LETTER TO SHAREHOLDERS

Thank you for being a shareholder of Fastenal.

We operate a simple business model at Fastenal, and we limit our priorities to just four things: our customers, our employees, our suppliers, and our shareholders. The situation determines the ranking of these four priorities. In most situations, customers and employees occupy the first two spots and suppliers and shareholders fill in the last two. We believe this prioritization benefits you, our shareholder, because we are at our best when we focus on our customers and those who serve them. We also take every opportunity to thank each constituent – *thank you* for being a shareholder of Fastenal.

We approach these four priorities with a long-term perspective and a 'short-term edge.' The long-term perspective builds a more durable business, and the short-term edge maintains our sense of urgency. That said, we sincerely hope you view Fastenal as a long-term investment, not a short-term rental – this ensures our goals are aligned.

It is early January 2019 as I sit down to write this letter. Since stepping into my current role late in 2015, I've followed a similar preparation: talk to some Fastenal employees, talk to some customers, talk to some suppliers, and reach out to a few shareholders. It's also a good time to re-visit the last several letters. This step helps me avoid getting caught up in repetition and rhetoric. It also illuminates some truths about the role. First, the longer a person is in this position, the more opportunities exist to just be wrong. Second, if you are fortunate enough to surround yourself with great people, we can get through the bad days and enjoy the good, always mindful of the beauty and wisdom of humility. Humility pulls the best out of people, and it also challenges us to periodically 'step it up.' (Note to self: In my case, 'periodically' should mean daily.)

My first three letters weren't especially profound, but they did capture the spirit of the year. To set the tone for 2018, here are the first three paragraphs of last year's letter.

Excerpt from our 2017 Letter to Shareholders (dated February 2018):

Our 50th year was a good year for Fastenal, a year for our customers and employees to experience improving success, a year for our suppliers to participate in this success, and a year for our shareholders to enjoy a return on their investment.

It was also a year to remind us about the nature of Fastenal. We believe in people. We believe we can accomplish anything if everyone in the organization pursues a common goal. And we believe we can accomplish our goals faster if we unleash the vast human potential within the organization.

We have a common goal; it's Growth Through Customer Service. We also have a means to unleash our potential; it's called challenging each other, providing great training, and operating with a decentralized decision-making mindset.

Our business continued to improve in 2018.

It improved not just in the financial results, but also in the ability of our team to execute on our growth drivers, including national accounts, Onsite, vending, international, construction, and e-commerce (scan ahead to the end of the letter for a more in-depth definition). A piece of this improvement can be explained by a good economy; however, we outperformed the economy and we continued to separate ourselves in the marketplace in terms of sales growth.

This separation is noteworthy because our growth comparisons became progressively more difficult as we moved through 2018. For background perspective, our daily sales grew 6.2% in the first quarter of 2017. This growth expanded more than four percentage points, to 10.6%, in the second quarter, then expanded to 13.6% and 14.8% in the third and fourth quarters, respectively.

In the interest of full disclosure, a piece of the improvement in the second quarter of 2017 (a little over one percent of our growth) came from a March 2017 acquisition; however, the real drivers run much deeper: a willingness of our customers (new and old) to trust us with their supply chain needs; a willingness of our employees to approach their business and customers with a 'Think Big!' mindset; a willingness of our suppliers to improve and change with us; and finally, a willingness of our shareholders to believe in us. (As mentioned in last year's letter, 'Think Big!' is a challenge to everyone on the Blue Team to have a plan, to stretch ourselves, and to vet our plans with those around us: our teams, our peers, our mentors and leaders.)

These human elements – trust, collaboration, ambition – underpinned strong financial results in 2018. Here's a quarter-by-quarter breakdown of how the year played out:

First quarter: Sales grew $138.1 million, or 13.2%, operating earnings grew $22.0 million, or 10.4%, and incremental operating margins (operating earnings growth versus sales growth) were 16.0%.

Second quarter: Sales grew $146.4 million, or 13.1%, operating earnings grew $31.5 million, or 13.3%, and incremental operating margins were 21.5%.

Third quarter: Sales grew $147.0 million, or 13.0%, operating earnings grew $33.9 million, or 14.8%, and incremental operating margins were 23.1%.

