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SNA - Q2 2014 Snap-On Inc Earnings Call

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OVERVIEW:

SNA reported 2Q14 net sales of $826.5m and net earnings of $106.1m or $1.80 per diluted share.

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PRESENTATION

Operator

Good day, and welcome to the Snap-on Incorporated second quarter results conference call. Today's conference is being recorded. At this time, I would like to turn the conference over to Leslie Kratcoski, VP of Investor Relations. Please go ahead.

Leslie Kratcoski - *Snap-on Incorporated - VP of IR*

Thanks, Randy, and good morning, everyone. Thanks for joining us today to review Snap-on's second-quarter results, which are detailed in our press release issued earlier this morning. We have on the call today Nick Pinchuk, Snap-on's Chief Executive Officer; and Aldo Pagliari, Snap-on's Chief Financial Officer.

Nick will kick off our call this morning with his perspective on our performance. Aldo will then provide a more detailed review of our financial results. After Nick provides some closing thoughts, we'll take your questions.

As usual, we've provided slides to supplement our discussion. You can find a copy of these slides on our website, next to the audio icon for this call. These slides will be archived on our website, along with the transcript of today's call.

Any statements made during this call relative to management's expectations, estimates, or beliefs, or otherwise state management's or the Company's outlook, plans or projections, are forward-looking statements, and actual results may differ materially from those made in such statements. Additional information and the factors that could cause our results to differ materially from those in the forward-looking statements are contained in our SEC filings.

With that said, I'll now turn the call over to Nick Pinchuk. Nick?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Thanks, Leslie. Good morning, everyone. I'll start today with some of the highlights of our second quarter, the general environment and the trends we're seeing, as well as some of the progress we have made. Then, Aldo will move into a more detailed review of the financials.

Our second-quarter results were encouraging. They offer strong evidence of Snap-on advancements along our runways for both growth, and for improvement. Our sales were up 8.2% from last year, the operating margin expanded by 130 basis points, and the earnings-per-share, they reached $1.80, up 20% compared with $1.50 reported last year.

The organic sales increase was 6.6%. Incremental sales from our Challenger acquisition in May of last year, and coupled with our acquisition of Pro-Cut this past quarter added another $10.5 million, which along with the $1.4 million of favorable foreign currency, brought our total sales for the period to $826.5 million.

The operating margin for OpCo reached 16.7%, up from 15.4% in 2013. Financial services' operating income increased to $34.8 million from last year's $30.6 million, driving the consolidated operating margin to 19.7%, also up 130 basis points.

Now from a macro perspective, we believe that favorable conditions remain for our businesses serving automotive repair customers. The tools group and the repair systems and information, or RS&I group. Both have continued to experience strong demand, and in the second quarter, both of them reached new sales levels.

Tools group activity increased 6.6%. The strength of our van channel is clearly evident in those numbers, and in the [triangle]. RS&I had overall organic gains of 7.7%, led by significant essential tool and facilitation sales in OEM dealerships.

For the C&I group, for C&I, there are also continued signs of improvement along our runways for growth. We saw important and clear progress in our efforts, extending to critical industries and in building the physicals in the emerging markets of Asia Pacific.

US military activity, it's been a significant C&I headwind. Well, the military experienced somewhat of a resurgence, up double digits from the second quarter of last year, the first year-over-year increase since mid-2012. The C&I results are positive.

We do, however, remain cautious as to the improvement within the US military business. At this point, the length and the amplitude of any recovery is quite uncertain. With that said, though, the opportunities for C&I definitely outweigh the challenges, and the results confirm it.

More broadly, the operating income gains across the Corporation clearly demonstrate the leverage and the power of the Snap-on value creation processes. Safety, quality, customer connection, innovation, and rapid continuous improvement. They drive our improvement every day, and they helped author our 130 basis point gain this quarter.

As I speak to the segment results, I'll highlight some of those advancements in both growth and in improvement. Let's start with C&I. As I just said, an 8.4% organic sales increase. The group's operating margin was up 70 basis points, even while overcoming an unfavorable foreign currency impact of 80 basis points. Both higher volumes and the benefits of Snap-on Value Creation drove the margin improvement, more than offsetting the currency.

Related to the volume, there were some positive gains in the group's operating unit. SNA Europe had its third straight quarter of year-over-year growth. A promising trend, outperforming the present economic conditions within its own market. SNA Europe also showed clear margin improvements in the quarter, capitalizing on the volume increases, leveraging the uptick in activity, and realizing the benefits of RFCI in past restructuring actions. That effect was evident in SNA Europe's growing profitability.

Also in C&I, the industrial division saw particularly strong volume in the critical aviation sector. That's a continuation of the favorable trends we saw in the first quarter, and besides the encouraging aerospace volume, the quarter also saw a success in extending to other critical industries, like natural resources, where sales were up double digits.

Some of these gains can be attributed to a growing line of innovative products, guided by strong customer connections, specifically designed for critical applications. One such product was just launched, aimed at the power generation industry. It was the K3477, our ground mounted transformer access tool.

