Fastenal Company FAST [Nasdaq] | ★★

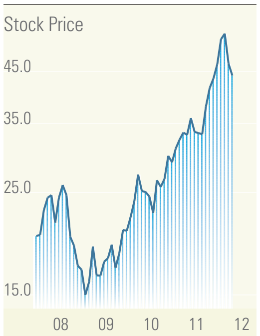
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
44.22 USD	34.00 USD	23.80 USD	45.90 USD	Medium	Wide	—	—	Industrial Distribution

AmazonSupply's foray in the industrial distribution business will pressure industry gross margins.

by Basili Alukos, CPA, CFA
Stock Analyst
Analysts covering this company do not own its stock.

Pricing data through May 23, 2012.
Rating updated as of
May 23, 2012.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Thesis May 10, 2012
Fastenal has differentiated itself by creating monopoly-like fastener distribution businesses across the United States, and we expect the firm to expand its advantage, going forward.

The industrial distribution industry is highly fragmented, with the top 50 distributors representing about 30% of the $160 billion U.S. market, and on the surface, the competitive dynamics suggest a company cannot generate an economic advantage. Customer switching costs are low--indeed, companies often buy from multiple suppliers--and we believe that new entrants can emerge because of the massive growth potential in the industry.

However, distributors like Fastenal perform a necessary function. They aggregate demand on a national level, which enables manufacturers to reduce inventory levels and essentially eliminate inventory risk. Manufacturers also prefer to employ distributors because selling directly to the end user is often prohibitively expensive and outside their core competency. Even still, Fastenal distinguishes itself from its peers in two main facets--focus on fasteners and store size--both of which help support the company's wide economic moat.

Fastenal is the dominant player in the fasteners business and it derives almost 50% of its revenue selling more than 400,000 fasteners. Fasteners are financially inconsequential, yet essential for production continuity, so customers are practically insensitive to price. Second, Fastenal thrives on small and mid-sized markets that typically accommodate one store. Operating smaller stores in third-tier locations enables Fastenal to break even with roughly $80,000 in monthly sales, a rate unobtainable by its larger competitors. Furthering its cost advantage, Fastenal operates an internal logistics firm that satisfies customer demand faster--most stores receive daily shipments--and at a lower cost than peers' systems that rely on third-party operators. Collectively, these advantages allow Fastenal to generate substantial economic value, and its returns on invested capital have averaged 16% since 2001, well above our estimated cost of capital.

Although we expect Fastenal to further its advantage against smaller companies, we think the company will face competition from larger foes. Fastenal believes that its current product offerings can cover 70% of its addressable market. Although there is tremendous growth opportunity, this still means that Fastenal is unable to meet roughly 30% of potential customers' needs. Furthermore, because the larger distributors have similar product offerings, Fastenal may be forced to compete on price, creating downward pressure on industrywide profitability. Also, Fastenal's future success depends on store location. Because a store requires about five years before achieving the revenue necessary to obtain profitability on par with companywide levels, poor location selection could impair returns as the company is forced to close the location.

Nevertheless, so long as companies demand fasteners, we believe Fastenal's broad reach and scale advantage will translate into outsized returns on invested capital going forward, and we believe the company will reward shareholders along the way.

Valuation, Growth and Profitability

Our fair value estimate for Fastenal is $34 per share. We project revenue growth using a two-pronged variance analysis approach, which estimates the growth in the number of new store openings annually and the implied change in same-store sales for existing stores.

We forecast that Fastenal will open stores at an annual clip of 6% per year over the next five years, which is at the low end of its pathway-to-profit goal of 7%-10%. This growth trajectory implies Fastenal will operate more than 3,300 stores by 2015, a 30% increase from 2010 levels. During this time, we forecast that same-store sales will

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Fastenal Company	USD	13,092	2,895	607	379
W.W. Grainger, Inc.	USD	13,709	8,388	1,094	688
MSC Industrial Direct Co., Inc.	USD	4,579	2,174	385	241
Anixter International Inc	USD	1,944	6,199	372	199

Morningstar data as of May 23, 2012.

increase at an average rate of almost 8% per year, which we believe is consistent with Fastenal's historical trends--stores churn out greater organic growth as they age. Our same-store sales analysis yields different figures from Fastenal's reported results because the company calculates same-store revenue from stores opened for more than two years, whereas we use revenue from stores open for more than one year. Collectively, this translates into an annual growth rate of nearly 15% over the next five years, which is slightly less than the company's historical average.

We expect operating margins will increase as history shows that newer stores increase in profitability over time. As such, we project that operating margins will average 22% per year over our forecast horizon. We project capital spending will hover around 2% of sales, reflecting our view that Fastenal will open fewer new stores.

