FINAL TRANSCRIPT

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SNA - Q2 2009 Snap-on Incorporated Earnings Conference Call

Event Date/Time: Jul. 31. 2009 / 2:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Marty Ellen
Snap-on Incorporated - CFO

Nick Pinchuk
Snap-on Incorporated - Pres., CEO

CONFERENCE CALL PARTICIPANTS

Jim Lucas
Janney Montgomery Scott - Analyst

Keith Schicker
Robert W. Baird & Company, Inc. - Analyst

Ben Kotter
South Point Capital - Analyst

PRESENTATION

Operator

Welcome to the Snap-on Incorporated 2009 second quarter conference call. At this time all participants are in a listen-only mode. (Operator Instructions). Today's call is being recorded. I would like to introduce you to Marty Ellen, Chief Financial Officer. Begin your conversation.

Marty Ellen - *Snap-on Incorporated - CFO*

Thank you. Good morning, everyone. Thank you for joining us to review Snap-on's second quarter 2009 results. By now you should have seen our press release issued this morning. Joining me today is Nick Pinchuk, Snap-on's CEO. Nick will kick off our call this morning with his perspective on our performance. I will then provide a more detailed review of our results, afterwards we will take your questions. Consistent with past practice, we will use slides to help illustrate our discussion. You can find a copy of the slides on our website next to the audio icon for this call. These slides will be archived on our website along were a transcript of today's call.

Any statements made during this call relative to management's expectations, estimates or beliefs or otherwise state management's or the Company's outlook, plans or projections are forward-looking statements and actual results may differ materially from those made in such statements. Additional information and the factors that could cause our results to differ materially from those in the forward-looking statements are contained in our SEC filings. This call is copyrighted material by Snap-on Incorporated. It is intended solely for the purpose of this audience, therefore they cannot be recorded, transcribed or rebroadcast by any means without Snap-on's express permission.

With that said I will now turn the call over to Nick. Nick?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Thank you, Marty. Good morning, everyone. Well, the challenges continue, but at the same time the evidence of further improvement of how far we have progressed also continued to be evident. Sales were down 23%, 16% if you exclude the impact of the currency and I think it is fair to say that the global economy is creating some strong headwinds. Having said that, we are encouraged by the overall results in a face of difficulty. In a period where volumes were quite weak, we managed to reach an operating margin before restructuring of 12.8%, double digit margins in a difficult environment and profit improvement of 160 basis points from the first quarter on essentially flat sales. Solid testimony that our operations are continuing with their trend of improvement and that our business models are strong and that RCI and our other value creating processes are indeed working.

As part of that progress, our emphasis on managing working capital, especially inventory levels, resulted in strong operating cash flow. Cash flow for the quarter exceeded $155 million. There are of course, some very real costs, underutilized manufacturing capacity. They resulted from reducing inventory levels and creating that cash. But we are showing the discipline to bear those near term costs in exchange for the long-term benefits of inventory reduction.

While we don't have perfect insight into the future we do remember confident, confident that our going forward -- that the going-forward prospects for our businesses remain strong. We see considerable runway in a number of directions. As we said before, we are acting aggressively to limit the damage associated with the downturn. Rapid continuous improvement, restructuring, focus on sourcing costs, are all being engaged and the benefits I think are evidenced in the results. But at the same time, we continue to invest in those areas we believe will be decisive going forward, creating advantages that positions Snap-on to emerge from the current difficulties with an even stronger competitive position.

In that regard, in that area we have identified four key areas of focus. Maintaining the health of our franchisee network, expanding the reach outside of the garage, rolling the powerful Snap-on brand out of the garage into other mission critical arenas and capitalizing on the opportunities that are in emerging. markets. And along those lines, we clearly are attending to the welfare of our franchisees. There is a special franchise stimulus package, promotions and advertising to help them better reach their technician customers. There are van expense reduction programs in areas such as communications, telecommunications, shipping, tires and office supplies. Little improvements. Those little improvements add up to substantial savings for our van drivers. And we have been raising the profile of our event marketing, helping our franchisees tie their selling efforts to special programs. A good example of that is a the Snap-on No Compromise tour, it is a moving product display including some specialty items like our Glow Mad 57 Chevy. It is now played to enthusiastic receptions around the country in 80 different locations, been visited by 200,000 customers and has created a nice sales boost for our franchisees. We spent quite some energy on these areas, all supporting the network and it has paid off. Franchisee sales and franchisee equity both have risen in recent months and that's a trend we're working hard to continue.

The auto repair garage itself is another area of strategic performance for us and in the quarter we made progress with some big wins for our Verus handheld diagnostic system. Verus is the most powerful diagnostic tool on the market today and it's penetration expanded throughout the second quarter. We have also spoken often about rolling the Snap-on brand out of the garage into some of the world's mission critical industries like aviation and aerospace and power generation. That effort continued at the June Paris Air show, where we previewed what we think is a groundbreaking unit, our level 5 automated tool control system. That unit offers unparalleled features and benefits and we expect it will advance the Snap-on penetration of several mission critical industries.