This new utility tool is perfect for removing or securing the penta-style bolts on underground utility transformers. It's also effective in a variety of other applications in the power generation and delivery industry. The K3477 features a pentagon socket at one end, and a three-quarter hex socket at the other. The pentagon side gains access, and the hex side is used on the terminals inside the transformer.

The new unit employs the Snap-on -- importantly, the new unit employs the Snap-on award-winning Dual 80 ratchet technology, for smooth performance, enabling the smallest of ratchet swings, very helpful in tight quarters within a transformer box. The K3477, another tool born from Snap-on customer connection, making work easier for professionals at workplaces of consequence.

Reaching into new markets, the industrial division organized hands-on product training just for its Latin American region. The meeting was attended by about 125 customers, and a number of our sales reps. It included a series of in-depth technical training sessions, familiarizing customers with our latest product offering, emphasizing opportunities across the continents in multiple segments, areas like mining, oil and gas, aerospace.

Industrial. Our industrial division, rolling out of the garage, reaching new segments and new geographies, like Latin America. Industrial's also working to create more customers for life in technical education. We continue to add to our list of Snap-on certified schools. Already this year, 35 new institutions have embraced our certification protocols, helping us lead in providing top-notch curriculums to the technicians of the future. We continue to build in emerging economies, areas of strong potential, and we saw sales progress in bellwether markets like China and India, activity up nicely compared to last year.

C&I did have a positive quarter. It did have a positive quarter. And we know there's even more opportunity, and we're continuing in the pursuit.

Let's move to the tools group. Sales increased 6.6% organically. Operating margin of 16.4% was also up versus the 15.7% recorded last year, overcoming within the quarter 60 basis points of unfavorable currency impacts, largely related to our operations in Australia and Canada.

The 70 basis points brings our tools group's OI margins to new levels, and that performance clearly speaks to our improving position. And when combined with the growth this quarter, it clearly demonstrates the success we're having on this decisive runway, enhancing the franchisee channel. You can see it in the sales, and you can see it in the overall franchisee health metrics, trending positively again this quarter.

Snap-on franchisees are a committed and capable force, and we're working hard every day to support their efforts through creative marketing, in-house customer financing with Snap-on Credit, and a growing array of innovative new products, new products like our push-pull spring tool range, designed to remove and install springs on automobiles, heavy-duty trucks, and agricultural equipment, with precision and speed. Today's techs commonly use picks and screwdrivers for these applications, but these standard tools sometimes slip, causing the spring to go flying, or to drop into the mechanism. It's a productivity killer.

Snap-on's push-pull spring units are uniquely designed with a robust shank, and a deep V and C-shaped grooves to securely hold and maneuver small- and medium-size springs. It's a winning tool line, shaped by direct observation, customer trial and feedback.

Products like our power tools. Our new power tools, let's take one, a 14.4-volt, 3/8 inch, cordless impact wrench. High torque, small size, power in your pocket. This impact gun and its twin, the 14.4-volt cordless screwdriver, combine to display Snap-on innovation, and to help drive the tools group volume.

On another front, the growing strength of our tools group marketing is also evident, with the increases in big-ticket sales, and a lot of that credit goes to Snap-on hands-on demonstration vehicles, the Rock 'N Roll Cab Express and the Techno Express vans, both driving excitement and sales. The Rock 'N Roll Express showcases a broad range of Snap-on tool storage -- of the Snap-on tool storage line. Colors, shapes, options. If you've been listening to these calls for any time, you've heard that the product variety made available for hands-on selection on the Rock 'N Roll vans is a significant contributor to the tools group growth.

For hand-held diagnostics, the Techno Express vans follow the path blazed by the Rock 'N Roll Express, offering customers the ability to touch, and to feel, and to navigate. In essence, try out our assortment of diagnostic solutions, easing the way to make that big-ticket buying decision. All under one roof. And we keep adding to our Techno fleet. We now have 24, with more on the way.

Another advantage for the tools group is our financial services arm, Snap-on Credit, strategic programs aimed at smoothing the way for those big-ticket categories of tool storage and diagnostics. Again this quarter, our credit company played an essential role in enhancing our van channel, and helping us drive the sales growth. Well, that's the tools group, attractive new products guided by customer connection, innovative marketing, and a unique credit capability, all helping the vans reach new levels.

Now let's move to RS&I. Organic sales growth of 7.7%, while the second-quarter operating margin of 23.2%, compared to last year's 23%. The overall sales gain was $32.3 million, or 13.1%. $19.1 million of organic sales, $2.7 million of favorable currency, and $10.5 million of sales from our acquisition, Challenger Lift, and our recent add, Pro-Cut International.

We're excited to add Pro-Cut to the portfolio, a well-established brand that complements the RS&I line up. Challenger Lifts and the newly acquired Pro-Cut advance brake servicing product line, both giving us more to sell to vehicle repair shop owners and managers, to customers and independent shops, and national service chains, and in OEM dealerships. They are both positive steps along our runway for coherent growth in the repair garage.

