LETTER TO **SHAREHOLDERS AND EMPLOYEES**

Thank you for taking a few minutes to read this letter. We had an interesting year in 2019, and I'm excited to share our story.

We principally sell into the industrial marketplace, and the trend in our 2019 results felt a bit like 2015 (the last time we saw a sustained contraction in this end market). Here is a quick comparison of our growth in net sales and in operating income for both periods.

	2019	2015
Q1 Net Sales	**10.4%**	**8.8%**
Q1 Operating Income	11.4%	13.9%
Q2 Net Sales	**7.9%**	**5.0%**
Q2 Operating Income	2.2%	9.2%
Q3 Net Sales	**7.8%**	**1.5%**
Q3 Operating Income	7.4%	3.4%
Q4 Net Sales	**3.7%**	**-0.4%**
Q4 Operating Income	2.4%	-5.2%
Annual Net Sales	**7.4%**	**3.6%**
Annual Operating Income	5.8%	5.2%

Not surprisingly, the pattern above matches the trend our customers experienced. This was reflected in the Purchasing Managers Index (PMI),[1] a well-known manufacturing industry benchmark. Here is the index for the first and last quarters of the same years.

	2019	2015
Q1 PMI (average)	55.4	52.6
Q4 PMI (average)	47.9	49.0

For those of you unfamiliar with this index, any number above 50 indicates an expanding industrial economy, while any number below 50 indicates a contraction.

A second view of our end markets is our selling activity with our 'Top 100' customers. We have a deeply established business relationship with each of the companies in this group. Therefore, the principal driver of changes in the growth pattern is usually more about trends in their underlying business activity, and less about changes in our relative market share with them. They also have a very meaningful sway on our results; their activities have historically represented about 25% of our net sales.

If we look at our Top 100 customers, here are the percentages that grew their business with us in the first and last quarters of 2019 and 2015.

	2019	2015
Q1 'Top 100' growing	81.0%	72.0%
Q4 'Top 100' growing	57.0%	49.0%

In the interest of providing a contextual explanation (similar to the 'above/below 50' metric for the PMI), history has shown we have good market conditions if >75% of our Top 100 customers are growing. We would change this to 'very good' if it's >80%.

A couple of things stand out in the comparison. From a net sales growth perspective, 2019 started a bit stronger. The PMI in the first quarter of 2019 was 55.4 versus 52.6 in 2015, which certainly helped; however, I feel the real difference was the success we enjoyed establishing our Onsite model over the last several years. (We'll take a deeper dive into our Onsite model later in the letter.) From the same net sales growth perspective, 2019 also ended a bit stronger than 2015; and notably, it did so even as the PMI dipped a bit lower (47.9 in Q4 2019 vs. 49.0 in Q4 2015). What explains this relatively better performance? I believe our strong Onsite progression has added an element of resiliency to our business. Another factor is our national accounts sales team. This team has always been talented, but today they are more than that; they are incredibly talented and they are laser-focused. I'm not sure if the Onsite model pushed national accounts to improve, or if national accounts pushed our Onsite capabilities to improve. It's the old 'chicken or egg' conundrum, and since I'm more of a bacon person, I'm not going to give it much more thought.

The net sales growth comparison highlights some favorable trends in 2019. Here are a couple of less favorable items:

(1) Our performance, measured by operating income growth, really stunk up the place in Q2 2019 (no excuses, we were caught by a slowing economy, squeezed by tariffs, and challenged to quickly react to many moving pieces). Fortunately, we stepped it up and reacted well in Q3; this shines through in our Q3 operating income growth relative to net sales growth comparison. (In the interest of full disclosure, we had an extra business day in Q3, which also helped.)

(2) As mentioned, our success with Onsite location growth helps our sales grow, but the expansion of operating locations does lessen our ability to manage operating expenses in the short term. This aspect hurts short-term operating income growth in a weakening marketplace. In many respects, it feels a bit like the old days when we were opening a lot of new branch locations.

This is the start of year five for me in this role. It continues to be a learning experience every day. This is good – I believe we all should learn something every day. Someone recently asked me what makes Fastenal special, and also how Fastenal manages to grow faster than others. The answer to the first question is simple – we have great people, and a high percentage of these people *are leaders*, regardless of their role. We also operate with a decentralized decision-making process, which allows us to move faster. The key is challenging everyone to pursue the same goal. I believe the answer to the second question is our established North American footprint.

(1) The Purchasing Managers Index (PMI) is compiled monthly by the Institute for Supply Management (ISM). It is based on a survey and is intended to reflect the business outlook of purchasing managers at U.S. manufacturing firms.

There is no other industrial distributor with the same touchpoint density across the continent. This allows us to engage with and service our customers in a fundamentally different way.

We have always talked about *Growth Through Customer Service.* This mindset has allowed us to grow organically for 50-plus years as we established our North American footprint. It has also allowed us to expand rapidly outside North America over the last 20 years. Our supply chain capabilities and our local presence (branch and Onsite) strengthen every day. With this, we believe our brand is evolving. Our branding goal is simple: We want each customer to think of Fastenal as their best global supply chain partner. This brand is important for all customers, not just multinational companies. An efficient local supply chain solution benefits every business, regardless of size or location count.

'Global' refers to our geographic presence, but also to the scope of solutions we can provide to meet wide-ranging customer needs. For a small local fabrication shop, their priority might be fast e-commerce fulfillment and a basic bin stock program, while a large manufacturing facility across town might benefit from an industrial vending solution, high-level specialist support, or even a dedicated Onsite location. With this in mind, we've developed a market strategy to educate our sales force about the best ways to approach and service different customer segments – from an efficient 'self-serve' e-commerce model for small customers, to our full suite of solutions, services, and specialists for larger operations. The goal: give our branch teams a framework to create a plan for every customer, ensuring great service while optimizing energy and resources within the branch.