Finally as we have spoken of often on these calls we are also continuing to invest in emerging markets. The construction of our new plants in Belarus and China are progressing on time. We are adding new products to those regions. A great example is our just introduced CT 561 pocket impact wrench, Snap-on brand, designed in the US, manufactured in Kunshan, great power to weight ratio. We are confident it is going to gain share on multiple continents.

During the quarter we did spend $8 million on restructuring. As part of that, we acted on the consolidation of mid-sized operations in both Europe and North America and executed a number of targeted downsizing actions across the corporation. Those restructuring actions have resulted in consolidation but without loss of manufacturing capability. Now, consistent with the conviction that our markets will recover and our competitive position to take advantage of that comeback is strengthening, we have chosen not to reduce long-term capacity. Of course, there is some capacity carrying penalty associated with that strategic choice. We did, however, bear that weight in the second quarter and still achieved sequential improvement.

Now I'll landscape the performance at our individual operating groups. The cost of maintaining capacity and managing inventory levels are clearly evident in the results of the commercial industrial segment. Actually, the challenges to those operations that we faced three months ago, they intensified. The broad based recession deepened, particularly in Europe, and I think we should remember that the businesses included in CNI operate in the markets that are being exceptionally hard hit by the recession. Big ticket items like garage equipment. The industrial sector which had held up for us fairly well and then declined in the second quarter. And Europe where the GDPs are down and distributors are destocking. Overall the segment saw sales and profit declines compared with both 2008 and with the first quarter of the year.

Our European based tool business, SN&A Europe accounted for much of that decline. While the sales for that business increased -- decreased almost 25% for the last year, excluding currency, the earnings of the business were uniquely hit on a number of fronts. First, over $4 million of our restructuring was incurred at S&A Europe. I believe that was probably appropriate for a business so challenged. Second, S&A Europe sells primarily through distributors and we continue to see those channel partners destock. On the last call we said that logically destocking had to end at some time but we haven't seen it yet abate. And that phenomenon accounts for about half of S&A Europe's sales decline. Also in the face of declining sales and in the interest of inventory control and cash management, production in S&A Europe was scaled back even more than the decrease in customer demand. In fact, an analysis of cash flows for the quarter shows the Company generated cash over $55 million as a result of inventory reductions, a majority of that was at the CNI segment and S&A Europe was a significant contributor. Therefore, I think you can say substantial costs of inventory reduction and maintaining capacity were born by our operation S&A Europe and that burden reflected not only the markets they serve but also the decision to reduce production levels even further than the decline in demand.

As befits the environment there, actions are being taken to lower break even and limit the damage in Europe. A significant portion of the second quarter restructuring was aimed at S&A Europe and a major share of our second half restructuring will be focused on that business as well. We are confident we are taking the right actions to recover. We are, however, moving into the third quarter where European business is slowed by vacation so the S&A -- the recovery at S&A Europe will not be immediate.

Speaking of the other CNI operations, sales in our equipment division was down -- were down 20% excluding currency and while it is still a very tough market, we were encouraged that the year over year declines in North America were less than we saw in the first quarter. Some improvement. Consistent with Europe in general, however, we did not see the same improving trend in Europe, although things seem to have stabilized for equipment in that arena. During the quarter at the auto promote tech show in [Belonya], we did strengthen our position in the strategically important vehicle repair segment with the launch of the world's most advanced tire changer, the [QUADRIGA]. It incorporates advanced sensors, motion control elements that ensure the changer will do no harm to the more sophisticated and expensive tires and rims. So even in this market we continue to launch new and innovative products, utilizing advanced technology and we believe based on innovation like the [QUADRIGA] Snap-on is capturing share as a result.

As I said earlier, the industrial business also felt the impact of the economic environment in the second quarter. Year over year sales declined 30%. Some of that was due simply to delivery timing, but we did see a general softening. We do believe, however, that Snap-on has a unique opportunity to gain share during the down turn. For example, in this era of cost control, mission critical industries like aerospace and power are focusing heavily on improving their operational efficiencies and with our strength in providing productivity enhancing solutions, we are in a good position to gain as customers explore new products, processes and embrace innovation. As part of the driver for new industries we recently launched a new tech -- a torque certification program designed specifically for the growing global wind industry. Programs like that and other certification programs and partnerships with technical and vocation schools are creating effective runway for Snap-on. They're gaining a foothold with mission critical users as they learn their trade and we are confident that the certification effort will translate into even more share gain, as the student techs enter the workforce.

Moving on at Snap-on tools, we saw some positive trends in the van segment. Constant currency sales were down 7.5% from last year but up over 4% from the first quarter. Sales in the US were down 8.5% from last year. We did see an encouraging sign with big ticket, diagnostics and tool storage being a bit stronger. I'd say, though, that it remains to be seen if the good news will hold, but it is encouraging to see the positive trend, even if it is only for a quarter. Now the US van count remained essentially flat from last quarter but we continue to work hard against the challenges of this uncertain economic environment to move that van count forward.

Speaking for a moment about macro-economics, it is worth noting that auto repair spending in the US continued to show shrink as cars age in the face of significant reductions in new car sales. What that says is the auto repair industry is robust and its future is positive and when the current uncertainty wears off, we are quite confident that our franchisee network will be healthy and in a strong position to take full advantage.

