

Automotive Aftermarket Retailers

Independent Automotive Repair Garage Survey: August 2012

Overview

- According to the survey responses from nearly 250 independent garage owners, demand trends in the DIFM channel increased during August relative to the prior year, as our Current Sales Index finished the month at 53.8.
- While the performance in August marked the first time in eight months that the index finished in expansion territory in successive months, demand during the period was clearly not as strong as it was in July.
- In sum, while sales trends appear to have improved from the cadence witnessed earlier in the year, our research suggests that underlying demand trends across the industry remain relatively weak. In other words, we believe that the breadth of mechanics experiencing a sales increase was wide, but the magnitude was weak in both July and August.
- In what is starting to sound like a broken record, our contacts noted that the behavior toward routine maintenance remained a headwind to sales and traffic trends during August.
- Despite the fact that our survey respondents noted that sales trends increased year-over-year for the second consecutive month (the first occurrence in eight months), the Three Month Outlook Index dropped 6.1% to close at 58.4.

Conclusion

While we continue to appreciate the opportunity that the publicly traded players in the automotive aftermarket have to gain market share in the DIFM channel, current valuations are not attractive enough to pique our interest, especially given the recent deterioration in sales trends and signs that the industry remains under some pressure. Furthermore, we have growing concerns over what a changing mix of automobiles in the nation's light vehicle fleet could mean for demand trends over the next 4 to 5 years. See our recent initiation on Monro Muffler Brake for more details. As a result, we are maintaining our NEUTRAL ratings on Advance Auto Parts, AutoZone, Monro Muffler Brake and O'Reilly Automotive.

Symbol:	Price	Target Price	Rating	EPS (\$) Cur Qtr	EPS (\$) Cur Year	EPS (\$) Out Year	Mkt. Cap (M)
AAP	67.84	NA	N	\$1.36e	\$5.38e	\$5.88e	4,987.2
AZO	\$372.89	NA	N	\$5.32e	\$27.31e	\$31.27e	\$13,807.4
MNRO	\$34.99	NA	N	\$0.38e	\$1.58e	\$2.02e	\$1,084.7
ORLY	\$84.24	NA	N	\$1.26e	\$4.62e	\$5.15e	\$10,015.3

Rating Legend: B=Buy, N=Neutral, S=Sell

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INTEGRITY

TRUST

VALUE

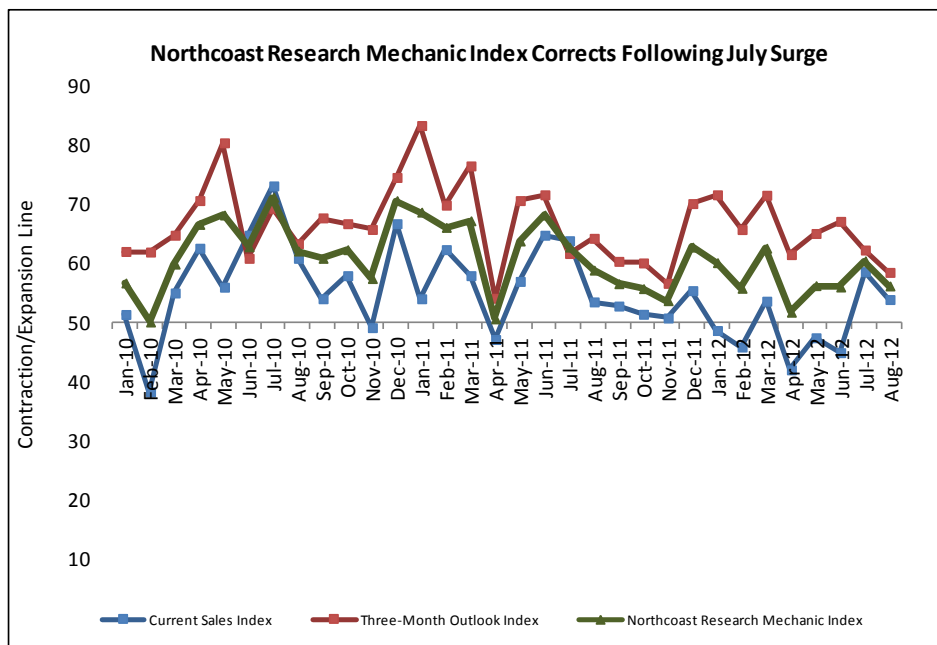
Independent Automotive Repair Garage Survey

Each month we publish the **Northcoast Research Mechanic Index** based on the results of our survey, which encompasses the feedback from more than 100 independent repair shops operating in the top 10 states, based on the light vehicle fleet population and Advance Auto Parts, AutoZone, and O’Reilly Automotive’s aggregate store count. The composite index is an equal-weighted average of two sub-indices—**Current Sales Index** and **Three Month Outlook Index**. Readings above and below 50 indicate market expansion and contraction, respectively.