Beyond acquisitions, RS&I registered organic sales gains across the group, from repair information to diagnostic products within independent repair shops, to program activity in support of OEM dealerships. The robust organic sales were driven in part by innovation in new product launches. In April, the diagnostic division was again voted a Top 10 Tool Award Winner by the readers of Undercar Digest magazine. These awards are determined by technicians and shop owners, the people who use diagnostics every day to make their living. And they voted two Snap-on hand-held units, the VERUS PRO and the ETHOS Plus, as being among their most important tools.

This again extends our string of Undercar Digest Top 10 Awards for Snap-on diagnostics. Our past winners include, listen to this list, VERUS, VERDICT, SOLUS PRO, SOLUS Ultra, and now the VERUS PRO and ETHOS Plus, a parade of innovation. New products also helped bolster our sales in our OEM solutions business, up double digits in the quarter.

One assist in that growth was our expansion in the agriculture sector. In the period, we launched distribution of the essential diagnostic system for a major manufacturer of agricultural equipment, with repair outlets over five continents. The system will be used in six facilities, and in mobile shops, to deliver diagnostic repair services across the globe. We like this program, it has significant strategic importance in extending our diagnostic reach to new customers in another critical arena, agricultural equipment.

Another product, another new product. The Snap-on PRO-LINK Ultra heavy truck diagnostic tool, was also launched in the quarter. It's a next-generation device that will make work easier in more than 60,000 heavy-duty shops throughout North America. This new unit helps diagnose and repair a variety of problems, including engine, transmission, and brake issues on commercial vehicles ranging from light diesels to Class A heavy-duty trucks.

The PRO-LINK Ultra-has a faster processor, includes more memory, is Wi-Fi enabled, incorporates updated OEM software, and arrives pre-configured for a repair connect upgrade. That's Snap-on's proprietary system, that allows users to link trouble codes with the most likely fixes, based on our extensive library of real vehicle repair data. To wrap up RS&I, we see new diagnostics, unique repair information for cars and for trucks, and a growing undercar equipment offering that now adds both Challenger and Pro-Cut products to our established line, real strengths that are driving positive trends, and have improved our position with repair shop owners and managers, and you can see it in the results.

Well, that's the highlights of the quarter. Growth and improvement. Sales up 6.6% organically, overcoming headwinds. OI margin of 16.7%, up 130 basis points.

C&I strength with critical industries, and with SNA Europe's ongoing improvement, the third straight quarter of year-over-year growth. The tools group getting stronger, robust sales and operating margin, continuing to enhance our franchise network with success. RS&I advancing its position with gains in both independent shops and OEMs, and financial services raising its contribution, both financially and strategically.

It was another encouraging quarter. Now, I'll turn the call over to Aldo, who will take you through the financials in detail.

Aldo Pagliari - *Snap-on Incorporated - CFO*

Thanks, Nick. Our second-quarter consolidated operating results are summarized on slide 6. Net sales of $826.5 million in the quarter increased $62.4 million, or 8.2% from 2013 levels, reflecting broad-based gains across all segments, and include higher sales to auto repair mechanics, customers in critical industries, and OEM dealerships.

Organically, sales increased 6.6%, excluding $10.5 million of acquisition-related sales, and $1.4 million of favorable foreign currency translation. Consolidated gross profit of $400.4 million increased $27.2 million from 2013 levels. The gross margin of 48.4% in the quarter decreased 40 basis points, primarily due to 60 basis points of unfavorable foreign currency effects, partially offset by savings from ongoing RFCI initiatives.

Operating expenses of $262.3 million increased $6.9 million. The operating expense margin of 31.7% improved 170 basis points from 33.4% a year ago, primarily due to sales volume leverage. Restructuring costs of $1.4 million in the quarter compares with $1.8 million of such costs last year. As a result of these factors, operating earnings before financial services of $138.1 million in the quarter increased $20.3 million or 17.2% and as a percentage of sales, improved 130 basis points to 16.7%.

Operating earnings from financial services of $34.8 million increased 13.7% over prior-year levels. Consolidated operating earnings totaled $172.2 million, and the operating margin of 19.7% improved 130 basis points from 18.4% a year ago. Our second-quarter effective income tax rate of 32.9% compared with 32.5% last year. Finally, net earnings in the quarter of $106.1 million, or $1.80 per diluted share compared to net earnings of $88.4 million or $1.50 per share last year, representing a 20% increase in earnings per share.

Now, let's turn to our segment results. Starting with commercial and industrial, or C&I group, on slide 7, sales of $287.2 million in the quarter were up 8.4% organically, primarily reflecting a double-digit sales gain to customers in critical industries, and a mid-single-digit sales increase in our European-based hand tool business. Gross profit in the C&I group totaled $111.8 million in the quarter. Gross margin of 38.9% decreased 70 basis points from last year, as benefits from increased sales and savings from ongoing RFCI initiatives were more than offset by higher costs, including $2.7 million, or 80 basis points, of unfavorable foreign currency effects.

Operating expenses of $73.6 million in the quarter increased $1.8 million over 2013 levels, primarily due to higher volume-related expenses. The operating expense margin of 25.6% improved 140 basis points, primarily due to sales volume leverage. As a result of these factors, second quarter operating earnings for the C&I segment of $38.2 million increased $4.6 million, or 13.7% from 2013 levels. And the operating margin of 13.3% improved 70 basis points from 12.6% last year, despite 80 basis points of unfavorable currency effects.

