“Saving up” for a purchase is a phrase that connotes consumer behavior in the pioneer days of *Little House on the Prairie*. In impatient millennial America, we borrow to buy. Snap-on, Inc. (SNA) and Signet Jewelers Ltd. (SIG) are the case studies in the modern-day application of high-yield consumer credit at a late hour in the business cycle. We’re bearish on each.

Short-sellers will keep reading, of course, but so will a thoughtful bull. Our featured companies open a micro-level window on the macroeconomic difficulties to which Bernie Sanders and Donald Trump owe no small part of their celebrity. New survey results by the Federal Reserve show that 46% of Americans don’t have enough ready cash to cover a $400 emergency expense (including 19% of those earning $100,000 or more). For many nowadays, a savings account is a MasterCard.

Founded almost a century ago in the 1920–21 depression, Snap-on manufactures premium tools and diagnostic equipment. From its headquarters in Kenosha, Wis., it faces the world today in three separate business units: the eponymous Snap-on Tools Group, a repair systems and information subsidiary (RS&I) and a commercial and industrial unit (C&I). Tools Group is the biggest, with $402.5 million in first-quarter sales. The C&I unit, with $287 million in first-quarter sales, brings Snap-on products to customers in heavy industry in the U.S. and beyond (having founded its domestic business in 1920, Snap-on ventured abroad in another troubled macroeconomic year, 1931). RS&I, the No. 3 unit, with $278.8 million in first-quarter revenue, sells heavy-duty equipment to auto-repair shops.

Tools Group is the 90-year-old progeny of the founding Snap-on Wrench Co. Its first sockets were the epitome of the better mousetrap: Just click them on an interexchangeable company handle and go to work; there were 10 sockets and five handles to a set. Snap-on today also makes awls, files, wrenches, hammers, pry bars, axle pullers, piston-ring expanders, hex-nut sockets, pliers, mobile tool chests and the like, as well as machines that tell a mechanic what’s wrong with your car. Snap-on tools may cost more than those from other brands—DeWALT, for instance—but that’s because they’re worth more; so affirms the marketing material.

Snap-on’s distribution system, developed in the 1950s, was as innovative as its socket wrenches. To this day, the company comes to the customer, whoever that customer may be: auto mechanic, motorcycle-repair shop, auto dealer, truck dealer, fleet-maintenance center, etc. You get delivery from a Snap-on franchisee who pulls up in his or her walk-in van. The company maps the sales route, the franchisee does the selling.

Snap-on Credit (SOC), the company’s captive finance sub,
facilitates the purchase of tools and franchises alike. As for the latter, it will lend to prospective franchisees a portion of their low-six-figure start-up expenses.

Having acquired a Snap-on franchise, the franchisee may tap SOC on behalf of his or her customers. The mechanic segment of the market may very well require help: Average earnings for American mechanics averaged $37,910 last year, according to the Bureau of Labor Statistics. Let us say that a 14-piece, ¼-inch drive, six-point SAE shallow general-service socket set, with a price tag of $296.50, is the apple of the customer’s eye. To clinch the sale, a franchisee may extend such credit to allow 10 weekly payments of $29.65. For more expensive items, e.g. a $3,895 SOLUS ultra-full-function scan device, a customer must apply for vendor financing to Snap-on Credit. The franchisee will render assistance with the application. Then, too, if the loan goes bad, the franchisee will eat 25% of the loss.

While Snap-on serves a worldwide market, the American automobile repair bay is where it prospers. Between 2010 and 2015, net sales compounded at a 5.1% annual rate; global C&I sales grew by only 2.1% per year. Only 31% of last year’s sales were booked outside the 50 states.

To make the same point a little differently: The Snap-on Tools Group and the RS&I group, both of which sell to auto-repair shops, generated compound annual sales growth of 8.6% and 5.6%, respectively, between 2010 and 2015. The record is all the more impressive in view of the slow-motion expansion of a major portion of the customer base; in those five years, mechanical and electrical automotive repair jobs rose at an annual rate of only 1.6%.

“How long can you grow a business in premium hand tools at a better than 6% rate when you warrantee this product forever and the population of users is not growing?” Bret D. Jordan, an analyst who covers Snap-on for the Jefferies Group LLC, asks colleague Evan Lorenz. “We are seeing a contraction in service bays nationally. Independent small shops are going out of business because they can’t work in new technology. Again, they are selling a product that is super premium and lasts forever. Once a guy buys a socket-wrench set from Snap-on—unless he is losing his sockets—he will probably never need to buy another one. How do you sustain that growth rate?”

