Fastener Distributor Index – August 2017

Written by R.W. Baird analyst David J. Manthey, CFA 9/8/17

Key Takeaway:

The seasonally adjusted FDI for August 2017 was 62.7 – accelerating from July’s 55.1 reading and remaining well in expansionary territory. Selling conditions improved m/m, with the seasonally adjusted sales index coming in at 77.1 vs. July’s 69.8. Qualitative commentary on market conditions was universally positive as several respondents noted a recovery across all end markets, as well as tailwinds from higher pricing. The FDI Forward-Looking Indicator also remains well in expansionary territory, registering a seasonally adjusted 59.9, but decelerating modestly vs. last month (July 62.9).

Key Points:

About the Fastener Distributor Index (FDI). The FDI is a monthly survey of North American fastener distributors, conducted with the FCH Sourcing Network and the National Fastener Distributors Association. It offers insights into current industry trends/outlooks. As a diffusion index, values above 50.0 signal strength, while readings below 50.0 signal weakness. Over time, results should be directly relevant to Fastenal (FAST) and broadly relevant to other industrial distributors such as W.W. Grainger (GWW), and MSC Industrial (MSM).

August FDI up nicely vs. July. The seasonally adjusted August FDI (62.7) accelerated from July’s 55.1 reading, driven mainly by improved sales trends. In the August survey, 70% of respondents indicated sales were “better” relative to seasonal expectations, well above July levels (47%). Relative to historical seasonal readings in the month of August, this month’s seasonally adjusted sales index of 77.1 suggests selling conditions remain very healthy overall. Pricing was again a solid tailwind for the second consecutive month as 61% of distributors saw higher prices y/y. This resulted in an FDI pricing index of 78.8 – the highest reading in over two years. As it relates to customer inventories, most respondents continue to view inventory levels as relatively in line with expectations (79% of responses), while 21% indicated inventory levels are too low. This compares to July results of 70% and 30%, respectively.

FDI Forwarding-Looking Indicator remains solidly in growth mode. The FDI Forward-Looking Indicator is based on a weighted average of four forward-looking inputs from the FDI survey. This indicator is designed to provide directional perspective on future expectations for fastener market conditions. August’s seasonally adjusted Forward-Looking Indicator ticked down modestly to 59.9 vs. 62.9 in July. The Forward-Looking Indicator averaged 49.7 during 2016, but has averaged 60.9 year-to-date in 2017. Given solidly expansionary FDI and FLI readings, market conditions appear likely to remain in growth mode in the coming months.
Manufacturing employment ticks up. Consistent with improved sales momentum, hiring sentiment also picked up slightly m/m. 30% of respondents indicated employment was higher in August relative to seasonal expectations vs. 17% in July, while 64% saw hiring levels as in line with seasonal expectations (vs. 73% in July). This resulted in an FDI Employment Index reading of 62.1, up vs. July’s 53.3 reading and continuing a pattern of strong YTD results (61.8 average YTD vs. 48.9 in 2016). The August US jobs report, meanwhile, came in slightly below expectations, but nicely positive (+156,000 adds vs. +180,000 consensus). Manufacturing employment, however, saw a nice m/m gain at +36,000 jobs. Average hours per work week for manufacturing employees was down slightly at 40.7 hours (vs. 40.9 in July).

August sentiment bullish. Survey commentary on current market conditions was universally positive this month vs. more mixed commentary in July. Several respondents noted improving end-market conditions driving strong top-line growth. One distributor said, “Recovery in all sectors of our business is improving,” while highlighting mining as particularly strong. Another respondent indicated a significant uptick in demand is already being seen from disaster recovery efforts: “Hurricane Harvey is creating a lot of business!” As previously mentioned, pricing was also a solid tailwind this quarter. One respondent commented on this, saying “Pricing is up sharply from overseas. So are lead times. Quote replies [are] also taking longer. Obviously, business is up.” Lastly, the outlook for the remainder of the year remains positive, with 45% of respondents expecting higher activity levels over the next six months vs. today, though this is down slightly vs. July (57%).

Fastenal reported August daily sales growth of +12.8% y/y, nicely ahead of our +11.0% estimate and reflecting growth in all end markets/product lines. Underlying “core” growth (excluding acquisitions and foreign exchange) was +11.3%, the third consecutive month of double-digit growth. Additionally, Hurricane Harvey disruption was an estimated 40-50bps headwind in the month. Fasteners saw strong growth at +12.2% y/y (up vs. 11.3% last month), including the recent Mansco acquisition (+8.4% ex-Mansco). Based on FDI data and other research inputs, we continue to expect a substantial uptick in growth among the public industrial distributors this year, with Fastenal daily sales growth expected to average double-digit y/y growth rates for the remainder of 2017.

