

# 2004

## *President's Letter to Shareholders*

Helped by a growing national economy, Fastenal had a very good year in 2004. Our 2004 net sales of \$1.238 billion represented a 24.5% increase over the 2003 level. Our net earnings of \$131 million represented a 55.7% increase over the 2003 level. Earnings per share increased from \$1.11 in 2003 to \$1.72 in 2004. This is the highest level of earnings growth we have produced since 1994 and the second best year since we went public in 1987.

The earnings growth was helped by the stronger sales growth but is more attributable to the efficiencies we are experiencing from our store upgrade project. We refer to the store upgrade project as the Customer Service Project, or CSP. Since the beginning of the CSP in May 2002, the sales per store employee has grown by more than 30%. This improvement has allowed us to improve our compensation structure, while also lowering our overall labor costs relative to the size of the Company.

In 2004, we experienced the most significant inflation in product cost that we have seen in many years. This inflation was caused by the steel shortage from China. A large portion of our fastener product line we sell is imported from Asia. In these product areas we saw price increases during the year ranging from 5 to 40%. Approximately 40% of our fasteners are imported. Our product buyers worked hard to stay ahead of the increases to minimize the impact on our customers. The store personnel also had to work hard explaining this increase to the customers and had to raise prices. Although it is never easy to raise prices, it was made somewhat easier because of all the media coverage the steel shortage received.

Our sales growth in 2004 was driven by many factors. One of the most important is our new store openings. In 2004 we opened 219 stores compared to our previous record of 151 stores opened in 2003, an increase in store openings of 45%. We opened 127 stores in the first half of the year and 92 in the second half. Opening the stores earlier in the year helped to contribute to our improved sales growth in the second half of the year. This milestone was made possible by the strong leadership of our regional managers. They challenged their district managers to open

as many stores as possible in the first half of the year and they worked to find better locations and better buildings. During my travels throughout the year, I found that most of them fit the criteria. We believe this effort has helped, and will continue to help, our business grow faster.

The Customer Service Project was Fastenal's biggest focus in 2004 as it was in 2003 and the last half of 2002. To date, we have converted approximately 90% of our stores to this new open format. In 2005, we will complete the initial roll out of the project and continue to upgrade existing CSP stores. Our merchandising people have been very aggressive in improving the layout and merchandising of our stores. We are currently on the fourth version of CSP.

During 2004, we re-set more than 200 existing CSP stores. These were stores converted to the CSP format early in the project. The results show that the new format is far more efficient. A key ingredient is prepackaged product, which allows customers to serve themselves. We have also been able to negotiate better prices with our suppliers by committing to stock their product in all of our stores. This has allowed us to improve the gross profit margins in the CSP stores.

Because of the success of the CSP project, we developed a product test program to identify other products that should: 1) sell well in the new store format, and 2) produce above average returns on the inventory investment. In December 2003, we began this test program at 100 stores. Our marketing department selected the 100 locations to get a good cross section of stores with different age, size, and geographic characteristics. The product development managers each identified what they believed were good candidate products; next, they presented their suggestions to a small group of senior managers (I also participated). As a group, we decided which products should be tested. For the first test, we decided on 44 product groups which represented approximately \$20,000 in additional inventory per store. Each product was monitored on a monthly basis and by November we were prepared to make stocking decisions. Of the 44 product groups tested, 11 were dropped and 17 were left in the test for one more year to get more information.

The remaining 16 product groups are being added as standard stock in the CSP stores.

The product development managers have selected a second group of products that will be tested using the same process and same test stores in 2005.

The inventory investment for CSP continues to be high. Our inventory grew 32% in 2004. This is one area we did not do as well as we had planned in 2004. One factor we had not fully anticipated was the impact inflation would have on our ending inventory. This was caused by replacing our existing import fastener inventory with new inventory at a higher cost. We also made a decision to buy import fasteners more heavily in an effort to reduce the fill-in buys caused by stock outs. This decision increased our inventory of fasteners but also contributed to our higher gross margins. I still believe it was a good decision. The rest of the growth had been planned for new stores and CSP conversions.

Sourcing products continues to be a major focus for our Company. Our Asian trading company (FASTCO) is growing very rapidly. The FASTCO team has identified several new suppliers for products we are currently sourcing through other trading companies. We have experienced significant savings, and in many cases improved quality. Our purchasing volume through this company grew 54% from 2003 to 2004. We currently have 28 employees in Asia.