The study is designed to capture the following factors in the DIFM channel:

- Recent business trends and the corresponding drivers
- Major inflection points in sales trends
- Expectations for demand over the next three months
- Major changes in consumer behavior
- Insight into market share trends and the relative rate at which installers are switching wholesale parts suppliers

Northcoast Research Mechanic Index—August Snapshot



Source: Northcoast Research

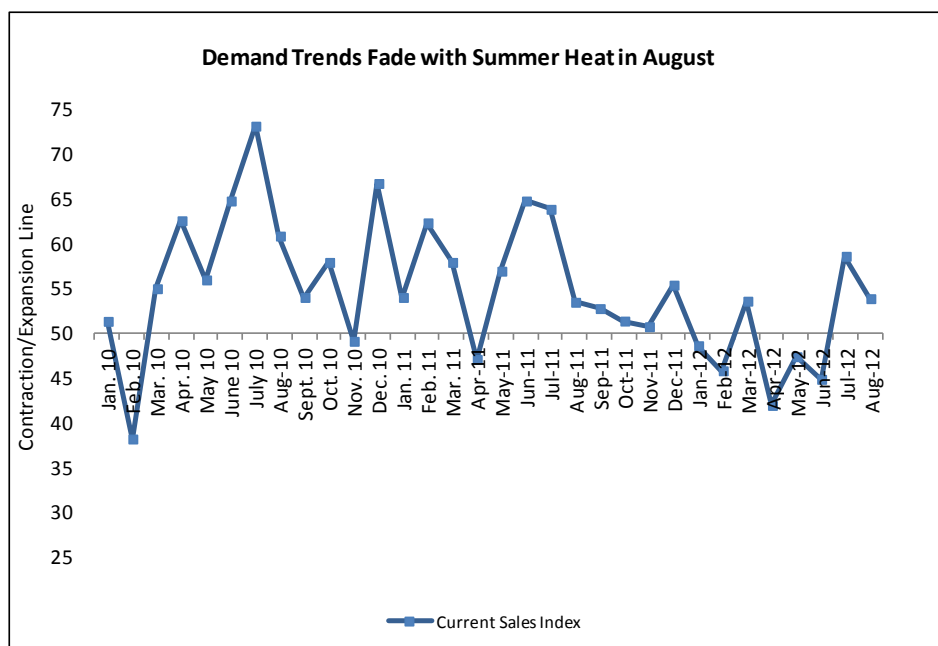
According to the survey responses from nearly 250 independent garage owners, demand trends in the DIFM channel increased during August relative to the prior year, as our Current Sales Index finished the month at 53.8. That said, this performance represented a sequential deceleration from the trends witnessed in July. Additionally, the outlook of the respondents moderated, which coincided with the sequential deceleration in sales trends throughout the month. Consequently, the composite index fell 7.1% to 56.1. We provide further details on the drivers of the two sub-indices below.

Sales Trends Moderate as Cooler Temperatures Arrive

During August, the Current Sales Index dropped 8.1% sequentially to finish the month at 53.8. While the performance in August marked the first time in eight months that the index finished in expansion territory in successive months, demand during the period was clearly not as strong as it was in July. In our view, the sequential slowdown was partially related to the fact that, with the exception of the second week of the month, temperature trends across the country were less favorable this year compared to the equivalent period in the prior year. Accordingly, many of the mechanics that we spoke with experienced a decline in the amount of work tied to cooling systems, radiators and thermostats, which helped stimulate demand trends in July. We were particularly disappointed to see respondents indicate that weak traffic trends re-emerged as a significant headwind to business during the month.

On a positive note, the benefit from a higher repair order remained essentially unchanged from July as the combination of a mix shift to repair work (versus maintenance work) and higher parts prices year-over-year drove the average ticket higher. That said, the benefit from both of these factors is much less significant than it was throughout 2010 and 2011.