FAST Risk Synopsis

Risks include economic sensitivity, pricing power, relatively high valuation, secular gross margin pressures, success of vending and on-site initiatives, and ability to sustain historical growth.

Industrial Distribution Risk Synopsis

Risks include economic sensitivity, pricing power, online pressure/competitive threats, global sourcing, and exposure to durable goods manufacturing.
<table>
<thead>
<tr>
<th>Metric</th>
<th>Aug</th>
<th>Jul</th>
<th>Jun</th>
<th>May</th>
<th>Apr</th>
<th>Mar</th>
<th>Feb</th>
<th>Direction</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>PMI (Manufacturing Sector)</td>
<td>58.8</td>
<td>56.3</td>
<td>57.8</td>
<td>54.9</td>
<td>54.8</td>
<td>57.2</td>
<td>57.7</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>FDI (Fastener Sector)</td>
<td>61.0</td>
<td>52.9</td>
<td>60.5</td>
<td>66.3</td>
<td>53.7</td>
<td>61.3</td>
<td>55.4</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>FDI (Seasonally Adjusted)</td>
<td>62.7</td>
<td>55.1</td>
<td>60.8</td>
<td>64.6</td>
<td>50.2</td>
<td>60.0</td>
<td>57.0</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>Sales (SA)</td>
<td>77.1</td>
<td>69.8</td>
<td>86.6</td>
<td>79.6</td>
<td>43.8</td>
<td>74.6</td>
<td>62.7</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>Forward-Looking (SA)</td>
<td>59.9</td>
<td>62.9</td>
<td>64.0</td>
<td>63.3</td>
<td>58.9</td>
<td>57.4</td>
<td>61.0</td>
<td>Growing</td>
<td>Slower</td>
</tr>
<tr>
<td>Employment</td>
<td>62.1</td>
<td>53.3</td>
<td>68.0</td>
<td>73.6</td>
<td>57.4</td>
<td>59.8</td>
<td>62.9</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>Supplier Deliveries</td>
<td>65.2</td>
<td>65.0</td>
<td>64.0</td>
<td>72.2</td>
<td>66.2</td>
<td>61.0</td>
<td>61.4</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>Respondent Inventories</td>
<td>62.1</td>
<td>51.7</td>
<td>52.0</td>
<td>58.3</td>
<td>52.9</td>
<td>61.0</td>
<td>58.6</td>
<td>Growing</td>
<td>Faster</td>
</tr>
<tr>
<td>Customer Inventories</td>
<td>39.4</td>
<td>35.0</td>
<td>32.0</td>
<td>36.1</td>
<td>38.2</td>
<td>43.9</td>
<td>40.0</td>
<td>Declining</td>
<td>Slower</td>
</tr>
<tr>
<td>Pricing, month-to-month</td>
<td>72.7</td>
<td>65.0</td>
<td>52.0</td>
<td>59.7</td>
<td>60.3</td>
<td>63.4</td>
<td>60.0</td>
<td>Higher</td>
<td>Faster</td>
</tr>
<tr>
<td>Pricing, year-to-year</td>
<td>78.8</td>
<td>76.7</td>
<td>66.0</td>
<td>75.0</td>
<td>73.5</td>
<td>72.0</td>
<td>70.0</td>
<td>Higher</td>
<td>Faster</td>
</tr>
</tbody>
</table>

**6-Month Outlook - August**

<table>
<thead>
<tr>
<th>Higher</th>
<th>Same</th>
<th>Lower</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>45%</td>
<td>45%</td>
</tr>
</tbody>
</table>

FDI and Pricing are diffusion indexes. A reading above 50 suggests the category outperformed expectations, while a reading below 50 suggests the category underperformed expectations.

**Source:** Robert W. Baird &Co., FCBJ Sourcing Network, Institute for Supply Management
Fastener Distributor Index (FDI); Seasonally Adjusted

Source: Robert W. Baird & Co., FCH Sourcing Network, company reports

FDI vs. Forward-Looking Indicator (Seasonally Adjusted)

Source: Robert W. Baird & Co., FCH Sourcing Network
Appendix – Important Disclosures and Analyst Certification

Covered Companies Mentioned
All stock prices below are as of 9/7/2017.

Fastenal Company (FAST- $41.87)
W.W. Grainger Inc. (GWW- $161.62)
MSC Industrial Direct Co. Inc (MSM- $68.03)
(See recent research reports for more information)
Robert W. Baird & Co. Incorporated makes a market in the securities of FAST, GWW, and MSM.