Turning now to slide 8, second-quarter sales in the Snap-on tools group of $369.1 million increased 6.6% organically, reflecting a mid-single-digit sales increase in our US franchise operations, and a high single-digit sales increase in our international franchise operations. Gross profit of $161.1 million increased $8.2 million from 2013 levels while the gross margin of 43.6% decreased 60 basis points due to $2.1 million, or 60 basis points, of unfavorable foreign currency effects.

Operating expenses of $100.6 million in the quarter increased $2.2 million from 2013 levels, primarily due to higher volume-related expenses. The operating expense margin of 27.2% improved 130 basis points from 28.5% last year, primarily due to sales volume leverage. As a result of these factors, operating earnings of $60.5 million for the Snap-on tools group increased $6 million or 11%, and the operating margin of 16.4% improved 70 basis points from 15.7%.

Turning now to the repair systems and information, or RS&I group, shown on slide 9, sales of $278.5 million increased $32.3 million, or 13.1% from 2013 levels. Excluding $10.5 million of acquisition related sales, and $2.7 million of favorable foreign currency translation, organic sales were up 7.7%, primarily due to a double-digit gain in sales to OEM dealership service and repair shops, and a mid-single digit increase in sales and diagnostic and repair information products to independent repair shop owners and managers.

Gross profit of $127.5 million in the quarter increased $12.6 million over 2013 levels. Gross margin of 45.8% decreased 90 basis points, primarily due to a shift in sales that included higher volumes of lower gross margin products, including increased essential tool and facilitation sales to OEM dealerships, as well as sales of Challenger products. Continued savings from ongoing RFCI initiatives more than offset $0.6 million, or higher restructuring costs.

Operating expenses totaled $62.9 million in the quarter, and the operating expense margin of 22.6% improved 110 basis points from 23.7% last year, largely due to sales volume leverage, including benefits from the sales shift discussed earlier. Second-quarter operating earnings of $64.6 million for the RS&I group increased $7.9 million from prior-year levels, and the operating margin of 23.2% in the quarter improved 20 basis points.

Now, turning to slide 10, in the second quarter, earnings from financial services of $34.8 million and revenues of $51.7 million compares with operating earnings of $30.6 million on revenue of $44.5 million last year. The average yield on finance receivables of 17.5% compared with 17.4% last year. The average yield on contract receivables of 9.5% compared with 9.6% last year. Originations of $232.7 million in the quarter increased 14.6% from 2013 levels.

Moving to slide 11, our quarter-end balance sheet includes approximately $1.3 billion of gross financing receivables, including $1.1 billion from our US Snap-on Credit operation. Approximately 80% of our US financing portfolio relates to extended credit loans to technicians. During the second quarter, our worldwide financial services portfolio grew approximately $65 million. As for finance portfolio losses and delinquency trends, these continue to be in line with our expectations.

Now turning to slide 12. Cash provided by operations of $124.4 million in the quarter increased $14.3 million from comparable 2013 levels, primarily as a result of higher 2014 net earnings. Net cash used by investing activities of $119.7 million included $58 million to fund the net increase in finance receivables, and also included $41.6 million for the previously communicated acquisition of Pro-Cut. Capital expenditures of $22.7 million in the quarter compared with $16.7 million last year.

Turning to slide 13, days sales outstanding for trade and other receivables of 64 days compared with 62 days at 2013 year-end, and 65 days at the end of the first quarter. Inventories increased $33.1 million from 2013 year-end, primarily to support continued higher customer demand, and new product introductions, and from the addition of inventories related to Pro-Cut. On a trailing 12-month basis, inventory turns of 3.7 times compared with turns of 3.8 at 2013 year-end.

Our quarter-end cash position of $115.8 million decreased $101.8 million from 2013 year-end levels. That's primarily due to a $100 million March 2014 debt repayment. The net decrease in cash also reflects the impacts of funding $370.6 million of new finance receivables, share repurchases of $62.5 million or 550,000 shares, dividend payments of $51.2 million, the acquisition of Pro-Cut for $41.6 million, and $41 million of capital expenditures. These uses of cash were partially offset by $282.3 million of cash from collections of financed receivables, and $212.7 million of cash from operations.

At the end of the second quarter, our net debt to cap ratio was 26%. In addition to our $116 million of cash and expected cash flow from operations, we have more than $700 million in available credit facilities, and our current short-term credit ratings allow us to access the commercial paper markets. At quarter-end, we had $29.5 million of commercial paper borrowings outstanding.

I'll conclude by mentioning a few outlook items. We continue to expect that our full-year 2014 effective income tax rate will be comparable to our 2013 rate of 32.3%, and we now anticipate capital expenditures for the year will be in the range of $75 million to $80 million.