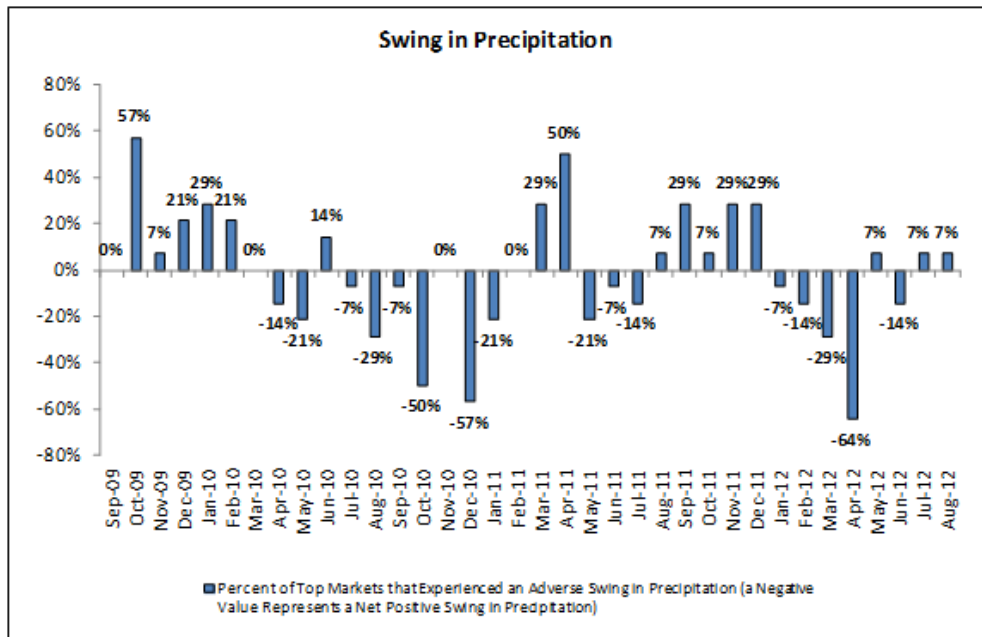
In sum, while sales trends appear to have improved from the cadence witnessed earlier in the year, our research suggests that underlying demand trends across the industry remain relatively weak. In other words, we believe that the breadth of mechanics experiencing a sales increase was wide, but the magnitude was weak in both July and August. Indeed, our vendor contacts have expressed concern over the duration of the lackluster demand trends, and have noted that they are beginning to prepare for a more sustained period of weakness. In fact, many suggested that some of the stabilization in the prior two months can be directly attributed to a significant increase in promotional activity by the installers, which clearly is not a sustainable strategy.



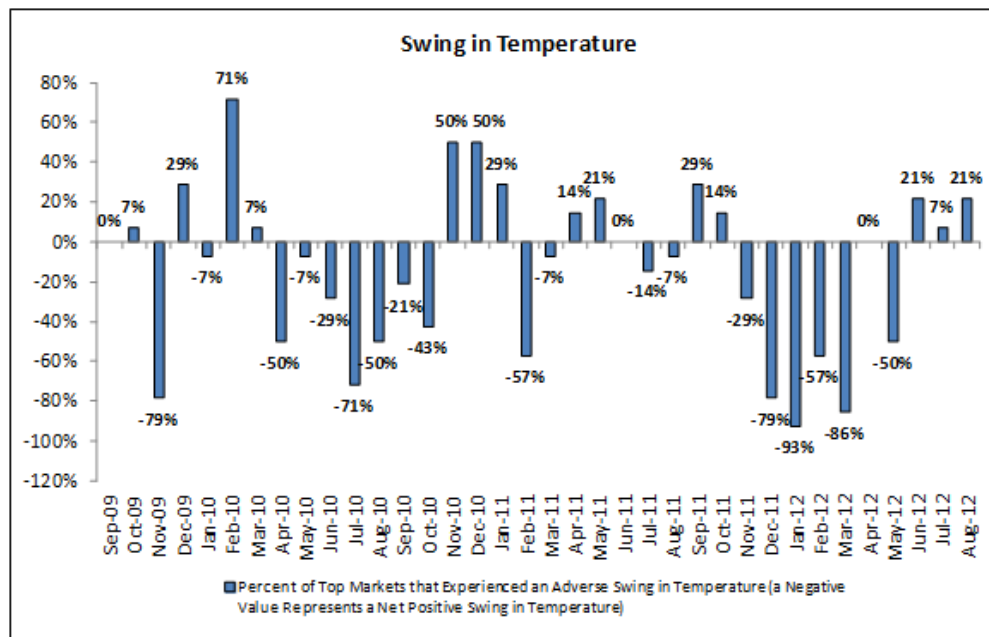
Source: Northcoast Research

Weather Screener

According to our proprietary weather screen, precipitation and temperature trends in the key markets of our survey were slight headwinds relative to the prior year's period. Specifically, the first chart below illustrates that precipitation was slightly higher, as a net 7% of the markets witnessed more precipitation during the month. The second chart highlights the fact that temperatures adversely affected business as a net 21% of the territories experienced cooler weather in August relative to the prior year.