Robert W. Baird & Co. Incorporated and/or its affiliates have been compensated by Fastenal Company for non-investment banking-securities related services in the past 12 months.

Robert W. Baird & Co. Incorporated and/or its affiliates expect to receive or intend to seek investment-banking related compensation from the company or companies mentioned in this report within the next three months.

Robert W. Baird & Co. Incorporated may not be licensed to execute transactions in all foreign listed securities directly. Transactions in foreign listed securities may be prohibited for residents of the United States. Please contact a Baird representative for more information.

Investment Ratings:

**Outperform (O)** - Expected to outperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months. **Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months. **Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

Risk Ratings:

**L - Lower Risk** - Higher-quality companies for investors seeking capital appreciation or income with an emphasis on safety. Company characteristics may include: stable earnings, conservative balance sheets, and an established history of revenue and earnings.

**A - Average Risk** - Growth situations for investors seeking capital appreciation with an emphasis on safety. Company characteristics may include: moderate volatility, modest balance-sheet leverage, and stable patterns of revenue and earnings.

**H - Higher Risk** - Higher-growth situations appropriate for investors seeking capital appreciation with the acceptance of risk. Company characteristics may include: higher balance-sheet leverage, dynamic business environments, and higher levels of earnings and price volatility.

**S - Speculative Risk** - High-growth situations appropriate only for investors willing to accept a high degree of volatility and risk. Company characteristics may include: unpredictable earnings, small capitalization, aggressive growth strategies, rapidly changing market dynamics, high leverage, extreme price volatility and unknown competitive challenges.

Valuation, Ratings and Risks. The recommendation and price target contained within this report are based on a time horizon of 12 months but there is no guarantee the objective will be achieved within the specified time horizon. Price targets are determined by a subjective review of fundamental and/or quantitative factors of the issuer, its industry, and the security type. A variety of methods may be used to determine the value of a security including, but not limited to, discounted cash flow, earnings multiples, peer group comparisons, and sum of the parts. Overall market risk, interest rate risk, and general economic risks impact all securities. Specific information regarding the price target and recommendation is provided in the text of our most recent research report.

Distribution of Investment Ratings. As of August 31, 2017, Baird U.S. Equity Research covered 711 companies, with 54% rated Outperform/Buy, 44% rated Neutral/Hold and 2% rated Underperform/Sell. Within these rating categories, 13% of Outperform/Buy-rated and 7% of Neutral/Hold-rated companies have compensated Baird for...
investment banking services in the past 12 months and/or Baird managed or co-managed a public offering of securities for these companies in the past 12 months.

Analyst Compensation. Analyst compensation is based on: 1) the correlation between the analyst's recommendations and stock price performance; 2) ratings and direct feedback from our investing clients, our institutional and retail sales force (as applicable) and from independent rating services; 3) the analyst's productivity, including the quality of the analyst's research and the analyst's contribution to the growth and development of our overall research effort and 4) compliance with all of Robert W. Baird's internal policies and procedures. This compensation criteria and actual compensation is reviewed and approved on an annual basis by Baird's Research Oversight Committee.

A complete listing of all companies covered by Baird U.S. Equity Research and applicable research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx. You can also call 800-792-2473 or write: Robert W. Baird & Co., Equity Research, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.

Analyst Certification

The senior research analyst(s) certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's personal views about the subject securities or issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

Disclaimers

Baird prohibits analysts from owning stock in companies they cover.

This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST

The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available.

Baird is exempt from the requirement to hold an Australian financial services license. Baird is regulated by the United States Securities and Exchange Commission, FINRA, and various other self-regulatory organizations and those laws and regulations may differ from Australian laws. This report has been prepared in accordance with the laws and regulations governing United States broker-dealers and not Australian laws.

Copyright 2017 Robert W. Baird & Co. Incorporated

Other Disclosures

The information and rating included in this report represent the Analyst's long-term (12 month) view as described above. The research analyst(s) named in this report may, at times and at the request of clients or their Baird representatives, provide particular investment perspectives or trading strategies based primarily on the analyst's understanding of the individual client's objectives. These perspectives or trading strategies generally are responsive to client inquiries and based on criteria the analyst considers relevant to the client. As such, these perspectives and strategies may differ from the analyst's views contained in this report.

Robert W. Baird & Co. Incorporated and/or its affiliates (Baird) may provide to certain clients additional or research supplemental products or services, such as outlooks, commentaries and other detailed analyses, which focus on covered stocks, companies, industries or sectors. Not all clients who receive our standard company-specific research reports are eligible to receive these additional or supplemental products or services. Baird determines in its sole discretion the clients who will receive additional or supplemental products or services, in light of various factors including the size and scope of the client relationships. These additional or supplemental products or services may feature different analytical or research techniques and information than are contained in Baird's standard research reports. Any ratings and recommendations contained in such additional or research supplemental products are consistent with the Analyst's ratings and recommendations contained in more broadly disseminated standard research reports.