Risk

Fastenal faces risks similar to those of a traditional industrial company because nearly half of its customers are in the manufacturing sector. Specifically, the company is more prone to a U.S. downturn because nearly 90% of its stores are located in the country. Cannibalization is a concern for Fastenal as it opens new stores and introduces its vending machines, which ultimately compete against older stores. Last, working capital management is extremely important because poor decisions can cause Fastenal to deplete cash right as demand sours.

Bulls Say

- Fastenal started growing its previously nonexistent U.S. government business in early 2010. As government spending becomes a greater portion of U.S. GDP, we believe this segment will present a substantial growth opportunity.
- Fastenal believes its internal distribution model is about 10 times cheaper than using a third-party logistics firm even though the task is demanding--almost 80% of daily deliveries occur before 8 a.m.
- Fastenal estimates that it has less than 2% share of the $160 billion industrial distributor market, suggesting opportunities abound for the company to capture business.

Bears Say

- Fastenal's new vending machine product has negative unintended consequences that could reduce future growth. For instance, a large industrial customer reduced its carbide insert consumption by 45% as users realized the increased accountability from using the machines.
- Fastenal is named as a party in legal proceedings relating to a violation of an exclusive agreement with a supplier. Although Fastenal believes the probability of an incurred liability is remote, the alleged amount is $180 million.
- Cannibalization is always a problem for Fastenal as the company increases its store density and adds vending machines. This growth can eat into the profitability of older stores.

Financial Overview

Financial Health: Fastenal's financial profile is impeccable.

The firm holds $226 million in cash and marketable securities and has no debt.

Company Overview

Profile: Fastenal provides customers with maintenance products, including 410,000 types of fasteners and 586,000 other general-purpose maintenance, repair, and operations items. Fastenal operates more than 2,600 locations, most of them in the United States. The firm generated $2.8 billion in revenue in 2011.

Management: Will Oberton has led the firm as CEO since December 2002. Oberton began his career working for Fastenal in 1980 and, consistent with the firm's internal hiring practice, he's worked his way through the company, including managing a branch and a district prior to becoming COO. The remaining members of upper management each have more than 20 years of experience working with the company. We are pleased that Oberton's annual salary is relatively low, but we'd like to see the company incorporate more stock-based compensation. For example, quarterly cash installments based on pretax earnings comprise the majority of annual compensation, although no bonuses were paid in 2009, 2010, or 2011. Even still, the firm's impressive returns on invested capital during the past decade and its strong insider ownership do temper our concerns.

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Analyst Notes

Apr. 12, 2012

Fastenal Reports 1Q Earnings

Fastenal reported first-quarter results Thursday that were mostly consistent with our projections. We are leaving our fair value estimate unchanged. Revenue increased 20% compared with the year-ago period. Same-store sales increased an average of 18% during the quarter compared with the prior-year period. Fastenal increased its store base by 1% (or 28 stores) and ended the quarter with 2,611 stores. The company delivered an 80-basis-point decline in gross margins, but gained about 200 basis points in profitability from operating and administrative expenses. As a result, operating margins expanded 100 basis points to 21%.

We were surprised by Fastenal's commentary on gross margins, specifically its relatively unsuccessful attempts to offset inflation via price increases. Management noted that it is harder to enact price increases today because there are only pockets of inflation, compared to periods of systematic inflation when the company has greater success.

We view this as a discouraging trend for two reasons. First, many of the products Fastenal sells are individually inexpensive--most products represent a fraction of a company's daily operating costs--yet in some instances are necessary to ensure production remains on schedule. Second, convenience purchases make up a portion of Fastenal's sales, meaning a customer is normally willing to pay up for the product. Collectively, we believe these reasons provide Fastenal with strong pricing power in all growth environments and explain its impressive 51% gross margins.

We thought declining gross margins would stem from operational issues, not pricing. Therefore, we think the pricing issues suggest customers are becoming more sensitive to costs and are willing to comparison-shop. This habit is the antithesis of the value proposition that industrial distributors like Fastenal offer, and we expect that greater comparison-shopping will threaten long-term gross margins.

Jan. 18, 2012

Fastenal Reports 4Q Earnings

Fastenal reported fourth-quarter results Wednesday that exceeded our revenue expectations. We will update our projections to incorporate the annual figures.

Revenue increased 22% compared with the year-ago period. Same-store sales increased an average of 18% during the quarter compared with the prior-year period. Additionally, Fastenal grew its store base by 5% and ended the year with 2,585 stores. The firm once again reported strong profitability. Operating margins expanded 150 basis points to 20% due to better operating and administrative cost containment.

