above that, we'd expect to get some volume leverage in combination with some margin expansion through productivity gain and what we call Snap-on value creation.

Matt McConnell - *RBC Capital Markets - Analyst*

And I want to touch on some of the adjacent markets outside of auto repair. But first, give anybody in the audience a chance to ask a question if there are any. So, one of your strong advantages is that you've been working with auto repair shops for 90 plus years. How do you translate that advantage into adjacent markets and maybe give us a sense of what the highest priorities are?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Fair question. I think that again having been in the business of affecting mechanical repairs for 94 years, it rubs off. So anyone who is in the world of repair, whether it be a jet aircraft or a machine tool, has been exposed to Snap-on in some way. So among working men and women, it's a very powerful brand and the brand awareness is very high. Even if they don't own the tool themselves, people know about Snap-on if they're involved

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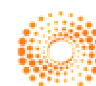
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in mechanical repairs of any sort. So accessing the flight line or the repair shop or the factory is something that Snap-on has access to and usually a pretty receptive person because of the reputation. Snap-on views my job as important that there's a certain amount of dignity that's associated in our space with the working men and women and I think Snap-on conveys that so again get a receptive audience.

And now Snap-on is starting to approach those other adjacent markets a little bit more clinically and says okay, I know I got sockets and wrenches, but I always made those available for the military and for aviation and for oil and gas. But now if I can start to study how do they do work, what are the problems that they encounter; if I can better understand that, I have more than just a product. Now I'm offering a solution; a solution could be a combination of product, technical tips, software information, and a relationship. So again, over the recent years let's say in the last four or five years, we've been more clinical in terms of how we research that business; how do we develop product support for the sales people when they come back with the idea that they see in the field so we can translate it more rapidly into a product; how do we get engineering more in touch with these problems; how do we get them out to the field as necessary.

I think these are still early days and where Snap-on is still translating would study the work for so many years in the auto repair sector and now taking that to these other industries. And the industries you mentioned or that you asked for; oil and gas, military, aviation, technical education; these are all areas natural resources. I think I mentioned before, these are all areas where professionalism is valued, the productivity associated with the repair and its effectiveness, its reliability, and repeatability is very important. And in these spaces, Snap-on usually can extract a value because it brings value to the workplace.

Matt McConnell - *RBC Capital Markets - Analyst*

And so have you done work to understand how recognizable the Snap-on brand is now within those end markets first maybe when you started some of these initiatives and how that compares to kind of your core auto customer?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

The brand I'd have to say actually is very recognizable even before this initiative of how to more surgically attack the marketplace. I'd say even in emerging markets, if you go to Dragonair or Shanghai, you will find that in aviation the same tools and reputations that are used by Singapore Air or Lufthansa or American Airlines are used by the Asian Airlines. So in most circles, we're well understood. It's a matter of now seeing that brand awareness trickle down to the wider variety of goods and services that are provided underneath the emerging market umbrella and in there, Snap-on is still making inroads in terms of people becoming more acquainted with it. But among the mature markets, people underestimate the value.

Usually when we go to visit people on Wall Street is a good example because there's a lot of high rises, we find when we're checking in at the security counter many times the person there said wow, you guys make good stuff. As you go up a number of floors in the elevator, you'll find that sometimes when you meet with an investment banker and they Snap-on, now I know of you but what is it you guys do? So it's just the fact that people in our circles don't necessarily repair their own vehicles where people that are closer to the working men and women do see the tools (inaudible). So, our brand's pretty well known so we think the doors are open to the floor.

Matt McConnell - *RBC Capital Markets - Analyst*

Let's talk about your finance business where you used to be 50-50 partners until the financial crisis. Is this among your core competencies and do you consider this to be a growth driver in and of itself?

Aldo Pagliari - *Snap-on Incorporated - SVP, Finance & CFO*

Let's see how can I best answer this? Snap-on has been in the business of lending money to mechanics since the 1930s. If you look at some of the old pictures on the truck that will say earn now, pay later. We formed that into a credit company in the 1980s and then in the 1990s I believe when

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Snap-on wanted to do some acquisitions, it decided to raise cash by selling off its portfolio. It formed a joint venture company with what ended up being ultimately acquired by CIT and CIT was our partner from 1999 I think or so through 2009. And with the financial crisis, they ran into certain unique problems that presented an opportunity where we decided that if you're going to have a business that depends on lending money to subprime mechanics, before the word subprime was invented, Snap-on had a profile of clients that fit that profile, then you can't afford to get involved in bankruptcy court and things of that nature.

So, we exercised our right to buy out the contract. We continue to manage the portfolio for CIT, which is about $800 million in size at the time in the United States, and we continue to roll that on to our balance sheet. So if anybody looks backward at our balance sheet, you'll see quite a large change since 2009. And the fact of what you see doing is slowly the progression of $800 million moving from off balance sheet CIT owned on to the books of Snap-on and today you have a $1.3 billion portfolio on our books. To grow it for the sake of growing the finance company is not its main objective. The finance company is there primarily to serve the needs of the operating business units, which is primarily Snap-on Tools and the reason I say that is we know what we do well and we know what we don't.

We've talked a little bit already today about an intimate relationship with the mechanics. The credit company is actually a form of, for lack of a better word, old community banking where the banker actually knew need the individual, knew what they were trying to accomplish, knew what their wherewithal was to repay the loan or the amount that's being credited, and worked with them to accomplish that common objective. That is what the franchisees actually do on behalf of Snap-on today. They know their customer, they know them intimately and as a result of that interaction and seeing them each and every week, they get what would be deemed subprime credit to perform like prime credit.

So even through the crisis of 2009 if you look at the bad debt experiences of the credit company, before the great recession the lifecycle losses of those loans were about 3%. They peaked in Q4 of 2009 at about 4% and they've gotten better each and every quarter since then and now are down back below 3%. So I say hey, 3% or 4% to 25% deterioration. On the other hand, you talk to most people that had experienced the financial crisis and say look your bad debt experience was 100 basis points worth, not so bad. And what the credit company does it facilitates a more consistent performance on the operating company's ability to sell tools to people that [for] their living have to bring their own tools to the workplace and perform their task.

Matt McConnell - *RBC Capital Markets - Analyst*

Well, with that, I think we're out of time. So Aldo, thanks very much for joining us.

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