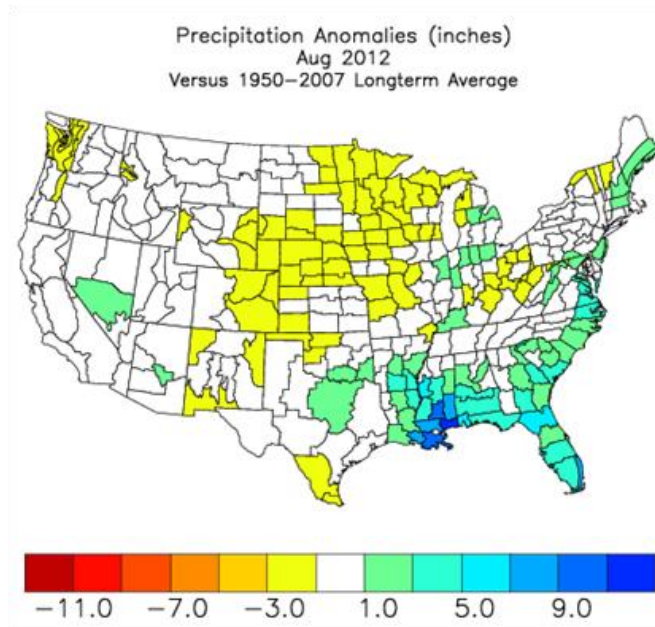


Source: Northcoast Research, U.S. Department of Commerce

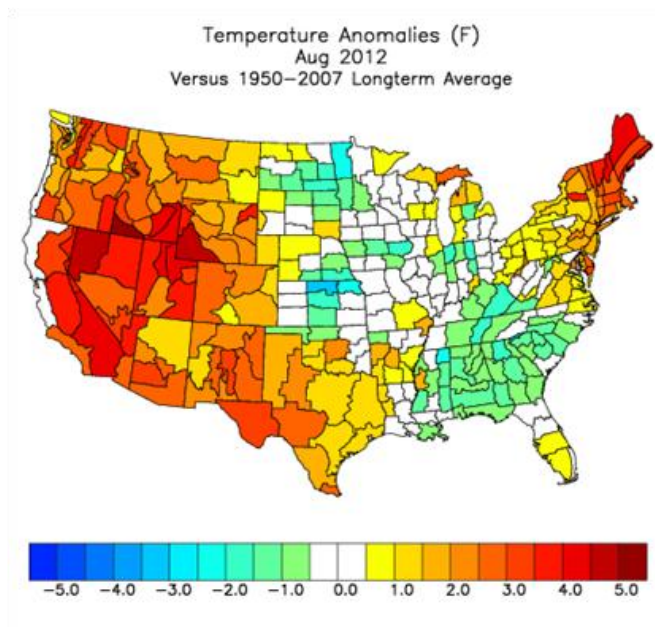


Source: Northcoast Research, U.S. Department of Commerce

The following maps illustrate weather trends during August 2012 relative to the long-term averages.

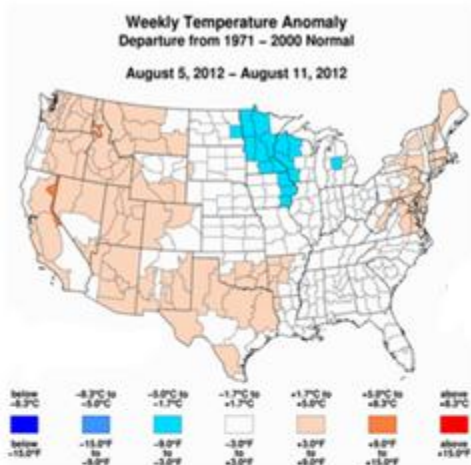


Source: U.S. Department of Commerce

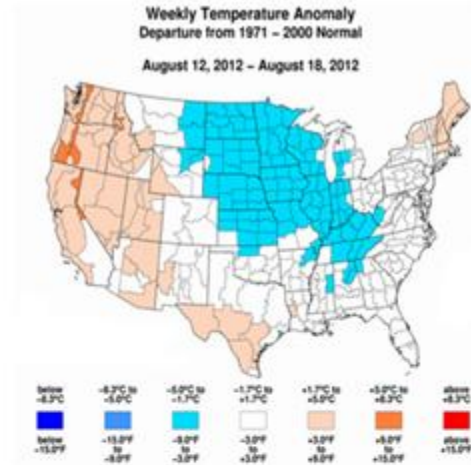


Source: U.S. Department of Commerce

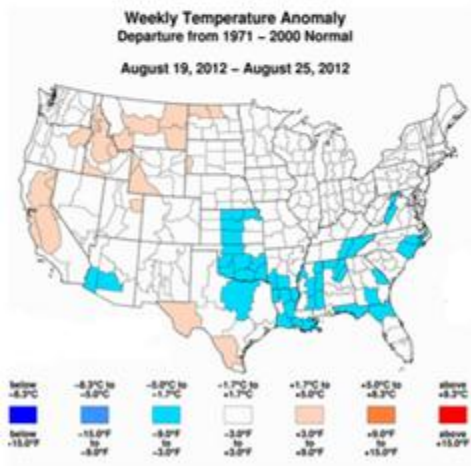
The following maps illustrate weekly temperature trends during August 2012 relative to the long-term averages. We would note that the most unfavorable trends were seen in the Midwest and upper Plains states.



