

The year 2005 was a productive year for Fastenal. We had very good sales and earnings growth; however, I believe our greatest accomplishments were the new initiatives we started in 2005. These initiatives were designed to help us improve our customer service, enhance career opportunities for our employees, and increase the returns to our shareholders. I will explain several of these initiatives in greater detail later in this letter.

Our 2005 net sales of \$1.5 billion represented a 23.0% increase over the 2004 level. We added close to \$300 million in new business in 2005; more than our total sales were in 1996. We were able to do this because of our opening of new stores, while at the same time continuing to upgrade our existing stores. We opened 222 new stores in 2005 and almost completed the store upgrade project (previously referred to as the 'Customer Service Project' or CSP) which began in the latter half of 2002. We haven't completed the remaining store upgrades because of a few locations with time left on their lease.

Fastenal produced net earnings of \$166.8 million in 2005, which is a 27.4% increase over 2004. This increase was made possible by the combination of increased sales growth and better expense management. With labor being our biggest expense, we continue to work very hard to increase productivity. Increased productivity allows us to improve both earnings and the level of compensation for our employees, while maintaining our high level of customer service.

In the fourth quarter of 2004, our Board of Directors approved a plan to implement a profit sharing contribution for our employees' retirement plan. This is a performance-based plan that rewards the employees if the company achieves specific performance goals. Because of our strong financial performance in 2005, the company contribution for the year was approximately \$2.5 million. The allocation of this contribution is limited to a percentage of employee contribution under \$5,000 per year, so that all enrolled employees can enjoy the benefit.

Since 2002, CSP has been our main marketing focus and we continued our efforts in 2005. We realize that if we truly want to be the best

industrial and construction store in every market we serve, we need to continue to improve our stores. Based on this belief, we have spent the last 18 months working on developing the next generation of CSP. As a logical progression, we have named it 'CSP2'. We now refer to our original CSP conversion as the standard store model because it is our typical store today.

In developing our criteria for what a CSP2 store should be, we listened to both our field personnel and our customers. Based on this feedback, we developed our list. The most important items on this list were a better store location, a proven manager, and a broader inventory selection. We also have a technology team dedicated to this project. Their goal is to speed up the transaction time so customers can buy what they need and get back to their work site as quickly as possible. Our merchandising team has also improved the store appearance by creating better product displays. The last and perhaps the most important change is that we increased our outside sales force in each CSP2 store by two people. We felt we needed to increase our customer contacts so both our current and potential customers were aware of the additional products we have available at our local store.

As we started to develop a financial plan for the CSP2 format, one of our biggest challenges centered on quantifying the investment per store and our expectations for results. To assist in this process, we looked at the hundreds of stores we have previously opened. We have very good data on the initial investment and the timeline for a return on these new store investments. After many discussions, we decided to quantify the investment similar to a new store opening. This investment, excluding items related to a new physical location, includes approximately \$62 thousand of incremental inventory, two additional sales people, and two additional vehicles. We then quantified our goal for sales and profit improvement at a store converted to the CSP2 format to mirror the impact we get from a new store investment.

Another area we focused on very heavily in 2005 was our transportation system. We have been operating our own fleet of over the road trucks for more than 20 years. These trucks carry, by

weight, almost 90.0% of the product we sell. Even with these trucks moving the majority of our product, we were still spending more on outside carriers to move the remaining 10.0% than we were spending to operate our entire fleet. Seeing this outside freight expense as an opportunity to reduce costs, we put together a team to rethink our entire transportation system. The team determined that if we wanted to make real improvements and reduce our outside expense, our systems would have to be as good as the best freight and parcel companies.

Based on this direction, we hired people trained in the latest mapping software to do our routing and we assigned one of our best system developers to lead the transportation technology team.

The truck routing group spent most of the year working with our regional operations managers, remapping routes and adding trucks where necessary. Due to the truck route changes, we have been able to increase the service level to our stores. Over 85.0% of our stores are currently receiving shipments five days per week; this is up from 15.0% at the start of 2005. The majority of the deliveries are now before 8:00 A.M., which increases our ability to provide a high level of service to our customers. With this efficient truck routing, our cost per store delivery (i.e. each time we stop at a store) has dropped from \$72 to \$48. Although we have not completely eliminated our need to use outside freight carriers, we have seen a significant decrease in this expense. The technology group is just starting to implement a new tracking system that will allow us to know where every package is at all times. Our store personnel, armed with this information, will be able to provide better service to our customers. We will continue to work on this transportation initiative in 2006, and I believe we will continue to improve our service and lower our cost.

Another major initiative we undertook in 2005 was the centralization of the collection call component of our accounts receivable. We did some benchmarking in 2004 and determined that we were not performing at the same level as other distributors in our industry.