Finally, for the tools group, I had the opportunity to spend last weekend with more than 2,000 of our franchisees at their annual conference. They were enthusiastically taking part of the training and the support initiatives. We make them available at the meeting to help them run their business. I have to say, they were almost unanimously positive about the business outlook. It was quite a counterpart to the everyday bad news that seems to surround us constantly and there was tangible testimony to their positive attitude. This is not just a training event, it is also a tool show where franchisees make fairly significant purchases and this year sales orders set a record, beating the old mark by significant margins. Of course, one show won't deliver us from difficulty, but it is some cause for encouragement.

In the diagnostics and information group, sales were down 12.5% from last year on a constant currency basis. Our OEM facilitation business continues to be impacted by the reluctance of OEM dealerships to make large investments in big ticket items. Sales for the segment however were up about 2% from the last quarter. DNI was helped by the UK launch of Verus. As I said before, that product is loaded with features including over one million trouble shooter time saving tips and the ability to access the web. The Verus is proving to us again that innovation and productivity enhancing products sell even in these poor economic times. As I mentioned last quarter, Snap-on has limited direct business with automotive OEMs. Overall our business is generally tied more to industry repair volume and the fundamentals in that section remain strong. Having said that, selected franchisees may see some difficulty until root adjustments can be made to accommodate dealership closers. In aggregate though, we expect the repair hours from terminated dealerships to move either to another dealership or to an independent garage. To the extent it moves to independent, it favors Snap-on. Independent mechanics buy more tools and equipment per capita than those in dealerships. So if independent share of repair keeps growing as it has recently, it is a positive for Snap-on.

The current turmoil in the automotive business does create challenges for us. Specifically in our Snap-on business solutions and equipment solutions areas. These are the businesses that engage directly with the OEMs in the dealerships. Each of those divisions however, actively engaged in mining and capturing opportunities in international markets in adjacent industries like heavy trucks. Those opportunities are providing and will provide some offset to potential disruption associated with that dealer consolidation in the United States.

Now in a moment Marty will speak about the financials and other details related to the recent events surrounding our termination of the financing joint venture with CIT. What I'll do is just remind you that CIT's role in the venture was primarily as a bank to fund the operations. We believe we have adequate liquidity and availability of funds to fill that void. Most importantly we are confident that the transition will be seemless to our franchisees and to our other customers. We expect there will be no negative effects on sales within the van channel or anywhere else.

Finally, no Snap-on discussion would be complete without touching on Snap-on value creation. The suite of processes that drive our success focus on safety, quality, customer connection, RCI and innovation. The value of our RCI I think is written across Snap-on's results in the second quarter and for many previous quarters. I'll only say that our energy dedicated to that process remains substantial and the apparent opportunities for gain continue to be abundant. Regarding innovation, you've heard about our effort in formalizing our product development processes and our actions to enable those processes with a significant new facility Innovation Works in Kenosha. Just in this quarter, we have evidence that it is working in products like the [QUADRIGA], the world's most advanced tire changer, the CT 561 our unique pocket impact wrench and level 5 automated control tool system. But also, I spoke of the enthusiasm at our franchisee conference. One of the primary reasons for that excitement was that Snap-on introduced over 60 new products at that event, more than ever before. We are going to keep investing in innovation. We are confident it will sell even today and will position us for leadership as the economies clear.

So that's our second quarter. Continuing headwinds, encouraging profitability, sequential improvement, actions to offset the challenges. Run way for the future and continued investment in the four strategic dimensions, which will give us the advantage going forward. Now Marty will take you through the financial details. Marty?

Marty Ellen - *Snap-on Incorporated - CFO*

Thanks, Nick. I will begin on Slide six Reported sales in the second quarter of $590 million were down 23% from last year. Absent the effects of foreign currency, this reduction was 16.4%. As expected the effects of currency continued to hit us hard on two fronts giving the strengthening of the US dollar from prior year levels. First, currency translation reduced reported US dollar sales by $50.2 million, contributing a $7.1 million decline in operating income. We also have currency exposure to cross-border product flows, the most significant related to our Snap-on branded products manufactured in the US and sold by our international franchisees. The net global effect was a reduction in gross margin of $3.2 million. So, in total, currency reduced consolidated operating income in the quarter by $10.3 million. Year-to-date currency has reduced 2009 operating income by $21.3 million. Assuming current exchange rates hold, we expect to see a somewhat lessened currency impact on our third quarter year over year comparisons.

We recorded $8.6 million of restructuring costs in the quarter, which is a fairly substantial increase over the $2 million recorded both last year and last quarter. We communicated to you last quarter to expect this higher level of restructuring spending in response to the economic climate. Of the $8.6 million, $6.7 million relates to the commercial and industrial segment. Year-to-date restructuring expenses are $10.6 million with $8 million related to the CNI segment. We intend to spend about another $12 million over the balance of 2009 with most of this related to the CNI segment. Our full year expected restructuring spending is estimated to result in about $34 million in annualized cost savings.