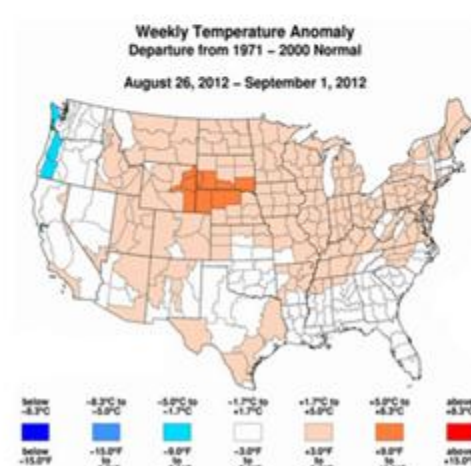
Source: U.S. Department of Commerce



Source: U.S. Department of Commerce



Source: U.S. Department of Commerce

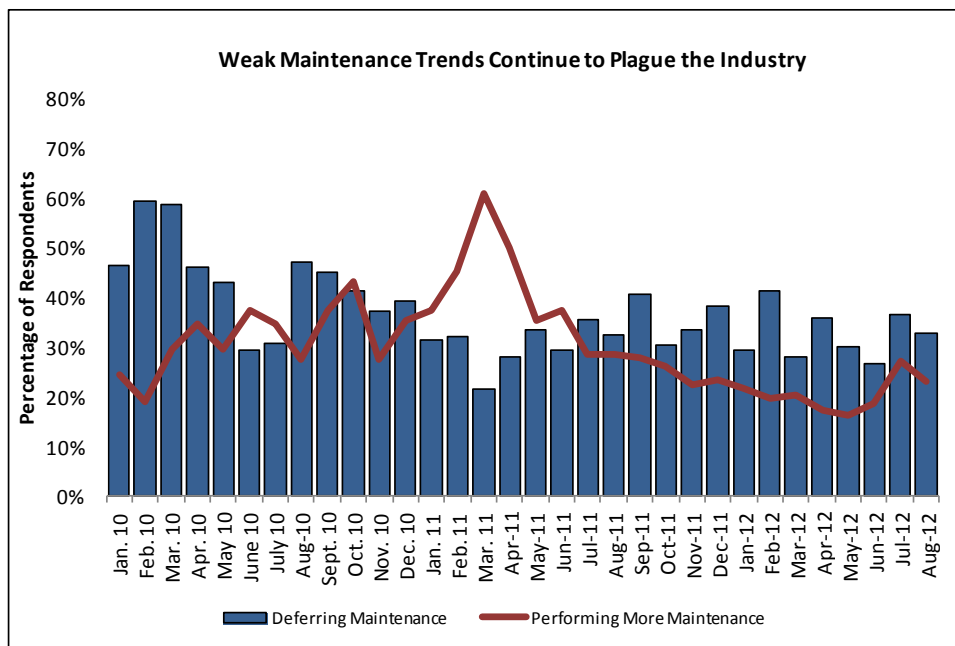


Source: U.S. Department of Commerce

Deferred Maintenance Remains a Headwind

In what is becoming to sound like a broken record, our contacts noted that the behavior toward routine maintenance remained a headwind to sales and traffic trends during August. As we mentioned previously, the modest sales increase during the month was a function of a higher average ticket, which offset weaker traffic trends. Specifically, 9.9% of the respondents, on a net basis, reported that their customer base was deferring routine maintenance, which is up slightly from a net 9.5% in July. In our opinion, this performance validates our theory that last month’s favorable swing in traffic was merely the result of favorable weather patterns, and that the underlying demand trends in the industry were, and remain anemic.