A post-crisis bull market in used cars explains part of Snap-on’s recent success. Since the start of 2010, the Manheim U.S. Used-Vehicle Value Index has averaged 123. Its previous, pre-2008 high, recorded in 2001, was 117.4. Or consider: In 2009, $5,000 would have got you a ride with 85,000 miles on the odometer; in 2015, with the same dollars, that odometer would have read just over 120,000 miles. All this has contributed to the aging of the American light-vehicle fleet, to 11.5 years in 2015 from 10 years in 2007. Old cars, like superannuated drivers, require more repair, more diagnostic attention than new models. Besides, the higher electronic content of new vehicles creates a demand for the trouble-shooting apparatus to decode the digital machine.

“However,” adds Lorenz, “an even bigger reason why Snap-on’s sales have been so robust over the past five years has been an explosion in lending. Snap-on segments its lending activity between finance receivables, which fund franchisees’ customers, and contract receivables, which fund franchisees themselves, as well as customers in the RS&I and C&I groups. Over the past five years, finance receivables have grown by 15.9% per year over the same time period.”

As striking as the growth in lending are the interest rates that SOC is able to exact: Yields on finance and contract receivables averaged 17.9% and 9.5%, respectively, in the first quarter. Lorenz asked Snap-on’s vice president of investor relations, Leslie H. Kratcoski, why the company charges what it does. “The rates charged by Snap-on Credit reflect the credit-risk profile of our customers,” Kratcoski replied, which is to say that the borrowers are subprime.

Vendor financing dominates the portfolio. As of April 2, net finance receivables, i.e., loans to customers, footed to $1.3 billion vs. $349 million for net contract receivables, i.e., loans to franchisees. And the finance operations are hardly insignificant to the bottom line. In the first quarter, Snap-on Credit chipped in 23.2% of total operating income.

It’s a point of pride in Kenosha that Snap-on survived the Great Depression, just as it did the Great Recession; in 2009, losses on Snap-on’s customer-financing activities registered a modest 3.9%. As to whether past performance is indicative of future results, only time will tell. You may count us skeptical. For one thing, Snap-on’s captive finance unit was run as a joint venture with CIT Group, Inc. until the middle of 2009. For another, there’s risk embedded in the previously cited frenetic growth of lending, far in excess of the pace in sales.
Finally, there’s risk built into the used-car market. On this score, note the virtual cessation in sales growth, as well as the complementary rise in inventory, at CarMax, Inc., the top used-vehicle dealer in the United States, in the six months to Feb. 29. Thus, CarMax closed the 2016 fiscal year with 56 days of inventory (i.e., the number of days required to clear the lots based on trailing sales) compared with a fiscal year-end average of 48 days over the past decade. It would do Snap-on no favors if a reversal in the long upsweep of used-car prices condemned more jalopies to the junkyard instead of to the auto-repair shops. Certainly, any softening in the demand for auto-repair equipment would send up warning flares at Snap-on Credit.

The Street forecasts gains in revenue of 4.1% in 2016, up from the first-quarter sales growth of 0.8% year over year (or up 2.5% excluding the impact of foreign-currency movements and acquisition-related sales). Snap-on trades at 19.3 times trailing earnings and 17.9 times the 2016 estimate. With 3.8% of the float sold short, the company is a relatively undiscovered short-sale candidate (compare to hedge-fund whipping boy CarMax, with short interest equivalent to 16.8% of the float). Over the past 12 months, insiders have sold a net 96,907 shares for proceeds of $14.9 million. We believe that we know some of the reasons why.  

On, now, to the world’s largest retailer of diamond bijoux, Signet Jewelers. No step-in sales vans for Signet; the Bermuda-based company manages 3,611 stores across numerous brands: Jared, Kay Jewelers, Piercing Pagoda and Zales, the latter acquired in 2014. It’s true that 14% of Signet stores are situated in the United Kingdom, but only 7.6% of Signet sales are derived outside of the United States and Canada. With the exception of Jared, Signet’s brands are primarily mall-based.

More than a retailer, Signet is a finance company, too. In-store credit facilitated no fewer than 61.7% of sales in the quarter ended April 30. Furthermore, that percentage has been steadily on the rise: from 52.6% in fiscal 2008 to 61.5% in fiscal 2016. So it is that growth in accounts receivable outpaces growth of cash-register receipts; in the quarter ended April 30, sales rose by 3.2%, to $1,579 million, and net accounts receivable by 12.6%, to $1,689 million (both measured year over year). In fiscal 2016, the average FICO score of Signet’s portfolio was 662, only marginally higher than the 640 threshold of subprime.