Fastenal is a great business, and its growth trajectory has been impressive over the past few years. Ending 2011 revenue is 20% higher than 2008 (prior peak) revenue, while operating margins, at 21%, are nearly 200 basis points above 2008 levels.

However, we still think Fastenal carries a rich valuation. We project long-run operating margins of 21% in our $32 fair value estimate. If we increase this assumption to management's stated goal of 23%, our fair value estimate increases to $42 per share, which is still a

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Analyst Notes (continued)

premium to the current market prices.

Disclaimers & Disclosures

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Fastenal Company FAST

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
2,895	13,092	Industrial Distribution	Industrials

Fastenal provides customers with maintenance products, including 410,000 types of fasteners and 586,000 other general-purpose maintenance, repair, and operations items. Fastenal operates more than 2,600 locations, most of them in the United States. The firm generated $2.8 billion in revenue in 2011.

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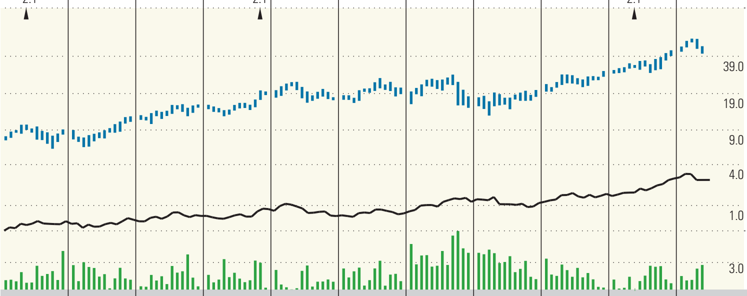
Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★	44.22	34.00	Medium	Wide	—

per share prices in USD

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	
10.84	12.75	16.13	20.98	24.66	26.47	28.24	21.14	30.20	44.40	55.05	Annual Price High
6.65	6.88	10.97	12.77	16.59	16.52	15.04	12.94	20.48	28.81	41.72	Low
2:1			2:1						2:1		Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500
52 week High/Low
55.05 - 29.14
10 Year High/Low
55.05 - 6.65
Bear-Market Rank
5 (10=worst)
Trading Volume Million

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
12.7	33.6	24.5	28.1	-7.3	13.9	-11.8	21.6	46.9	47.8	2.2	Total Return %
36.1	7.2	15.5	25.1	-20.9	10.4	26.7	-1.8	34.1	47.8	-2.5	+/- Market
20.6	16.2	-13.3	17.5	-15.3	-3.0	14.1	-4.7	7.1	21.5	-1.6	+/- Industry
0.1	0.3	0.4	0.8	1.1	1.1	1.5	1.7	1.4	1.5	1.4	Dividend Yield %
2837	3775	4671	5911	5416	6064	5176	6139	8833	12874	13092	Market Cap USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Financials
905	995	1238	1523	1809	2062	2340	1930	2269	2767	2895	Revenue USD Mil
49.5	49.2	50.4	49.8	50.2	50.8	52.8	50.9	51.8	51.8	51.6	Gross Margin %
119	135	207	268	320	376	450	296	430	575	607	Oper Income USD Mil
13.2	13.6	16.7	17.6	17.7	18.3	19.2	15.3	18.9	20.8	21.0	Operating Margin %
76	84	131	167	199	233	280	184	265	358	379	Net Income USD Mil
0.25	0.28	0.43	0.55	0.66	0.78	0.94	0.62	0.90	1.21	1.28	Earnings Per Share USD
0.01	0.05	0.10	0.16	0.20	0.22	0.26	0.36	0.41	0.65	0.57	Dividends USD
304	304	304	303	302	301	298	297	295	296	296	Shares Mil
1.65	1.90	2.25	2.59	3.05	3.37	3.85	4.04	4.35	4.94	5.20	Book Value Per Share USD
18	91	57	122	98	228	260	306	240	268	326	Oper Cash Flow USD Mil
-43	-50	-53	-66	-78	-56	-95	-53	-74	-120	-127	Cap Spending USD Mil
-25	40	5	56	20	172	165	254	167	148	199	Free Cash Flow USD Mil

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Profitability
14.6	13.9	18.4	20.1	20.6	21.1	22.7	14.0	19.0	22.7	22.7	Return on Assets %
16.3	15.6	20.8	22.7	23.3	24.1	26.0	15.8	21.5	26.1	26.8	Return on Equity %
8.3	8.5	10.6	11.0	11.0	11.3	12.0	9.6	11.7	12.9	13.1	Net Margin %
1.75	1.64	1.74	1.84	1.88	1.87	1.90	1.47	1.62	1.75	1.73	Asset Turnover
1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.2	Financial Leverage