At the end of June, our worldwide staffing levels have declined by almost 9% since the beginning of this year. Cost savings of $30 million in the quarter include $13 million of RCI-related productivity improvements, $10 million of general cost containment actions and material cost reductions of $7 million. These savings are clearly enabling us to maintain reasonable operating margins through this global recession. Before restructuring costs, the second quarter operating margin this year was 12.8%.

Our consolidated gross profit margin was 43.1%, down 210 basis points from last year. Before the effects of restructuring, the gross margin was 44%, down 120 basis points. A major factor this quarter was the effect of lower production volumes on the performance of our factories as a result of both lower customer demand and our desire to further reduce inventories. This caused about a 310 basis point decline in our consolidated gross profit margin with a significant portion of this due to our S&A Europe business. And as I said earlier, the net effect of currencies on our cross border product flows also reduce gross margin by about 50 basis points. We were able to partially offset these declines with improved pricing across some businesses, better mix and material cost savings and other cost reductions.

Consolidated operating expenses declined by $45.3 million. The reduction in year over year operating expenses is principally due to lower selling expenses, $17.2 million of savings from RCI and other cost reduction initiatives, $13.5 million reduction caused by currency translation and lower incentive compensation expense. Pension expense increased by $3 million as a result of last year's decline in pension asset values. As discussed in previous quarters we expect similar quarterly increases in pension expense throughout the remainder of 2009. This year's operating expenses include $3.1 million of restructuring costs compared to $2.1 million last year. As a percentage of sales, operating expenses were 33.9% compared to 32.1% last year. Financial services contributed $16.6 million of operating income in the quarter, as compared with $10.8 million last year. The termination of the joint venture agreement with CIT, which occurred on July 16th, did not have any impact on our second quarter results. I'll cover financial services in more detail in a later slide.

Our operating margin, 12.8% before restructuring, improved sequentially by 160 basis points. We believe this as a result from our balancing of RCI and cost reductions, while continuing to spend on key initiatives such as innovation and targeted growth opportunities. Interest expense in the quarter increased $2.8 million as a result of the first quarter issuance of $300 million of fixed rate five and 10-year unsecured notes. The higher interest expense was partially offset by lower interest rates on our existing floating rate debt. Our second core effective income tax rate was 31.9% as compared to 34.3% in the prior year period. The lower effective tax rate contributed approximately $0.02 to second quarter EPS and primarily resulted from certain foreign tax benefits. Finally, diluted earnings per share of $0.65 in the quarter was down 43.5% from the $1.15 earned last year. On a sequential basis however, EPS improved from the $0.60 earned in the first quarter notwithstanding $0.08 per share of higher restructuring costs in the second quarter.

With that I will now turn to our segment results. Starting with the commercial and industrial group on slide seven, segment sales of $256.4 million declined 25.3% without currency. The deepening of the recession across most of the European economies and spreading of more economic weakness to other industries had a more severe impact on the CNI segment, particularly in our S&A Europe business. Let me dissect the segments gross margin for the quarter as it declined from 37.9% last year to 28.6% this year. Approximately 200 basis points of this decline was due to restructuring charges of $4.9 million included in cost of sales. Approximately 550 basis points was due to excess manufacturing capacity costs due to significantly reduced production volumes. We scaled back production as a result of lower customer demand including the effects of distributor destocking and to achieve greater inventory reduction. This was particularly evident at S&A Europe. The upside to these inventory reduction efforts was a $35 million inventory reduction across the CNI segment in the quarter, which contributed importantly to our strong cash flow.

Furthermore S&A Europe selectively discounted certain products during quarter as part of a brand consolidation strategy, which reduced overall segment margins by about 50 basis points. While we were able to achieve some material cost savings and RCI cost improvements, these were offset by lower volume and mix effects across the businesses. Operating expenses in the quarter declined $24.3 million from prior year levels primarily due to $8.6 million of currency, lower sales volume-related expenses and $6.5 million of savings from ongoing RCI and other cost reduction initiatives. As a result of these factors, operating earnings for the CNI group were down $49.2 million year over year with more than half of this decline related to one business in the segment, S&A Europe.

Turning now to slide eight, on a worldwide basis organic sales in the Snap-on tools group declined 7.5% year over year, an improvement from the comparable 10.7% decline reported in the first quarter. On a sequential basis, organic sales increased 4.5% over first quarter levels. In the United States, Snap-on tool sales were down 8.5% year over year but did improve sequentially. Van count in the US at the end of the second quarter was flat with the first quarter and was up very modestly from last June. Measured in terms of sales per van, the sequential sales increase in the second quarter is about 5%. Similar to the sequential increase in delivered sales off the vans as reported by our franchisees in the second quarter. All regions in the US reported sequentially higher sales off the vans.

As Nick said US repair spending continues to rise. We expect this to continue and aid our business. In our international franchise operations, organic sales were down 4.9% year over year. Gross margin improved to 42.4% compared to 41.9% last year. The effect of the stronger US dollar on US manufactured products sold through the international businesses reduced the gross margin by about 170 basis points and excess manufacturing costs added another 120 basis points of the margin decline.