Fourth quarter: Sales grew $143.2 million, or 13.2%, operating earnings grew $30.1 million, or 14.8%, and incremental operating margins were 21.0%.

Annual: Sales grew $574.6 million, or 13.1%, operating earnings grew $117.5 million, or 13.3%, and incremental operating margins were 20.5%.

By contrast, in 2017 and 2016 our annual sales grew $428.4 million

(10.8%) and $92.8 million (2.4%), respectively; our operating earnings grew $85.9 million (10.8%) and contracted $32.9 million (-4.0%), respectively; and our incremental operating margins were 20.1% in 2017 and negative in 2016.

Several things should stand out in the summary above, including some changes and trends you started to see in last year's letter.

First, after summarizing our sales growth, the discussion's focus moves from our pre-tax earnings and net earnings performance to just a discussion of our operating earnings performance. The reasons for this change are simple: (1) Over the last several years we repurchased stock and changed our debt/equity structure. This structurally altered our net interest income/expense amounts, making pre-tax earnings performance a less precise comparison aspect. (2) The United States government passed income tax reform in December 2017. Since over 85% of our earnings occur in the United States, this structurally lowered our income tax liabilities (providing a benefit of about $127 million and $24 million in 2018 and 2017, respectively). This income tax savings amplified our 13.3% and 10.8% operating earnings growth to net earnings growth of 29.9% and 15.8%, respectively, and really muddied the water for comparability. We prefer straightforward comparisons, so we just focused on the operating earnings performance comparisons.

The second item that should stand out is our incremental operating margins in the last several years. Beginning in late 2015, we began an increased investment to reinvigorate our ability to grow the business. This investment centered on three things. The first was inventory to serve our customers, particularly our construction customers (more on this in a few paragraphs). The latter two centered on people resources to support our growth drivers and our technology needs. We have big plans to expand our relationships with national account customers and within channels such as vending and Onsite. We also have plans to utilize technology to deepen our relationships with all customers. These plans require a focused support infrastructure, so we expanded our headcount between late 2015 and late 2016 to start building it.

Looking at our earnings performance in 2016, you can see this investment was painful; however, it breathed new life into Fastenal, and we realized double-digit sales and earnings growth in 2017 and 2018. Of equal importance, we achieved 20%-plus incremental operating margin gains in each of the last two years. I'm proud of our Blue Team, and hope you are too.

At Fastenal, we work to inspire greatness in each other. We challenge each other, we learn, and we change. We also work on our shortcomings every day. Even in a good year like 2018, we had a few:

We could have produced a great fourth quarter. We didn't, and our operating margin leverage barely broke 20%.

Our growth drivers are fundamentally changing the business. The success of our growth drivers naturally lowers our gross margin percentage (it's no secret that these areas of our business carry an inherently lower gross margin). But this success also leverages our existing distribution network, naturally lowering our operating expense percentage. These trends are expected. Our shortcoming lies in the amount of degradation in the gross margin percentage. We have been actively battling inflation, particularly fastener (i.e., steel) inflation. We are moving at a fast pace, but the inflation is moving even faster, and we lost 20 to 40 basis points of gross margin in 2018 as a result. I believe we can recapture this, but only time and execution will determine if that belief can be made into a reality. In our February 2017 Letter to Shareholders, we indicated a plan to better manage expenses. This is where the Blue Team has really stepped up, enabling us to overcome our gross margin weakness through better expense management. Our strong operating earnings performance is the result.

Our business generates great cash flow, but like all distribution businesses, it weakens a bit with strong sales growth. We accept this trade-off as a good problem to have. The weakening has been more pronounced than normal because the source of our strong growth leans toward large national account customers, particularly in international markets. Unfortunately, these typically aren't our fastest-paying customers. Some of the weakness is an outcome of our national account success, but some is within our control. We need to alter this trend in 2019.

Inventory growth is a different matter. Several years ago, we made a decision to increase our inventory breadth and depth, particularly at the branch level. This required a sizable investment, but we have seen a great improvement in sales performance, particularly with construction customers, re-establishing Fastenal as a construction supplier. We also invested in inventory to support our strong growth with national account customers, particularly Onsite and international locations. As president, I have been willing to accept high single-digit inventory growth to support double-digit sales growth with our growth drivers. We are generating attractive returns with this investment.