Baird Research Analysts may provide incremental data points or views regarding covered companies in the form of Research Posts and Flash Reports. All Posts and Flash Reports are available to clients via https://bol.rwbaird.com/Login, but not all are sent directly to clients. Baird Associates may, at their discretion, choose whether to send these Posts and Flash Reports to Baird clients after they are posted online. Such decisions are
based on, among other things, client interest, coverage, stock ownership and indicated email preferences. The incremental content and/or analysis contained in these pieces may be useful to investors as part of a broader investment thesis, but is not sufficient to warrant a change in the Research Analyst's published opinion, including rating, estimates and price targets. Access to https://bol.rwbaird.com/Login is available to all Baird Clients. Contact your RWBL representative if you would like access to https://bol.rwbaird.com/Login.

United Kingdom (“UK”) disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W. Baird Limited (“RWBL”) holds an MiFID passport.

The contents of this report may contain an “investment recommendation,” as defined by the Market Abuse Regulation EU No 596/2014 (“MAR”). Please therefore be aware of the important disclosures outlined below. Unless otherwise stated, this report was completed and first disseminated at the date and time provided on the timestamp of the report. if you would like further information on dissemination times, please contact us. Please note, this report may provide views which differ from previous recommendations made by the same individual in respect of the same financial instrument or issuer in the last 12 months which is available at https://baird.bluematrix.com/sellside/MAR.action.

This material is distributed in the UK and the European Economic Area (“EEA”) by RWBL, which has an office at Finsbury Circus House, 15 Finsbury Circus, London EC2M 7EB and is authorized and regulated by the Financial Conduct Authority (“FCA”).

For the purposes of the FCA requirements, this investment research report is classified as investment research and is objective. The views contained in this report (i) do not necessarily correspond to, and may differ from, the views of Robert W. Baird Limited or any other entity within the Baird Group, in particular Robert W. Baird & Co. Incorporated, and (ii) may differ from the views of another individual of Robert W. Baird Limited.

All substantially material sources of the information contained in this report are disclosed. All sources of information in this report are reliable, but where there is any doubt as to reliability of a particular source, this is clearly indicated.

Robert W. Baird Group and or one of its affiliates may at any time have a long or short position in the company/companies mentioned in this report. Where the Group holds a long or short position exceeding 0.5% of the total issued share capital of the issuer, this will be disclosed separately by your RWBL representative upon request.

This material is only directed at and is only made available to persons in the EEA who would satisfy the criteria of being “Professional” investors under MiFID and to persons in the UK falling within articles 19, 38, 47, and 49 of the Financial Services and Markets Act of 2000 (Financial Promotion) Order 2005 (all such persons being referred to as “relevant persons”). Accordingly, this document is intended only for persons regarded as investment professionals (or equivalent) and is not to be distributed to or passed onto any other person (such as persons who would be classified as Retail clients under MiFID).

Robert W. Baird & Co. Incorporated and RWBL have in place organizational and administrative arrangements for the disclosure and avoidance of conflicts of interest with respect to research recommendations. Robert W. Baird Group and or one of its affiliates may be party to an agreement with the issuer that is the subject of this report relating to the provision of services of investment firms. An outline of the general approach taken by Robert W. Baird Limited in relation to conflicts of interest is available from your RWBL representative upon request. Baird’s policies and procedures are designed to identify and effectively manage conflicts of interest related to the preparation and content of research reports and to promote objective and reliable research that reflects the truly held opinions of research analysts. Analysts certify on a quarterly basis that such research reports accurately reflect their personal views.

This material is not intended for persons in jurisdictions where the distribution or publication of this research report is not permitted under the applicable laws or regulations of such jurisdiction.

Investment involves risk. The price of securities may fluctuate and past performance is not indicative of future results. Any recommendation contained in the research report does not have regard to the specific investment objectives, financial situation and the particular needs of any individuals. You are advised to exercise caution in relation to the research report. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

RWBL is exempt from the requirement to hold an Australian financial services license. RWBL is regulated by the FCA under UK laws, which may differ from Australian laws. As such, this document has not been prepared in accordance with Australian laws.

Dividend Yield. As used in this report, the term “dividend yield” refers, on a percentage basis, to the historical distributions made by the issuer relative to its current market price. Such distributions are not guaranteed, may be modified at the issuer’s discretion, may exceed operating cash flow, subsidized by borrowed funds or include a return of investment principal.

*****