However, higher pricing realization and improved mix, along with material cost reductions, more than offset these negative factors. Operating expenses of $81.6 million in the quarter were down 6.6% from 2008 primarily due to savings from RCI and other cost reduction initiatives. Currency translation contributed $2.8 million of the decline. Operating earnings for the Snap-on tools group of $28 million in the quarter declined $7.3 million from 2008, largely due to the lower sales volumes, cost to carry excess manufacturing capacity and $6.5 million due to currency. As a percentage of sales, operating earnings in the second quarter of 10.8% declined from the 12.1% realized a year ago. However, as compared to the first quarter of 2009 operating earnings increased $6.9 million or 32.7% and the operating earnings margin of 10.8% increased 210 basis points from the first quarter.

Turning to the diagnostics and information group which is shown on slide nine, second quarter sales of $137 million declined 12.5% before currency, primarily due to lower essential tool and facilitation sales to OEM dealerships. Compared to first quarter

2009 levels, however, organic sales increased 2.3%, primarily due to stronger sales of diagnostics products worldwide. Gross profit of $71.1 million was down $5.9 million from 2008 primarily due to lower sales, $3.2 million of unfavorable currency and $1.8 million of higher software development costs. These declines in gross profit were partially offset by an improved sales mix and $2.3 million of savings from RCI and cost improvement initiatives. Gross profit margin of 51.9% in the quarter improved considerably over 46.7% a year ago primarily due to an improved sales mix resulting from increased sales of higher margin diagnostic and software products as well as the savings from RCI. As a result of this improved sales mix and $6.9 million of savings from RCI and other cost improvement initiatives, operating earnings in the quarter of $34 million increased $3 million or 9.7% from 2008 and as a percentage of sales, improved from 18.8% from last year to 24.8% this year. As compared to first quarter 2009 levels, operating earnings in the second quarter increase $8.3 million and the operating margin increased 540 basis points on a sequential basis.

Turning to slide 10. Financial services operating income of $16.6 million increased $5.8 million from 2008. The year over year improvement is primarily due to lower market discount rates and 2.5% increase in originations. I'll provide more detail on Snap-on credit in a moment.

Now let me turn to a brief discussion of our cash flow and balance sheet. Turning to Slide 11, our operating cash flow performance was quite strong, about $156 million in the second quarter. Inventory reduction alone contributed $55 million. Capital spending of $19.5 million in the second quarter of this year included plant growth spending for our plant in Belarus and the further expansion of our plant in Kunshan, China. Last year, second quarterback capital spending was $17.9 million. Our current plans call for 2009 capital spending to be in a range of $60 million to $70 million.

As seen on slide 12, accounts receivable decreased nearly $50 million from year end levels primarily due to lowered sales and continued diligence on collections. Days sales outstanding were 65 days at quarter end compared to 64 days at year end. Of our all businesses are continuing their vigilant effort in managing customer credit risk in this environment. Inventories at the end of the quarter were down $55 million from last quarter and $63 million from year end excluding currency. On a trailing 12-month basis, inventory turns decline to 4.1 times from 4.6 times at year end. This decline in turns is a function of the trailing nature of the computation and the fact that most of our inventory reduction occurred this quarter. At current inventory levels, turns would be approximately unchanged from year end.

Net debt at the end of the quarter of $295 million was down $105 million from year end 2008. Our net debt to capital ratio of 18.9% compares to 25.2% at year end and 26.5% last quarter. Our liquidity position and access to credit continues to remain strong. Cash on hand at the end of the quarter was about $524 million. In addition to the $524 million of available cash, as well as cash flows from operations, we currently maintain a $500 million revolving credit facility provided by a strong, diversified group of international banks, which does not expire until August 2012. We also have another $20 million of committed bank lines. At quarter end the full $520 million of borrowing capacity was available. In addition to these facilities, our current A2P2 short term credit rating allows us to access the commercial paper market should we need to do. At quarter end there was no commercial paper outstanding.

Now let's discuss Snap-on Credit beginning on slide 13. As you know on July 16th, we notified CIT that we were terminating our financial services joint venture agreement effective that day. We have since purchased CIT's 50% ownership interest in the joint venture for approximately $8.2 million. The joint venture was formed in 1999. For decades before that, this credit business was owned and successfully operated by Snap-on. It has always been operated as a separate business. The employees of Snap-on Credit housed about 30 minutes from our corporate headquarters here will remain with Snap-on Credit and the operations of Snap-on Credit are expected to be uninterrupted by this event. All activities surrounding the financing of extended credit contracts to customers, leases of shop equipment and loans to franchisees will continue without change. Going forward, Snap-on will provide financing for all new contracts and loans originated by Snap-on Credit. The CIT owned portfolio, which approximated $830 million as of the termination date, will continue to be owned by CIT but serviced by Snap-on Credit.