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	03-12	Financial Health
349	393	467	557	664	743	827	863	924	1048	1114	Working Capital USD Mil
—	—	—	—	—	—	—	—	—	—	—	Long-Term Debt USD Mil
500	577	684	784	922	1010	1142	1191	1283	1459	1539	Total Equity USD Mil
—	—	—	—	—	—	—	—	—	—	—	Debt/Equity

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
37.7	44.8	35.8	35.6	27.2	26.1	18.6	33.6	33.3	36.1	34.6	Price/Earnings
—	—	—	—	—	—	—	—	—	2.0	2.5	P/E vs. Market
3.1	3.8	3.8	3.9	3.0	3.0	2.2	3.2	3.9	4.7	4.5	Price/Sales
5.7	6.5	6.8	7.5	5.9	6.0	4.5	5.2	6.9	8.8	8.5	Price/Book
—	41.7	81.3	48.8	55.6	26.7	20.0	20.2	36.8	48.1	40.2	Price/Cash Flow

Growth Rates Compound Annual

Grade: C	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	21.9	5.7	8.9	13.0
Operating Income %	33.7	8.5	12.4	17.8
Earnings/Share %	34.4	8.8	12.9	18.0
Dividends %	58.5	35.7	26.6	50.0
Book Value/Share %	13.6	8.7	10.1	13.4
Stock Total Return %	38.4	41.8	17.0	16.9
+/- Industry	19.3	8.6	5.3	3.2
+/- Market	39.7	27.7	19.9	14.3

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	26.8	22.7	18.8	22.8
Return on Assets %	22.7	19.9	9.0	9.4
Fixed Asset Turns	7.0	6.9	9.7	7.6
Inventory Turns	2.3	2.0	4.2	16.9
Revenue/Employee USD K	190.9	171.2*	—	1057.9
Gross Margin %	51.6	51.6	32.0	39.8
Operating Margin %	21.0	18.5	9.6	16.8
Net Margin %	13.1	11.5	5.5	11.3
Free Cash Flow/Rev %	6.9	8.3	4.0	0.1
R&D/Rev %	—	—	—	9.5

Financial Position

Grade: A	12-11 USD Mil	03-12 USD Mil
Cash	118	199
Inventories	646	648
Receivables	339	387
Current Assets	1236	1350
Fixed Assets	436	450
Intangibles	—	—
Total Assets	1685	1813
Payables	76	123
Short-Term Debt	—	—
Current Liabilities	188	236
Long-Term Debt	—	—
Total Liabilities	226	274
Total Equity	1459	1539

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	34.6	29.5	21.0	14.1
Forward P/E	24.9	—	—	13.3
Price/Cash Flow	40.2	30.4	18.8	6.6
Price/Free Cash Flow	65.8	46.2	28.3	17.2
Dividend Yield %	1.4	—	1.5	2.1
Price/Book	8.5	6.3	3.8	1.8
Price/Sales	4.5	3.4	1.2	1.1
PEG Ratio	1.3	—	—	1.6

Quarterly Results

Revenue USD Mil	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	701.7	726.7	697.8	768.9
Prior Year Period	571.2	603.8	573.8	640.6

Rev Growth %	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	22.9	20.4	21.6	20.0
Prior Year Period	20.3	23.4	20.4	23.0

Earnings Per Share USD	Jun 11	Sep 11	Dec 11	Mar 12
Most Recent Period	0.32	0.33	0.30	0.34
Prior Year Period	0.24	0.26	0.22	0.27

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Fastenal Company	13092	2895	34.6	26.8
W.W. Grainger, Inc.	13709	8388	20.3	27.0
MSC Industrial Direc	4579	2174	18.9	23.6

Major Fund Holders

	% of shares
	—
	—
	—

*3Yr Avg data is displayed in place of 5Yr Avg

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies

Competitive Analysis → **Economic Moat™ Rating** → Company Valuation → **Fair Value Estimate** → Uncertainty Assessment → ★★★★★

Competitive Analysis	Economic Moat™ Rating	Company Valuation	Fair Value Estimate	Uncertainty Assessment	★★★★★
Analyst conducts company and industry research: • Management interviews • Conference calls • Trade-show visits • Competitor, supplier, distributor, and customer interviews	The depth of the firm's competitive advantage is rated: • None • Narrow • Wide	Analyst considers company financial statements and competitive position to forecast future cash flows. Assumptions are input into a discounted cash-flow model.	DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.	An uncertainty assessment establishes the margin of safety required for the stock rating.	★ ★★ ★★★ ★★★★ ★★★★★ The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.