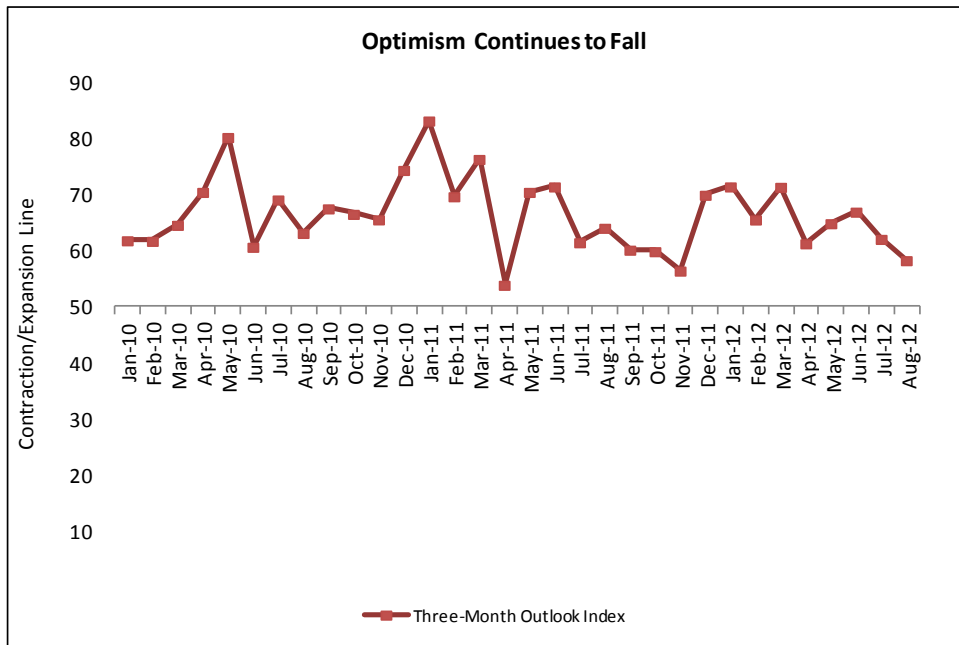
We continue to believe this behavior characteristic represents a formidable headwind for the automotive aftermarket parts retailers as the maintenance category represents a significant portion of their sales mix. Specifically, we estimate that the average store generates 35% to 45% of its revenue from maintenance-related merchandise. Additionally, maintenance services, including brake work, comprise approximately 46% of the sales mix at Monro Muffler Brake.



Source: Northcoast Research

Optimism Continues to Wane

Despite the fact that our survey respondents noted that sales trends increased year-over-year for the second consecutive month (the first occurrence in eight months), the Three Month Outlook Index dropped 6.1% to close at 58.4. The deterioration was driven by a decline in the number of respondents expecting to generate year-over-year sales gains during the next three months, as well as an increase in the number of garage owners anticipating that sales will decline over the same period. The four most commonly cited reasons for a slightly more pessimistic outlook were: (1) September business has gotten off to a slow/choppy start; (2) traffic and maintenance trends remain weak; (3) increased promotional activity was required to drive the stabilization in demand trends during the past two months, which is not a sustainable strategy; and (4) there are concerns that the trend of rapidly rising gasoline prices will cause the consumer to retrench. In our view, the latter factor is particularly concerning given the fact that the industry operated against a backdrop of lower year-over-year gas prices from May through July and demand trends across the industry during this period were weak.



Source: Northcoast Research

We were not surprised to see the Three Month Outlook Index decline as our channel checks in the space continue to suggest that the consumer is weak and that demand trends remain relatively anemic and very volatile. In our view, the soft demand trends that have been witnessed across the industry this year are partially emblematic of a structural change in the demographics of the nation’s light vehicle fleet, which we think is pressuring the underlying spending trends of consumers. As a result, we anticipate the operators’ outlook will continue to moderate as we move deeper into the structural change.

A Quick Look at Same-Store Estimates

Despite the fact our survey indicated that demand trends continued to stabilize in August, we still believe that the underlying demand trends across the DIFM channel are relatively weak and remain highly volatile, as our Current Sales Index has finished in negative territory in 5 of the past 8 months. Furthermore, many of our contacts have noted that business trends during September have been lackluster as the benefit from the excessive heat unwinds and the price of fuel has risen. As a result, we are maintaining our current 3Q CY12 estimates for Advance Auto Parts, AutoZone, O'Reilly and Monro until we see how September shakes out. The table below summarizes our current comparable-store sales estimates:

Comparable-Store Sales Trends						
Retailer						
Advance Auto Parts (AAP)	Dec-11	Apr-12	Jul-12	Oct-12E	Dec-12E	Apr-12E
Northcoast Research Estimates	2.9%	2.1%	(2.7%)	(1.3%)	(0.1%)	2.9%
Consensus				(1.3%)	(0.5%)	1.6%
AutoZone (AZO)	Nov-11	Feb-12	May-12	Aug-12	Nov-13E	Feb-14E
Northcoast Research Estimates	4.6%	5.9%	3.9%	2.1%	2.8%	2.9%
Consensus					2.4%	2.8%
Monro Muffler Brake (MNRO)	Dec-11	Mar-12	Jun-12	Sept-12E	Dec-12E	Mar-12E
Northcoast Research Estimates	0.0%	0.7%	(7.2%)	(4.5%)	2.5%	4.0%
Consensus				(5.3%)	2.9%	3.6%
O'Reilly (ORLY)	Dec-11	Mar-12	Jun-12	Sept-12E	Dec-12E	Mar-12E
Northcoast Research Estimates	3.3%	6.1%	2.5%	2.3%	3.2%	3.5%
Consensus				2.3%	3.7%	2.9%

Source: Company Reports, Northcoast Research estimates

Anecdotal Comments

Below are four anecdotal comments that best reflect what we heard from the survey respondents during the month.