With that, I'll now turn the call back over to Nick for his closing thoughts. Nick?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Thanks, Aldo. Well, as I said at the start, we are encouraged by the quarter. We believe the results are more confirmation of our progress, but they're also clear evidence of the opportunities that remain. We've been saying for some time that as we look forward, Snap-on has abundant runways, abundant and wide runways, for both improvement and for growth, and we believe that the quarter's performance adds to a long trend that reinforces that outlook.

We are demonstrating clear gains, moving down our runways for growth: Enhancing the franchise network, tools group sales growing, operating earnings at new heights, innovative new products strong franchisee metrics, and the credit company amplifying that strength, with greater effect.

Expanding repair shop owners and managers, RS&I growing. Diagnostics and information products stronger with independent shops. The successful Challenger acquisition, and the new Pro-Cut addition widening the product offering.

Extending to critical industries. C&I growing organically at 8.4%, with a 70 basis point increase in OI margins, overcoming 80 basis points of unfavorable currency. Rolling the Snap-on brand out of the garage to sectors like aviation, and natural resources. SNA Europe clawing back. Building in emerging markets. The physicals getting stronger each quarter, and seeing it in our market position.

We're also progressing down our runways for improvement. Snap-on Value Creation. Safety, quality, customer connection, innovation and rapid continuous improvement, driving margin gains across the entire corporation.

So we are encouraged by the continuing trends. Sales up 6.6% organically, OpCo OI margin reaching 16.7%, rising 130 basis points. But we believe there is much more, and we are confident that we're positioned with the capability and the intent to take full advantage, and to continue our trajectory of positive performance for the foreseeable future.

Before I turn the call over to the operator, it's appropriate to speak to our franchisees and associates. I know that, once again, many of you are listening. Our progress in the second quarter and the positive trends are a direct result of your extraordinary capability, and your continuing commitment. For the role you play in our ongoing achievements, you have my congratulations. And for your unfailing dedication to our team, you have my thanks.

Now, I'll turn the call over to the operator. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Liam Burke, Janney Capital Markets.

Liam Burke - *Janney Capital Markets - Analyst*

In terms of Snap-on tools, you have tools that are guaranteed for life. Now you're seeing pretty nice growth out of that base market. Is it bigger ticket items, is it new product introductions, or is it market share that are contributing to this better than expected growth?

Nick Pinchuk - *Snap-on Incorporated - CEO*

You asked a great question. One of the great questions, I think, is one of our big product lines are hand tools. We guarantee them for life, so how is it we have a business at all?

And the answer is, is what happens in the marketplace, particularly in the auto repair marketplace, there's a tremendous motion of technology that creates the requirements. Things like the spring tool, the Push-Pull Spring tool I talked about, and a number of other products. And so when you look at this business, you see first and foremost, you see innovative new products rolling out, because our Snap-on value creation around customer connection and innovation is working better than ever before, and we're having more hit products than we've ever had.

Five or six times what we had just in 2006, so you see a lot of those, and that creates excitement, so we're doing that better. Underlying that is the change in the vehicles. That's one.

Two is, we're reaching more customers because we are enabling our van drivers to be more effective. Part of that is really innovative marketing, things like the Rock 'N Roll Cab Express and the Techno Express, and other things we're doing on the van to make our drivers better. And this general productivity rolling through the van is pretty good.

And then thirdly the credit company, since we brought the credit company home, we've learned more things about credit than we ever thought we could. Especially applied strategically in the marketplace, and all this is coming together with a team that's starting to learn this, and the tools group is singing. You see the sales of 6.6% this quarter, and I think that last second quarter was 7%, and the second quarter before that it was 10% and the second quarter before that it was 10%, and the second quarter before that it was 7.6%.

Now, I'm not -- as I say, we think we say we're going to grow organically at 4% to 6%, and the tools group, by all rights, should be at the lower end of that, and that's what we keep saying. But our team and the tools group is doing a great job, and they're expanding their position. I'm not going to say we have bigger market share, but I like the numbers.

Liam Burke - *Janney Capital Markets - Analyst*

And real quickly on C&I, you're continuing to see some momentum build in Europe. Are there any verticals or critical industries that are doing particularly well?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Look, I think Europe, the play is more by country perhaps, you might say that. I think, no particular industry. I don't think you're seeing the construction industry come back too quickly, and we sell in some of that. The agricultural industry is good, big industry is good, aviation is okay.

But I want to emphasize what I said in my call, we're growing mid-single digits in Europe, in places like Germany and France and even Spain, the UK, and this is defying the GDP. The GDP in Germany for example is forecasted in the second quarter at 1.8%, France is 0.4%, Spain is 1%. UK is 3.1%. So our guys are outgrowing the GDP.

I just think it's the fact that we have had faith in that market, and seeing our customers didn't go away, continuing to pound Snap-on Value Creation, making them more efficient, and one of the more efficient places is developing better products, more innovative products, and that's playing out now that they are seeing even a little sliver of daylight. That's what's working for us there. So there's nothing particularly special. I think it's just being in the proper position, when a little bit of opportunity presents itself.

Liam Burke - *Janney Capital Markets - Analyst*

Great. Thank you, Nick.