At first glance, the Signet credit portfolio would seem to be shipshape. Nonperforming loans amounted to 3.6% of gross receivables on April 30, only 10 basis points higher than a year earlier. Second glance tells a different story. “Recency” is the name of the method that Signet elects to employ in accounting for credit delinquency. A layman might call it forgiving.

An example will underscore just how forgiving Signet is of its customers and of itself. Say that you owe $1,000 on June 30, but you pay $500 instead, and that you pay it on time. Because you have made a “qualifying payment” by the due date, your account is considered current. (Under the “contractual” method of accounting, a customer is counted current only if he or she has paid in full. You can see the lack of appeal of the contractual approach.)

Thanks to Marc Cohodes, former portfolio manager of Copper River Partners and a current short-seller of Signet, for identifying an alternative path to the true condition of Signet’s credit portfolio. Just count bankruptcy filings, Cohodes suggests. Thus, in the months of January through March, 3,274 American personal bankruptcy submissions named Signet or one of its brands as a creditor. Compare the 2,663 such listings in the fourth quarter 2015 and the 1,903 in the first quarter 2015. “Signet may have other issues,” Lorenz observes. “There are 301 registered complaints against Signet on the Consumer Financial Protection Bureau’s website. It’s a number that places Signet at heightened risk of a CFPB investigation, according to Height Securities analyst Edwin Groshans, ‘primarily because two-thirds of its consumer complaints deal with debt-collection practices. Debt-collection practices have received heightened attention from the CFPB.’ Perusing the complaints, one finds borrowers alleging that Signet placed harassing calls to their workplaces, divulged their personal information and incorrectly reported debts to the credit bureaus. World Acceptance Corp. attracted a CFPB investigation with fewer than 80 complaints, as Groshans noted.”

For whatever reason, or set of reasons, Signet has just engaged Goldman Sachs to conduct a strategic review of its credit portfolio. It is concerning news, inasmuch as the finance division not only facilitates sales but also is a key contributor to company-wide operating margins. Thus, in the April 30 quarter, the credit unit generated $39.2 million in operating profit, or 18% of the grand total.

“If Signet did manage to sell its portfolio,” Lorenz muses, “would a prospective buyer pay 100 cents on the...
dollar for receivables marked on a recency accounting standard? Would that buyer extend credit to Signet customers as readily and on similar terms? How would Signet make up for the lost profits?”

Nor do inquiring bears confine their researches to Signet’s credit operations. They have poked around, too, in the company’s extended service plans. In the fiscal year ended Jan. 30, $347.8 million in revenue, or 5.3% of the whole, derived from sales booked through this channel. (Signet does not disclose the profit margin on these plans, but it appears that warranty profits may be a material portion of the $703.7 million in fiscal 2016 operating earnings.)

To comply with the terms of an extended-service agreement, a customer must typically return to Kay or Zales every six months for a kind of well-baby diamond checkup. Trawl through Facebook looking for “Zales” or “Kay,” and you’ll find allegations that Signet employees have taken the opportunity of these inspections to replace bona fide diamonds with lesser-quality stones. Some complain that Signet stores have switched diamonds with Moissanite, a man-made diamond substitute. BuzzFeed reporter Stephanie McNeal has corroborated some of these stories in April 22 and May 25 exposés. Did Signet have a comment? Not for Grant’s; our pings went unanswered.

“People can get in the business without ripping off the consumer,” Cohodes tells Lorenz. “For me, you are setting yourself up for a Lumber Liquidator’s scenario where any news show can send in hidden cameras and then the stock gets cut in half. Who is to say that ABC or 60 Minutes doesn’t walk into one of these stores with a hidden camera and gets the diamond appraised and the clerk hands it back not as the A-grade stone that the customer actually bought but as Moissanite or as a D-grade diamond instead?”

Besides which, competition is hotting up; on its May 11 earnings call, Macy’s announced plans to renew and revamp its jewelry offerings. Two weeks later, Signet laid an egg with the news that an earlier fall-off in traffic and sales had continued into May. The shares plunged by 10.5%, though the handwriting had been on the wall. Same-store sales showed just a 2.4% year-over-year rise in the quarter ended April 30. That was below the guidance delivered on March 24, for a rise in sales on the order of 3% to 4%, and down from a fourth-quarter increase of 4.9%.

After last week’s swoon, Signet trades at 14.4 times trailing earnings per share and 11.9 times the forward estimate. Of the 18 sell-side analysts on the case, 16 rate the shares “buy.” And the insiders? Over the past 12 months, they have sold 27,864 shares more than they bought for net proceeds of $3.7 million. On the evidence, they are discerning investors.

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