- “While business was weak in August, I feel that it is not just my shop as I have heard that others in my area have also been very slow.” (New York)
- “Consumers are still deferring maintenance at an abnormal rate, which is weighing on sales. I think that this behavior is related to a general sense of uneasiness surrounding the strength of the economy.” (Georgia)
- “All of this deferred maintenance has led to increased parts failures. Needless to say, my business benefited from all of the higher-ticket repair work we did during August; however, traffic trends were weak.” (North Carolina)
- “I think that my customers are doing less maintenance because they just don’t have much money and they are so uncertain about the economy that they don’t want to commit cash to any non-essential repair.” (New York)

Conclusion and Investment Thesis

While we continue to appreciate the opportunity that the publicly traded players in the automotive aftermarket have to gain market share in the DIFM channel, current valuations are not attractive enough to pique our interest, especially given the recent deterioration in sales trends and signs that the industry remains under some pressure. Furthermore, we have growing concerns over what a changing mix of automobiles in the nation’s light vehicle fleet could mean for demand trends over the next 4 to 5 years. See our recent initiation on Monro Muffler Brake for more details. As a result, we are maintaining our NEUTRAL ratings on Advance Auto Parts, AutoZone, Monro Muffler Brake and O’Reilly Automotive.

DISCLOSURES

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Ratings

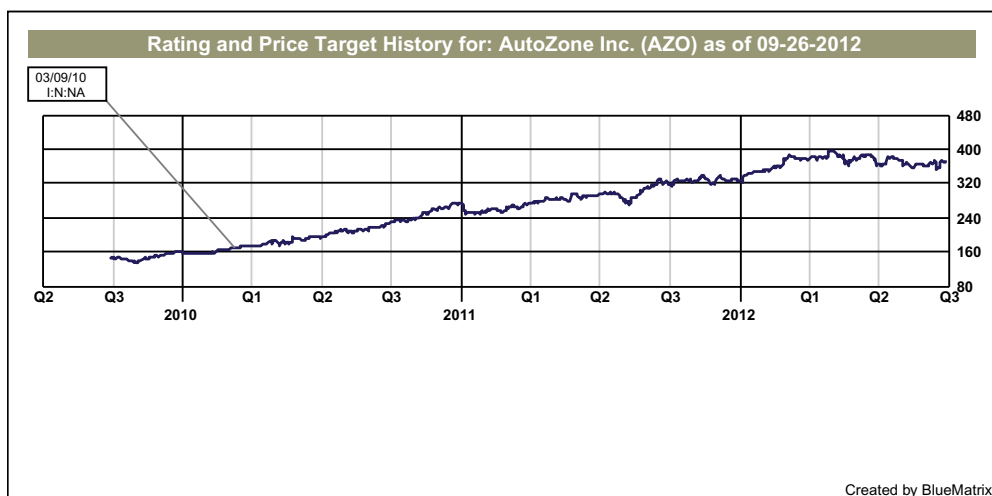
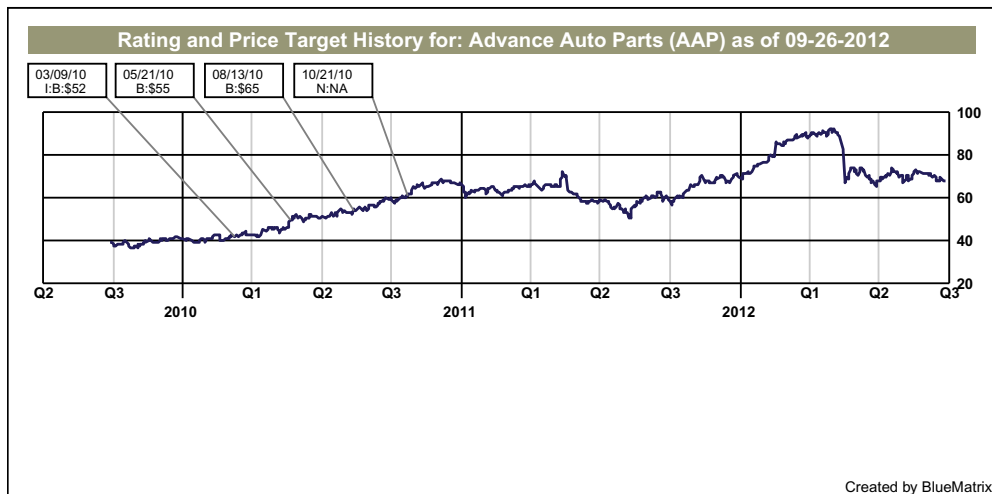
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