Operator

David Leiker, Robert W. Baird.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

I want to follow-up on the organic growth. It seems like well, it doesn't seem like. We've had an acceleration in the growth rate, the 6.6% across the Company. My numbers show that's the best since the first quarter of 2002. Do you think there's something in particular going on this quarter that's behind that, or do you think this is an inflection higher, and a new trend to a higher pace of sales than we've seen the last two years?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Look, it's better than a stick in the eye to see the 6.6%, of course. And I'm still sticking to my 4% to 6%. I think we are quite pleased with what we saw in the second quarter.

We always know that -- and we're seeing positive trends, what were we like, 5% in the first quarter? And so on. So we're seeing our businesses start to become more effective, and I think there are elements inside these businesses that are working that way. I think as we look forward, I think we expect this kind of trend to continue, but I think 4% to 6% are the right numbers. But when you look at these numbers, you feel certainly more encouraged about that 4% to 6%.

As I have said on every quarter two call I've been on, and I'm not pre-staging anything up or down. The third quarter's always squirrelly because we've got vacations and so on, where the technicians take vacation, they go to the SFC, they park their van, and Europe is off in July and August, depending on where you are. And you never know when the distributors are going to come back.

And so it's more difficult to predict that. But I think if you look out over the trend of quarters, we're going to see -- and I'm not predicting anything bad in that, I'm just saying there always is more turbulence, more windage in that quarter. Over time, I think this has got to be encouraging to us.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

And then, thanks on that. And then if we look at the gross profit and the currency headwinds, Aldo I think -- or Nick, I don't remember which one -- called out Australia and Canada in particular. Is that shipping from the US into those markets?

Nick Pinchuk - *Snap-on Incorporated - CEO*

That's what it is.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

That transactional effect? Where is that coming from?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Tools group. It hits us in two places. Those particular currencies of course, translation, because we have operations there. And they do okay, and so to the extent the Canadian dollar is smaller, and the Australian dollar is weaker, there's an impact on translation, both at the sales line and the operating income line.

But the big effect was transaction, as you were referencing here, where we sell -- what we're talking about here mostly in Canada is taking the tools group, and selling out of the United States factories into those jurisdictions, and so what happens is, you've got a selling price that now is less in US dollars. And so you try to punch it up, but it takes a while to move the selling price up to match that. And so you inevitably, when currencies go down, you have transaction effect, and that's what's happening there.

The currencies, where the currencies are now, there's variations as we go through the year but where the currencies are now, I think they're about where they were at the end of last year, I think roughly, if you look at all the currencies together. So I don't see any trends -- for the end of the year, I don't see any changes in that currency position.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

But it sounds like, while the transactional aspect of this may be diminishing some, it sounds like --

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Nick Pinchuk - *Snap-on Incorporated - CEO*

Well, maybe. I think, look, the advantage, you might be entitled to the following. When you look at it the currencies and you start playing around month-by-month, there's a lot of variations. All I'm saying is when you get to the end of the year, there's a lot less variations where we are now.

So there's some goes ins and goes outs as you go through the year. But from an operating guide point of view, you might be entitled to the idea that if the currency drops, like in Australia and Canada, we'd be trying to push up the pricing to recapture some of that. That's where the opportunity would be.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

And I guess the question is, as we look at sequentially here, how long does it take for that pricing to start to flow through your numbers?

Nick Pinchuk - *Snap-on Incorporated - CEO*

I don't know. I can't give you any number. It's like, you know how this works. Okay you try to move the pricing up, and maybe it doesn't hold so well, and so on. So it's not an exact science.

You just charge your operating guys with saying, look, let's try to get some of this back. Doesn't always work. Sometimes it does work.

For example, this time last year, we had a big thing in India for example. And it took us a long time to get us back up, and we're still not back up, but we got some of it back.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

And then the last item for me is, you've done a great job across your businesses. Arguably in those businesses, you're outgrowing your competitors. What are you seeing across -- I don't know, a couple of the businesses maybe you can do this, what are you seeing the competitive reaction from your competitors, as you guys continue to put up a strong performance?

Nick Pinchuk - *Snap-on Incorporated - CEO*

I can only tell you what I hear from the people on the ground. And so I was just out at Joliet, where the drag race, we had the Nationals, the NHRA Drag Race out there, the Nationals. And we hosted 1,200 customers. I talked to a number of them, almost all of them probably. And they didn't mention the competition, whatsoever.

So I didn't hear anybody say -- I'm not saying people aren't doing stuff. I'm not saying they aren't smart people, I'm not saying they're not aggressive in trying to do things, but what I'm getting feedback from in the operations, and at the grassroots, are mostly focused on how we can get better, how we can strengthen our position with the customer. It's all about our relationship with the customer.

It's almost never oh, I got this competition that's going to bother me. It's almost all focused on our relationship, and I think this is the kind of feedback you get from a market leader, of which we are clearly the leader in almost all these segments.

David Leiker - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Great. Thank you very much.

Operator

David MacGregor, Longbow Research.

David MacGregor - *Longbow Research - Analyst*

Great job. I wanted to ask you, clearly you're benefiting from a lot of the innovation that you're taking to market, and I know historically there's been a fairly set level of spending on innovation, with respect to revenues. So I guess the question is just, what's gating you or limiting you from just accelerating your innovation investment, and where do you think the point of diminishing marginal returns are on that investment program?