Onsite solution for UMC (University Mechanical Contractors) in Mukilteo, Washington.

No matter what approach we ultimately take, we strive to change the customer mindset. Don't just think of our products as an expense in your business. Think of the *total cost* and the *total value.* Think of how your employees use the product – is it the best product for the application? Is there a more efficient way to bring that product to the point of use? Don't just have a fulfillment partner; have a supply chain partner. When we engage with each other, when we truly form a supply chain partnership, we will wear you out with ideas. We will help your business succeed.

Speaking of supply chain partnerships, let's take the deeper dive into our Onsite model promised earlier – specifically, an explanation of how Onsite impacts our results. We ended 2014 with about 200 Onsite locations, and we ended 2019 with just over 1,100. In 2015, our Onsite business represented about 15% of our net sales; in 2019, it was 30%. These percentages include not only our traditional Onsite locations, but also a small group of strategic selling locations that we view as Onsite incubators and represent approximately 4% of net sales in each period. This rapid expansion, this success, helps us to grow faster; however, it also comes at a price, at least in terms of the optics of our results.

Let's start with faster growth. Our motto is *Growth Through Customer Service.* I don't believe there is a higher service model in our industry than Onsite; however, you need a certain level of site-specific business activity to make the model economical. Fortunately for us, our break-even point is lower than our competitors'. Credit that to a great 'Blue Team' spread across an unmatched branch and distribution network, a great product supply chain, a great technology team with fast-growing capabilities for innovation, an efficient administrative support model – and, underlying it all, a frugal culture that has always allowed us to do more with less for our customers. (For those of you focused on 'greener operations,' we completely agree; we believe frugality and green go hand-in-hand.)

This frugal culture, and our ability to operate efficiently together, has been made easier by our historical ability to grow organically. Organic growers don't operate with a multitude of computer systems and conflicting business cultures. We all grew up on the same Blue Team, we ride the same blue bus, and we look at the customer through the same service-focused blue lens.

Next, let's discuss the optics of our results. The Onsite model differs financially from our branch-based model. First, it carries a lower gross profit margin profile. Fortunately, it also has a lower operating expense profile. Second, the operating margins are a bit lower than we see in our branch network. Fortunately, the operating margins are still industry-leading, and we believe the assets to support the model will also be lower. So it really becomes a discussion of return on investment – we like that discussion. Finally, from an individual site perspective, Onsites are ultimately limited by the activities of the individual customer location. The truth is, any business (regardless of the service model) is limited by the customer site constraint. And on the plus side, Onsite changes the competitive dynamics: It allows us to displace a wider range of suppliers, and we believe it builds a more defensible and wider moat.

There are a few more considerations related to our rapid Onsite location expansion. First, to accomplish this rapid expansion, we needed to expand our site implementations team, to expand our sourcing team, and to adjust our technology focus to support a different business model. Second, with the addition of so many new locations, our average revenue per Onsite contracted from $146,000 per month (on a per-location basis) in 2015 to $107,000 per month in 2019. This puts a drag on our profitability, on our returns, and ultimately on our ability to produce an ever-stronger cash flow.

For those of you with a longer Fastenal time horizon, think of this as a short-term 'Pathway to Profit' in reverse. We believe our rate of change will stabilize late in 2020/early in 2021. This will allow our revenue per Onsite location to stabilize and then begin to expand. It will also stabilize our 'branch economic drag.' Every time we pull a customer out of a branch and move Onsite (whether we are in their facility or nearby), we temporarily lessen the financial performance of the original branch. The trade-off: We ignite the customer relationship, unlock selling energy in the branch, and grow the market faster overall. As you can appreciate, we like the trade-off.

To learn more about Onsite and the rest of our growth drivers, please read the sidebar to the right (also featured in last year's letter).

Leadership is critical to our success at Fastenal, and I don't mean leadership in terms of a person, but rather in terms of a mindset. Every person can be a leader through their actions. If you look inside the back cover of this annual report, you will see two groups of people. The first set of photos is our board of directors. This group represents you every day. They take their governance seriously, but equally important, they challenge the Blue Team with their varying perspectives on the world, on business, and on people.

The second set of photos is our leadership team. Unfortunately, there isn't enough space to show the entire group. We have just under 22,000 employees at Fastenal. Everyone exercises daily leadership. They demonstrate this through problem-solving and by embodying our cultural values: Ambition, Innovation, Integrity, and Teamwork.

A person you won't see on the back cover, but whose influence is always present, is our founder, Bob Kierlin. Since Fastenal's founding in 1967, Bob has always demonstrated the wisdom of humble leadership – a willingness to trust others to make great decisions, along with the courage to challenge everyone to pursue a common goal. Our commitment to challenge one another (and ourselves) can cause some constructive friction, but we've found it creates an atmosphere that attracts and retains talent. This ability to retain talent is showcased every December when we celebrate our latest class of 25-year employees. Our 2019 class consisted of 60 employees, an impressive number given the size of our organization when they joined us back in 1994. We're proud (and fortunate) they chose to spend their careers with Fastenal.

Perhaps you noticed the change to the name of this year's letter. The inclusion of 'employees' in the name is a reflection of how we have operated for 52 years and the comments we made in last year's letter regarding our four priorities: our customers, our employees, our suppliers, and our shareholders.

Thank you for your belief in our Blue Team. And thank you for being a shareholder and/or an employee of Fastenal.

Dan

DANIEL L. FLORNESS
President and Chief Executive Officer

Understanding Our GROWTH DRIVERS

Onsite solution for the School Board of Sarasota County, Sarasota, Florida.

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.