From an income statement perspective, we will record the interest yield on new finance contracts over the life of the contracts as financial services revenue. Previously the Company sold this finance contracts to CIT and the gains on the sale of these contracts were recorded as financial services revenue. As a result of this change, operating income of the financial services segment will decline during the transition period as we build a new portfolio of finance receivables and associated interest yield ramps up. Consequently we expect that operating income from financial services, which is before interest expense and totalled $16.6 million in the second quarter of 2009, will be an operating loss of between $8 million to $10 million in each of the third an fourth quarters. We anticipate the financial services will be approximately break even by the first quarter next year producing positive and growing operating profits thereafter. Based upon current origination levels, yields, credit losses and operating expenses, we believe once the transition is fully complete in 2012, annual operating income from financial services will approximate $80 million to $85 million, again before interest costs. We estimate that the incremental financing needs for Snap-on credit will be approximately $450 million over the next 12 months. As noted in both today's release and release of July 16th, we believe that we have sufficient available cash on hand, cash flow from operating activities and available credit facilities to fund the financing needs of Snap-on Credit. We provided data on Slide 14 covering both the Snap-on Credit portfolio in the US as well as our existing on-balance sheet international portfolios for our finance businesses in the UK, Canada and Australia. Hopefully this will help demonstrate the quality of these businesses and assist you in developing your financial models.

This concludes my remarks on the second quarter performance. Before we open the call for questions, Nick would like to provide some final thoughts. Nick?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Thank you, Marty. Well, I believe the message of this quarter is that Snap-on did face headwinds, but our operations achieved, recording an OI margin of 12.8% before restructuring, up sequentially 160 basis points from what we believe was a fairly incouraging first quarter given the environment. Looking forward, we won't predict the near term but we do continue to see opportunity in runway. Runway in our franchisee network, in auto repair garages, in critical industries and in emerging markets. And even as we work to limit the damage of this downturn on our enterprise, we continue to invest in those strategic areas. We are confident that we are improving our position and will be well placed to take advantage of the future. In this quarter we also acted on a new front taking charge of our own destiny in the Credit Company. And while there will be a financial transition, we are confident we have the funding and capability. After all, I think history shows that Snap-on has been successfully managing technician credit for decades both on and off our balance sheet. We have a unique understanding of that space and we are confident we can wield that capability to our distinct advantage going forward.

Before I finish here though, I want to thank all of our franchisees and associates for your commitment and your effort. Your contribution to our corporation has once again been extraordinary. Now, we'll turn the call over to the operator for questions. Operator?

QUESTIONS AND ANSWERS

Operator

Today question an answer session will be conducted electronically. (Operator Instructions). It appears our first question comes from Jim Lucas with Janney Capital.

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Jim?

Jim Lucas - *Janney Montgomery Scott - Analyst*

Can you hear me now?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

I can now.

Jim Lucas - *Janney Montgomery Scott - Analyst*

All right. Good morning, sorry about that.

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

How are you doing?

Jim Lucas - *Janney Montgomery Scott - Analyst*

That's why I follow industrial and not technology stocks. First question on CNI where clearly that's where the economic impact has been felt the most as you look at the actions that you've taken there, if we go back before the economy turned over you had talked about some of the expectations for profitability ratios in that business. Do you still see longer term -- or you should say could you talk about where you see the CNI segment in a normalized environment from a possibility standpoint?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Our view of CNI has not changed. What we are seeing is two big changes this quarter is one, I think that we spent a lot of time talking about S&A Europe and Europe is having some difficulty. Our S&A Europe business, like many other European businesses are in difficulty. We don't see that as a long-term reduction of expectations of that business. If you just look at what has happened in the Europe in the recent period, you have announcements on GDP like Spain, which has got unemployment of I think almost 20%. They announced their GDP was down 3%. That was the good news. France was something like 3.2% down GDP in the first quarter. UK was 4.9%. Italy 6.0%. Germany was 6.9%. Russia, which is an extension of our eastern European business, was down 9.8%. So they are seeing, I think, the bad news for breakfast hit them that we saw -- that United States saw earlier. And you're seeing a lot of that hit the market. At the same time we are seeing as part of that we are seeing destocking continue for our distributors. So I feel that we are in a unique time in Europe. That economy will come back eventually. We believe actually we are holding or gaining share if you base distributor shelf space, if you base the reports -- if you believe the reports on distributor shelf space. So I think our expectations for S&A Europe continue, the industrial business was off quite substantially in the quarter. We believe the idea of taking the Snap-on brand to mission critical industries is still quite valid and still being quite well received and so I think those businesses for the longer term are still going to achieve the kind of mid-double digit earnings that we all expected.

Jim Lucas - *Janney Montgomery Scott - Analyst*

When you look at the incremental restructuring that you talked about in the second half of the year, do we look at another quarter kind of break even before seeing profitability restored?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

You know -- Well.

Jim Lucas - *Janney Montgomery Scott - Analyst*

Given seasonality?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Given seasonality. I think I said in my remarks this is the vacation period so this is quite an unpredictable period for us in CNI because they do have quite a bit of European component of their business. I don't think we are expecting near term. And when I said immediate I meant the third quarter. I don't necessarily say we are expecting much improvement I would expect the improvement once we get off the vacation period. Part of what I believe is happening, Jim, is because of this bad news, which is being publicized in Europe it has gone beyond the actuality of GDP in that distributors and customers are saying I'm going to go from at least a commercial point of view on vacation early. So I think we will probably see -- we saw some of the vacation creep into the second quarter I think this year and we will probably see a pretty good strong vacation effect in the third quarter. So we don't see improvement until the end of the year on CNI.