Nick Pinchuk - *Snap-on Incorporated - CEO*

I don't know. Look, I think what gates it is our own capability. At some level, we're not smart enough to do any more. And so part of it, though, is I think, that's one.

What I mean by that is this: our drive for innovation has to do with our observations in the field. It's not gated by the innovation back here. So in terms of what I mean, back here, I mean at the center, the R&D labs and so on.

David MacGregor - *Longbow Research - Analyst*

Right.

Nick Pinchuk - *Snap-on Incorporated - CEO*

So what I mean by that is, we're gated by how many people for how many hours we have in the workplace. Our R&D spending is up, and it will fluctuate from time to time, and we spend more in different places, and I guess you would say that over time, we're growing our capabilities, hiring more engineers. But in my view, the big pacing item is around the unique strategic value that Snap-on has. That is the understanding in the marketplace, and the feedback of that understanding into the innovation system, that creates these new products.

As I talked about today, that tool for the transmission door, for the power generation door, the transformer door. That came out of observing how people service transformers. Somebody was there watching, and said, boy, we could save a lot of time or the thing with the spring. Somebody's in the garage watching the springs being unloaded or taken out of a vehicle and watching them fly all over the place, and watching the mechanics chase them around. That fed back and said, boy, we can make this more productive.

That's the key, and that's what gates us. But it's a unique value and strategic advantage we have. And that's what we're wielding to greater effect now.

David MacGregor - *Longbow Research - Analyst*

How do you know you're pricing the innovation properly, with so much innovation coming down the pipe? How do you explore the upside or the elasticity?

Nick Pinchuk - *Snap-on Incorporated - CEO*

I don't know. I think we're priced pretty high, now. I think, we think we're up there, in terms of pricing. I don't think anybody's ever asked us, are you too shy in your pricing? I don't think anybody's thought that.

Now, you could ask, okay, where do you price it? And I think we get that from the field. We have our franchisees, our franchise performance teams that are out there, and if you want to take the tools group, with technicians who are out there all the time in the marketplace, and they have a feel for what a tool will sell for.

And I think then we price off our former tool and say, how much innovation is this? How much would it be worth for the customer, how flashy will this be? And we make a judgment. It's probably not as analytic as you would hope in some orbs, but our position in the marketplace is more an art, informed by a tremendous understanding of the customer.

David MacGregor - *Longbow Research - Analyst*

Okay. Second question. Just obviously you've had a lot of success with the Rock 'N Roll Cab Express, the Techno van. It's been driving big-ticket sales, it's been driving growth in the tool segment. But if you exclude those big-ticket storage and diagnostics business, can you just talk about what you're seeing in terms of possible acceleration and growth for sockets and wrenches, and just the core tools?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Actually, the sockets and wrenches are up somewhat higher than the average, this quarter. So, so that's going okay.

David MacGregor - *Longbow Research - Analyst*

Is that developing?

Nick Pinchuk - *Snap-on Incorporated - CEO*

I think -- sockets and wrenches are up higher. So we don't see any dimunization of that, I don't think. I think, look, you could argue that the extent we have more innovation, and we punch into new areas, and come up with more ideas that aren't exactly wrenches and sockets, they become a smaller percentage, of course, but they're no less important.

In fact I was on a van in Encino, California last week. One of our van drivers, Matt Scott, he took me around a Mercedes dealer and a Tesla dealer, where I saw a huge number of Snap-on tools and Snap-on boxes, and a couple of young technicians got on the van. Mark Scott, he had been a technician for like five years, and Juan Gutierrez gets on, and he's only three years, and they all have like -- they all say I have five or six ratchets already, but I need this special low-profile ratchet to get inside this particular product.

So I think there is no shortage of need for innovative new hand tools, ratchets and sockets and wrenches. Even with young technicians, even today. Even in a place like Tesla.

David MacGregor - *Longbow Research - Analyst*

Great. Thanks very much. Best of luck with continued progress.

Operator

Gary Prestopino, Barrington Research.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Most of my questions have been answered, but Nick, in terms of what you're doing in the van channel with the Rock 'N Roll Vans and the Techno Vans, have you expanded that outside of the US to other countries where --

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Nick Pinchuk - *Snap-on Incorporated - CEO*

Yes. We've got about five outside the U S. Sometimes when people say outside the US, we're talking -- I think for purposes of the way you asked the question, yes. 53 of the 58 Rock 'N Roll Cabs are inside the United States. We don't have one in Hawaii, I guess. We've got one in Puerto Rico, and we've got four or five in Canada. We've got four in Canada.

So yes, but there haven't been pushed as far outside the US. Canada, the routes are broader, so there's a different approach there, I think. You could argue, should they be in the UK and Australia? And we're looking at that now.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Okay.

Nick Pinchuk - *Snap-on Incorporated - CEO*

So maybe there's opportunity there. We're not sure yet.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Thank you.

Operator

Richard Hilgert, Morningstar.