On the sales front, all of our sales personnel did a great job. The government sales team, however, should get the MVP award this year. Because of their hard work and persistence, Fastenal was awarded a five year \$89 million contract to supply the United States Air Force with maintenance and shop supplies. I was very excited when we received the contract, but once I visited Hill Air Force Base and was able to see the enthusiasm from both our people and the people working at the base, I was not only excited but also very proud of our people and what they had accomplished. Our sales to the government grew by 74% in 2004 and contributed \$47 million to our total sales.

Our national construction team also saw strong growth in 2004. They signed 24 new supply contracts and contributed approximately \$19.8 million to our total sales, nearly doubling their sales over 2003. Our national accounts team, which concentrates on the large industrial accounts, signed 60 new agreements and contributed \$270 million to our total sales. This represents 22% of our 2004 sales. Our national accounts team continues to identify market opportunities that creates opportunities for our local stores.

Fastenal's manufacturing division also had a very good year in 2004. They continue to meet the needs of our customers and produce the special parts that many of our competitors would walk away from. They produce parts in hundreds of different material types and thousands of different shapes. Almost every day they receive orders from customers who need the part before it was ordered, and in most cases they produce and ship the part the same day so that the customer can get their plant or construction site back on track. We currently have 219 highly trained and dedicated people working four shifts to meet customer needs.

Distribution continues to be an important part of our business model. We have a strong commitment to giving our customer the best service possible. Without great distribution, meeting that commitment is not possible. Our distribution and transportation managers are using the latest technology to improve the movement of product from our suppliers to the customer. Over 50% of our product is processed steel. This creates a challenge of high shipping costs relative to the selling price. Our distribution model is efficient and provides us with a competitive advantage.

Having great technology is critical to our success. Without well designed systems it is impossible to provide our customers with the high level of service they need and expect. Our information systems people continued to work on improving all of our systems in 2004, with the main focus being the store system. They began the process of migrating to a new version of the windows operating system which has proven to be faster and more reliable. They have also

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developed and tested dozens of enhancements that we felt were necessary to meet the needs of our customers along with working on a new warehouse management system that we expect to begin testing in 2005.

I have written about many areas of our Company and all of the great things we are doing, but none of this would be possible without dedicated and well trained people. The Fastenal School of Business (FSB) had another record year in 2004. The FSB Team trained more than 2,400 people in 16 different programs. The programs they offer range in time from 2 days to 5 weeks with most courses being one to two weeks. The biggest program introduced in 2004 was a 3 week program for new district managers. I have received great reviews from the people who participated in this program. Three weeks is a big commitment from the employee, but everyone who I have spoken with has said it was well worth it. We added 10 people to our FSB staff in 2004, ending the year with 28 people.

For us to continue growing, it is important that we maintain a strong balance sheet. The inventory buildup and the increased dividend payment did not allow us to grow our cash position in 2004. We believe our strong focus on both accounts receivable and inventory will allow us to both support our dividend payments, and be a net producer of cash in 2005.

In December 2004, we had a national product show in Orlando, Florida. This is the fourth year we have had this show. The first three years were held in Clearwater, Florida. However, our growth and the increases in the number of suppliers that wanted to attend the show forced us to move to a larger facility. We alternate each year bringing the store managers one year and the assistant managers the next. This year the assistant managers attended, and over 1,700 employees made the trip. The show is designed to give our suppliers a chance to present their products to our people without the normal day-to-day distractions. The show gives me the opportunity to personally meet with hundreds of employees over a three-day period, some I have known for many years and others I have never met before. I learn a lot about what is going on in the Company and gather ideas on things we

could be or should be working on. It also reinforces to me, and I think all attendees, the power of Fastenal people and their ability to excel in an organization that values entrepreneurship. The suppliers who attend the show continue to tell me how professional,

energetic, and enthusiastic our people are. The question I am always asked is, "where do you find all of these people"? I always tell them that it is the employees in the field who do the recruiting, and it is much easier to recruit talent when you believe in your Company. So I believe if we continue to create a work environment where people can make decisions and create opportunities for themselves, they will continue to find the high quality people we need to grow our business.

In closing, I want to thank all of our shareholders for your continued support. I commit to continue leading the employees of Fastenal to achieve our common goal of "growth through customer service" and will always keep in mind Fastenal's core values of ambition, innovation, integrity, and teamwork.

Thank you,



Willard D. Oberton  
CEO and President