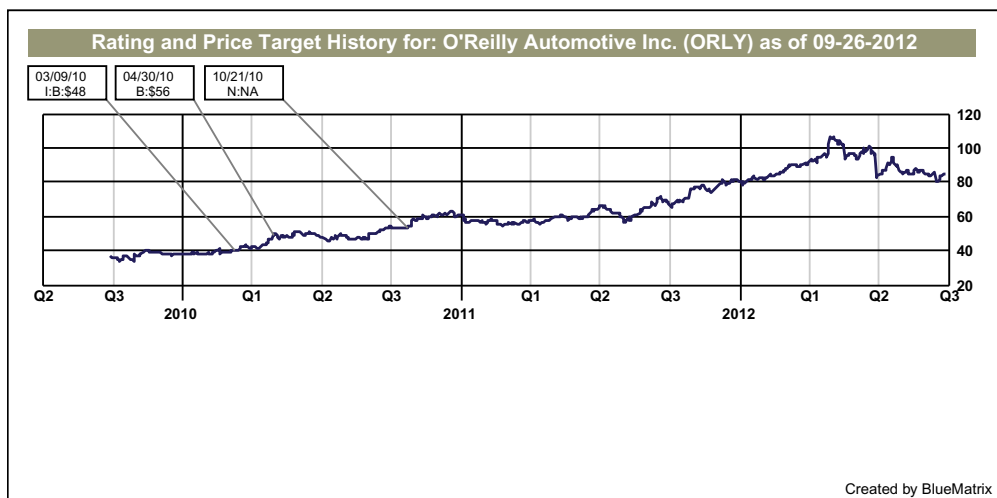
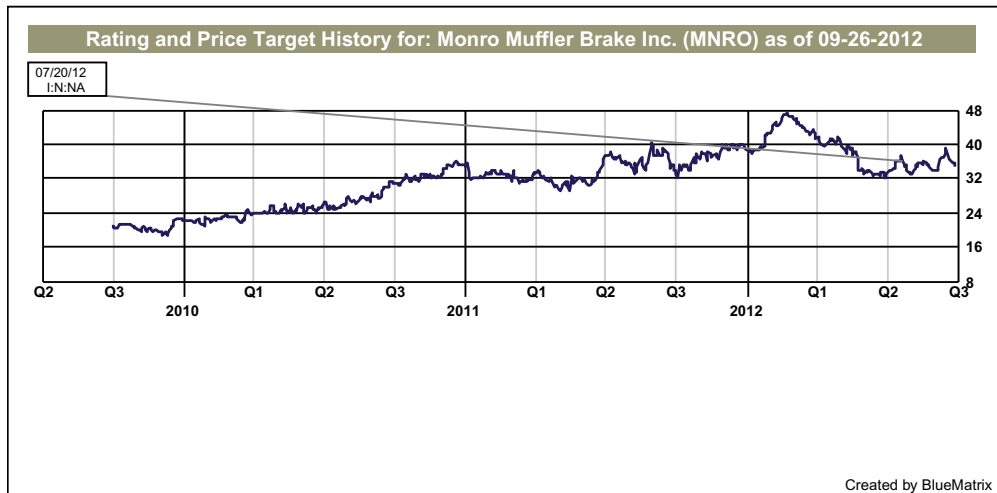
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

SELL – The stock is expected underperform the S&P 500 index over a twelve-month period.

Valuation and Risks

Our price target as well as our recommendation is based on a 12-month time horizon; however, we cannot guarantee an investor will achieve these results. We use a variety of methods to determine the price target of individual securities including fundamental analysis. In addition, we employ numerous valuation methodologies which include, but are not limited to, price to earnings multiples, enterprise value to earnings before interest taxes, and depreciation (EBITDA), book value, free cash flow yield, discounted cash flow, and relative valuation. All securities are subject to various risk factors. Please reference the above text and our most recent report for specific company valuation and price target.





Rating Summary

Distribution of Ratings Table		
Rating	Count	Percent
BUY(B)	72	47.37%
NEUTRAL(N)	79	51.97%
SELL(S)	1	0.66%
Total	152	

Analyst Certification

I, Nick Mitchell and Seth Woolf, certify that the views and opinions expressed in the research report accurately reflect my personal views about the securities and issuers mentioned in this report. Further, I certify that no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this report.

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