In the past, all of our collections work had been done by the local store employees. After researching best practices in accounts receivable and collections, we decided the best way to collect our receivables was through a central office

approach with trained and dedicated people. In February 2005, we opened our central collections office in Caledonia, Minnesota, a small city 40 miles south of Winona. Since the opening of this office, we have seen a continual improvement in both the number of days it takes to collect a sale and the amount of uncollectible dollars that have to be written off. Although our sales grew 23.0% in 2005, our year end accounts receivables have only grown 13.0%. While store personnel remain engaged in the collection process, this change has freed up time for our store personnel to go out and make more customer contacts. At the end of the year, this project had been implemented in 80.0% of our stores. We believe we will continue to see improvements in the accounts receivable area in 2006 as we complete the rollout.

We also worked hard to manage the growth in inventory in 2005. Our internal goal on inventory management is two-fold. First, we want to grow inventory at a rate less than sales growth, which we did in 2005. Second, we want to change the balance of inventory so there is less in the distribution centers, allowing us to use more of the additional inventory dollars for expanding our store selection and working on the CSP2 project.

Purchasing of product continues to be a major opportunity for Fastenal. We made several organizational changes in our central purchasing group this past year by focusing it into three distinct groups. We purchase the branded products in one office, the commodity fill-in buys in another office, and the import purchasing is done in our office in Shanghai, China. This reorganization of purchasing was designed to streamline the process and achieve two goals. The first was to reduce the time it takes to purchase the product once we fall below our desired inventory level. The second was to develop a system with better information so we could improve both our customer service and inventory turns at the same time. Our purchasing group is making great progress on both goals.

FASTCO, our Shanghai based trading company, continued to grow in 2005. The people of FASTCO continue to find new companies throughout Asia who can produce high quality industrial and construction products to meet our customers' needs. We currently have more than 60 employees working in Asia.

The only distribution building purchased in 2005 was in Modesto, California. This facility will be our main distribution point servicing our stores in the Western states. It is a 320,000 square foot facility from which we plan to start operating in mid 2006. This will replace our current facility in Fresno, California.

Our manufacturing division also had a good year in 2005. They were able to grow their sales by 18.0% year-over-year and added several large accounts late in the year that should help increase our sales growth in 2006. We purchased a small manufacturing company in Rockford, Illinois that makes cold formed fasteners. This company has the capacity and equipment to make longer production runs on both special and standard parts. This helps fill a void between our current specials manufacturing and the larger volume production parts we purchase from the large fastener manufacturers around the world. This business is growing and helps us better service our customers' needs. We plan to continue adding machinery at this new facility to expand our manufacturing capabilities.

Our sales specialists continued to impress in 2005. National Accounts, which represents 22.0% of our total net sales, grew their sales by 23.0%. National Construction, which represents 2.0% of our total net sales, had excellent growth at 82.0%. The Government Sales people continue to grow their sales at a rapid pace also. Government sales, which represents 3.0% of total net sales, grew at 54.0%. We continue to increase our investment in all of these markets with the belief that they all have great potential now and in the future. We also have created several other groups of sales specialists working in other markets that we believe have potential.

Having great computer systems continues to be a competitive advantage for Fastenal. Our information technology (IT) team continues to redesign and upgrade our systems. They worked all year on a rewrite of our warehouse management system. Installation of this new system will begin in the first half of 2006. They have also made many improvements to our branch point of sale system and our website, fastenal.com. While many companies are outsourcing their IT functions, Fastenal believes our internal ability to quickly modify our

systems to meet customer needs is one of our key competitive advantages.

I have written about many exciting endeavors underway at Fastenal. None of this would be possible without talented and well trained employees. Because of this, we have increased our commitment to the Fastenal School of Business (FSB) by giving it additional resources and asking it to do even more training. During 2005, FSB trained more than 3,500 people throughout the Company in over 20 different programs. In 2005, we also placed seven instructors in the field so we could reach more people and reduce our travel expense at the same time. This change has proven to be quite successful and we plan to increase the number of field instructors in 2006.

The most exciting thing the Fastenal School of Business accomplished in 2005 was the development of our new Associate of Applied Science (AAS) Industrial Distribution Program. Our people worked with representatives from the Minnesota State Technical School system to jointly develop a degree program. This program was designed to meet the needs of industrial distribution experts now and in the future. The classes will be jointly taught by the Minnesota State College - Southeast Technical and the Fastenal School of Business.

In closing, I believe it is important to thank all of the people on the Fastenal team who worked hard all year to produce the great results we are able to report. At Fastenal, we believe that a company is no more than a group of people brought together to accomplish a common goal. We currently have more than 9,000 people working to reach the common goal of Growth Through Customer Service. If we continue to challenge our people and, at the same time, help them in their own development, I believe we will continue to achieve our common goal. I also want to thank our shareholders for supporting Fastenal. Your belief in us gives us the confidence that helps in the pursuit of our goal.

Thank you,



Willard D. Oberton  
CEO and President