Jim Lucas - *Janney Montgomery Scott - Analyst*

Switching gear to diagnostics, where we've seen a lot of good improvement in mix, obviously less facilitation, more software and maybe this is more toward Marty, but how do we think about that business longer term because of where we have seen those margins the last two quarters. I mean is 20% plus kind of a normalized margin?

Marty Ellen - *Snap-on Incorporated - CFO*

Let me just give you some color. As you know the margins in that segment are significantly impacted by the mix of our businesses given the different margin structures and, for example, this year the whole arena of diagnostics and software was about -- was over 80% in terms of mix and if you go back a year ago it was 75% and recall that a year before that the OEM facilitation business, which was low margin had a large one off program if you will involving over 8,000 dealers across Europe. So it is all about the mix. We actually think the diagnostics and software business is the one that has probably the greatest runway going forward because as we have said before as repair moves for example, from OE dealerships, independence, the need for those products are enormously important and given that we would expect -- our model always was for the diagnostics and information group to sort of be at or approaching that 20% level. It was obviously greater this quarter in terms of our overall goal of about mid-teens operating margins.

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Actually, I'd like to amplify on that a little bit. We have a tremendous advantage in that sector in the database we have associated with the installed car park, the wide range of badges and the number of years and models we have in our database in terms of diagnosing products. And sometimes I think those of us who don't do this for a living, the value of that is lost but I recommend that you read in the New York City Times magazine the May 24th issue Matthew Crawford's article on the value of mechanical labor. This was a guy in the think tank in Washington, had a Phd then went to run a motorcycle shop and he tells you in several paragraphs about the difficulty of working on an older model and having to get advice from experienced technicians. Experience trumps the rule is what he says. And what we have in our diagnostics, one of the things in Mitchell and in some cases like [Varis] is our expert based systems, where experienced techs, long-time techs have helped us post solutions into an automated system

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where our subscribers can access those if they have problems with these long-term vehicles. So we have a great advantage and a great lead in that situation. So the diagnostics business for us I think is going to be strong margins for sometime to come.

Jim Lucas - *Janney Montgomery Scott - Analyst*

Final question. Marty gave us a lot of color on the credit business and the P&L impact and financing needs, but as a thing about the cash flow implications particularly with the accounts receivable balance rising, how should we think about the operating cash flow impact of having credit on the balance sheet?

Marty Ellen - *Snap-on Incorporated - CFO*

Well, Jim, from an operating cash flow point of view yes we will have to build what will appear in our cash flow going forward increased accounts receivable portfolio. We said in the release and this morning over the next 12 months that looks to be to us about a $450 million incremental financing need because as we build contracts each and every day they begin to pay down. So incrementally $450 million. They will rise a little bit thereafter. That won't be the peak but maybe $50 million or $100 million a couple or three quarters out. So that should be the full financing needs. So it is important to note while we expect to build at least a new $800 million portfolio we don't need to finance $800 million portfolio from debt. And because of the other cash flows and by the way as we model that incremental, say close to $550 million need if you dial out more than twelve months, okay. We have done that by also reserving what we think is adequate cash on hand for Snap-on so we don't drive our cash all the way down either.

Jim Lucas - *Janney Montgomery Scott - Analyst*

Okay. Thank you.

Marty Ellen - *Snap-on Incorporated - CFO*

Thanks.

Operator

And our next question comes from David Leiker with Robert W. Baird.

Keith Schicker - *Robert W. Baird & Company, Inc. - Analyst*

Good morning, it is Keith Schicker on the line for David.

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Hi Keith.

Keith Schicker - *Robert W. Baird & Company, Inc. - Analyst*

I was wondering if you could sort of discuss the restocking in the commercial and industrial seg many. Is that thing that will continue or is that going to throw as we go into the third quarter of the year?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

I hate to say this. Last time I thought -- somewhat I said last time was destocking logically can't continue. I stand by that. When it ends I don't know. We thought it might start to abate going off the second quarter but it did not so I'm not going to predict that. But logically it has to. And it represents between 40% and 50% of our decrease in Europe. What happened in the United States, I'll tell you, is if you use that as any indication, the franchisees destocked in some cases. In some cases at our urgency because we wanted them to generate cash and that took several quarters and then towards the end, in fact, in the last quarter that destocking has ended. So I think it probably took about two or three quarters in the US for that to roll out and we are probably going to see the same kind of thing or more in Europe. I'm not sure. We have seen a couple quarters of destocking already so I guess the short answer is I can't predict. I know it represents half, roughly half of our downturn but we did see a model for this in the US and destocking will end it is just hard to predict when.

Keith Schicker - *Robert W. Baird & Company, Inc. - Analyst*

Okay, that's great. If we look at the tools group you touched briefly on sort of the sequential improvement there. Can you just provide a little bit more color on what drove the sequential increase and how you see that trending going forward?