Richard Hilgert - *Morningstar - Analyst*

Congrats on the quarter, guys. Couple questions. First one, looking at the financial services balance sheet, we have been expecting the growth rates on the receivables to progressively come down a little bit, because you've grown the base over the last five years, and as the Company continues to grow, you're adding to that base, but the base is a much larger base. But we've seen here the first couple of quarters of this year, that it seems like the growth in financial receivables has accelerated a little bit, and I was curious if there was anything going on there.

Aldo Pagliari - *Snap-on Incorporated - CFO*

This is Aldo, Richard. Good morning. First off, sure, the first half of the year has been a strong beginning for financial services. And it reflects, if you go back over time, the trailing 12 month performance of our big-ticket items, is really where the sweet spot for financial services does well, and it continues to do so. So we're pleased with that.

And we work in concert with the tools group, to organize programs that call attention both to the tools that we would like to feature in the tools group and the innovative products that Nick described earlier, as well as programs that we have to make them attractive to the customers or the franchisees, that is, the mechanics. So our participation rates have been a little bit better, and again, first half of the year has been pretty good for Snap-on Credit.

Long wave, we continue with the view that over time, 90%-plus of what the financial services unit does is in support of the tools group, and over time, it will reflect the long-term growth rates of that division. So that's still the advice that we give when we model it ourselves internally, and I guess, when we talk to people like yourself.

Richard Hilgert - *Morningstar - Analyst*

Okay. Great. Looking at the quarterly CapEx, that's at an absolute level, one of the highest I've seen on a quarterly basis, going back over the last five years. Are we going to see an acceleration in CapEx going forward? Beyond the $75 million, $80 million that we're looking at this year?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Look, I don't think so. I think we said we were at $70 million to $80 million last quarter, and now we have said $75 million to $80 million but this is just a few more projects came up that we thought we could invest in. They were talking about the tools factories in the United States. There's some investment in Asia. Doing some in Europe, and some in R&D, or in our places here.

I think you're seeing noise in the quarter. And with a maybe slight bias for upward movement, but if I was -- shall I say, if I was a cash flow modeler, for example, I wouldn't be thinking that CapEx is going to explode, or get much higher. It will move up over time, but I'm not thinking we're going to double it or go up by 50% next year, or anything like that.

Richard Hilgert - *Morningstar - Analyst*

All right.

Nick Pinchuk - *Snap-on Incorporated - CEO*

Of course I'll probably have a big project next quarter that I'll announce, and it will go up 50%, but I don't think so. Yes.

Richard Hilgert - *Morningstar - Analyst*

All right. And then on the margins for the quarter, being what they are, and Europe still being, what is it, roughly 20% of overall revenue? Any --

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Nick Pinchuk - *Snap-on Incorporated - CEO*

That's about right.

Richard Hilgert - *Morningstar - Analyst*

Any thoughts to, you've had this target out there of midcycle or pardon me, mid-teens EBITDA margins, but even with Europe and the softness over there, we've seen it come back this quarter. You're still able to generate an EBIT margin above 16.5%, EBITDA margin slightly ahead of 19%. That's excluding or having financial services on an equity basis. Any thoughts to maybe that target of yours moving up a little bit, given the progress you've made, but still having that big chunk of revenue still being slow?

Nick Pinchuk - *Snap-on Incorporated - CEO*

Look, here's what I think I would say on that. I think we've said this to this effect in other orbs. I think we're looking at the midteens in the rearview mirror. What we thought was the midteens.

And so we're by that now, and that doesn't mean we won't have a quarter that's below that. I don't mean that. Every quarter, or anything like that, but I'm talking about the trend. I think we've passed our goal that we set back in what, 2005, or something like that, when we were back at 6.5% OI margin when we said midteens.

But what I think we're viewing it going forward is not necessarily a target, but I'm telling you that absent macroeconomic turbulence of significance, we don't see ourselves being interrupted in terms of our growth. We do think that if we never got another dollar of incremental sales, we would be able to increase the margins, because of Snap-on Value Creation and its effect on the operations, and there's so much more to improve.

And secondly, we do believe, though, that we're not going to be flat. We have ample runways for growth in the van channel with the repair shop owners and managers, with the extended critical industries in emerging markets, and that's going to add leverage to that. So we see our margins continuing to go up at some pace, and we don't necessarily see a near-term ceiling to that.

Richard Hilgert - *Morningstar - Analyst*

Okay.

Nick Pinchuk - *Snap-on Incorporated - CEO*

That doesn't mean there isn't a ceiling someplace, but we're sitting here looking at, we see that. So I'm not saying we're at a ceiling, or anything like that.

Richard Hilgert - *Morningstar - Analyst*

All right. Great. Thanks again for taking my questions this morning.

Operator

At this time there are no further questions in the queue. I would like to turn the call back over to Ms. Kratcoski. Please go ahead.

Leslie Kratcoski - *Snap-on Incorporated - VP of IR*

Great. Thanks, everyone, for joining us today. A replay of this call will be available shortly, and as always, we appreciate your interest in Snap-on. Thanks, and have a great day.

Operator

And this does conclude today's call. Thank you for your participation.