That said, in 2018 we didn't grow our inventory in the high single digits; we grew it about 17%. Several factors changed the math in the latter half of the year. The inflation mentioned earlier added to our inventory, as did the extra layer of import tariffs that began building in September with the implementation of the Section 301/List 3 tariffs. A related factor was a decision we made to accelerate some container shipments in the fourth quarter in light of additional pending tariffs. Please note, we decided not to accelerate our purchasing patterns, as the situation was just too fluid; however, we did instruct our suppliers to ship everything they had produced to beat the January 1st proposed tariff increase. These three items added about 4% to our inventory growth. Absent this, we added about 13%, and as mentioned earlier, we really should have added less than 10%.

These shortcomings are on me, and in no way should they overshadow the real Fastenal story of 2018: great execution by a great team. That said, we will work hard to improve in these areas in the year ahead.

We are wired for Growth Through Customer Service.

In 2018, we achieved sales and operating earnings of about \$5 billion and \$1 billion, respectively. Our internal discussions are focused on preparing Fastenal's Blue Team to become the \$10-billion organization we see in our future. This future requires a plan and an organizational willingness to change. We continually ask ourselves: What capabilities must our organization develop to serve our customers? What skill sets must our employees possess to serve our customers and each other within the Blue Team? What capabilities must our suppliers bring to be part of our customers' supply chains? What financial performance must we produce to attract long-term investors to Fastenal?

An example on the employee front involves developing leaders. Frankly, our organization has been good at this for the last 50 years. Our willingness to trust and challenge each other, our request of each person to be willing to learn and change – these aspects of the Fastenal DNA produce great leaders. However, like everything organic, sometimes we need to till the soil. Beginning in 2019, our Fastenal School of Business has a new course inspired by our leaders throughout the organization. The technical name is LDR450: Leadership Enhancement Program. It includes some self and peer assessments, but it really explores individual leadership stories, leadership competencies, methods to understand mindsets, and the ability to understand influence style and emotional intelligence. Given the willingness of the Blue Team to learn and change, we think it will give us the ability to develop great leaders even faster.

The list of questions continues: How should we best convey our business to all four constituencies? What new partners should we consider to improve our customer service capabilities, our employee skills, our supplier relationships, and ultimately our shareholder value? An example on the partner front is a relatively small investment we made in July 2018 with a technology firm based in the United Kingdom. They specialize in mobility (not one of our strengths), and we believe they share a similar set of priorities and culture with Fastenal. We look forward to the potential of other similar opportunities in the future.

Thank you for the patience you demonstrate with our long-term perspective (combined with a short-term edge). Our belief in people can make for a less controlled and sometimes bumpy ride, but we believe the trip is well worth it. Thank you again for being a shareholder of Fastenal.

Dan

DANIEL L. FLORNESS
President and Chief Executive Officer

Understanding Our **Growth Drivers**

Vending solution for Sellen Construction (Seattle, Washington)

There's a term used repeatedly in this letter and in our other conversations; the term is *growth driver*. For a bit of perspective, here is how we think of this concept. Historically, our primary growth driver was opening new branch locations. This expanded our reach, and we added people into these new locations and into existing locations as they grew. We also added people behind the scenes to provide deeper support. Beginning in the late 1990s, the rate of openings began to slow. By 2007, we had an established footprint in the United States and in Canada; therefore, we slowed our openings further. The pattern further decelerated to the point where we had minimal net openings in 2009, and we began to contract the network in the 2011 time frame. This maturation of our branch network gave us an opportunity to develop and fund new *growth drivers* (plural), adding new dimensions to our service.

Today, these growth drivers include an expanded **national accounts** team (focused on larger customers with operations around the planet), our **Onsite** service model (customer-specific locations, preferably inside the customer's facility, or at least very nearby), **vending** (point-of-use dispensing, storage, delivery, and reporting technology within the customer's facility and at our Fastenal facilities), **international** expansion (like branch openings of the past, a means to extend our reach of resources closer to the customer), **construction** (we are a great multi-location source for these transient customers, and we're making strides to serve them better), and **e-commerce** (making it easier for customers to source products and gain visibility into their supply chain, while introducing productivity gains for both the customer and for Fastenal in the process). We're excited about the evolution of our growth strategy and will continually evaluate new ideas and directions to best serve our customers in a fast-changing world.