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Sure. Well, sequential increase was driven in part by a 4% increase quarter over quarter in sales. That was one. That helped quite a bit. Then rapid continuous improvement activities throughout those organizations. Our RCI improvement. That's two. And three, we are constantly innovating and launching new products which create a buzz and sometimes get us a little better margin. So those three factors.

Keith Schicker - *Robert W. Baird & Company, Inc. - Analyst*

That's great. Thank you very much.

Marty Ellen - *Snap-on Incorporated - CFO*

Thank you, Keith.

Operator

Our next question comes from Ben [Kotter] with South Point Capital.

Ben Kotter - *South Point Capital - Analyst*

Good morning, guys. Congratulations on a great quarter. I had a question on the CIT transition. It sounds like you are losing the gain on sale that you get from the CIT partnership and if I understand this correctly that's about a $25 million impact per quarter starting in Q3?

Marty Ellen - *Snap-on Incorporated - CFO*

No, Ben, I think what's happening in Q3 we said on the call this morning that next two quarters the whole segment will lose $8 million to $10 million and that's, of course, driven by the change. We terminated on July 16th so actually there will still be a small benefit in the third quarter because up to the 16th of July we continue to sell contracts and recognize gain for half a month. So as we terminated July 1st it would have been a little first in the third quarter and improving somewhat in the fourth quarter.

Ben Kotter - *South Point Capital - Analyst*

But if I understand correctly, so instead of reporting a gain in the financial segment of roughly $16 million in Q3 and Q4 we are going to see a loss of $8 million to $10 million?

Marty Ellen - *Snap-on Incorporated - CFO*

That's correct. And just to remind everybody that segment includes the Snap-on Credit business in the US and our or international finance businesses which have always been on our balance sheet which are throwing off interest yield, which is what's in financial services revenue alongside with the gains on the sale of the contracts in the US. There are operating expenses, there are lost provisions an what you see in the second quarter is $16.6 million of operating income on that basis and you are correct, what we are telling everybody is that $16.6 million in the second quarter we expect to look like an $8 million to $10 million loss in each of the third and fourth quarters. Break even or so by the first quarter. Ramping up there after as the portfolio builds.

Ben Kotter - *South Point Capital - Analyst*

So as I think about the EPS impact that seems like from the run rate then all else equal that we will have about a $0.25 per share hit in Q3 relative to Q2. Is that about right after I tax the difference?

Marty Ellen - *Snap-on Incorporated - CFO*

You pretty well have it.

Ben Kotter - *South Point Capital - Analyst*

Okay. And then in Q1 and Q2 it sounds like the segment will break even, but we will be comping against a plus $16 million contribution from Q1 '09 or somewhere thereabouts. Is that about right. So it won't be $0.25 impact maybe it will be 60% of that or something like that?

Marty Ellen - *Snap-on Incorporated - CFO*

That's correct.

Ben Kotter - *South Point Capital - Analyst*

Okay.

Marty Ellen - *Snap-on Incorporated - CFO*

And against that right now we are funding the business out of our available cash so to the extent we go into the market to raise any more debt that will change whatever you have as interest expense in your models. But so far there would be no change because we haven't borrowed anything.

Ben Kotter - *South Point Capital - Analyst*

Have you guys pursued any other potential partners to replace CIT or do you want to keep all of this funding on your balance sheet going forward?

Marty Ellen - *Snap-on Incorporated - CFO*

Ben, look. I think we presented the data on the slide I think to show everybody how economically strong this business has been. We did this ourselves until 1999. There were circumstances in the late '90s which caused us to believe that in essence creating some financial flexibility through that CIT program by selling the portfolio at that time made sense. Snap-on had just made a number of acquisitions in the '90s and that was a way to create some liquidity to pay down debt. Look, we are always going to be looking at the most effective way to finance the business. We think it is a great return investment for our shareholders and at the same time we will always know that that portfolio gives us some financing flexibilities because they're finance assets and very financeable in all sorts of forms in all sorts of capital markets, transactions sort of with or without a joint venture structure. I think the structure just came with the need at the time to look at financing that part of our balance sheet in a different manner. That could change in the future. We have no existing plans to change that but we do recognize that that portfolio by itself can create liquidity and give us some flexibility down the road should we need to do so. And otherwise we expect it to provide great returns, particularly once we get through the ramp up period.

Ben Kotter - *South Point Capital - Analyst*

So in order to mitigate some of the hit we are going it take on the EPS impact have you guys considered trying to purchase those receives out of CIT?

Marty Ellen - *Snap-on Incorporated - CFO*

There have been no discussions with CIT about that.

Ben Kotter - *South Point Capital - Analyst*

Okay. Well, thanks for your help, guys.

Marty Ellen - *Snap-on Incorporated - CFO*

Thanks again.

Operator

And it appears we have no further questions in the cue at this time. I would like to now turn the conversation back over to Mr. Ellen for any additional or closing remarks.

Nick Pinchuk - *Snap-on Incorporated - Pres., CEO*

Thank you all for joining us for our second quarter conference call. Thank you.

Operator

That does conclude today's conference. Thank you for your participation.