Automotive Aftermarket Retailers

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Independent Automotive Repair Garage Survey: April 2012

Overview

- According to the results of our survey, sluggish sales trends returned to the industry in April after a brief respite in March, as the Current Sales Index fell 21.8% in April to close at 41.8, which was the second lowest reading that we have recorded since the inception of our survey.
- Furthermore, with last month's reading coming in below 50.0, the index has now been in contraction territory for 3 of the past 4 months. In our view, this strongly suggests that the DIFM channel is experiencing demand pressure relative to recent quarters.
- Moreover, we believe that the weakness is also reflected in a more promotional pricing environment over the past month as many aftermarket parts resellers are attempting to take market share with sharper pricing, especially on fast turning parts like break pads.
- According to our research, the sales pressure can be attributed to a sequential drop off in year-over-year traffic trends at the garages, which more than offset the benefit of solid ticket trends that continued to benefit from a mix shift to failure work (higher average ticket than maintenance jobs), as well as rising product costs, which are being passed through to consumers.
- According to our contacts, consumers' deferral of preventative maintenance was a major contributor to the soft traffic trends during April, which clearly depressed demand. In fact, with the exception of February, this is the worst level for our deferred maintenance indicator that we have seen since 2010.
- The Three Month Outlook Index fell 14.1% to close the month at 61.4. This decline reflects the fact that a smaller proportion of respondents anticipate year-over-year sales gains during the next 3 months (May, June and July).

Conclusion

While we continue to appreciate the opportunity that the national automotive parts retailers have to gain market share in the DIFM channel, current valuations are not attractive enough for us to dip our toes back into the water, especially given the decelerating sales trends and signs that the consumer remains under 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 note entitled ORLY: Change in Light Vehicle Mix Likely to be a Headwind in Coming Years for more details. As a result, we are maintaining our NEUTRAL ratings on Advance Auto Parts, AutoZone, and O'Reilly Automotive.

Symbol:	Price	Target Price	Rating	EPS Cur Qtr	EPS Cur Year	EPS Out Year	Mkt. Cap (M)
AAP	68.17	NA	N	$1.41e	$5.69e	$6.22e	4,992.8
AZO	$365.58	NA	N	$6.41e	$23.77e	$27.63e	$14,247.2
ORLY	$94.32	NA	N	$1.15e	$4.62e	$5.11e	$11,892.9

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

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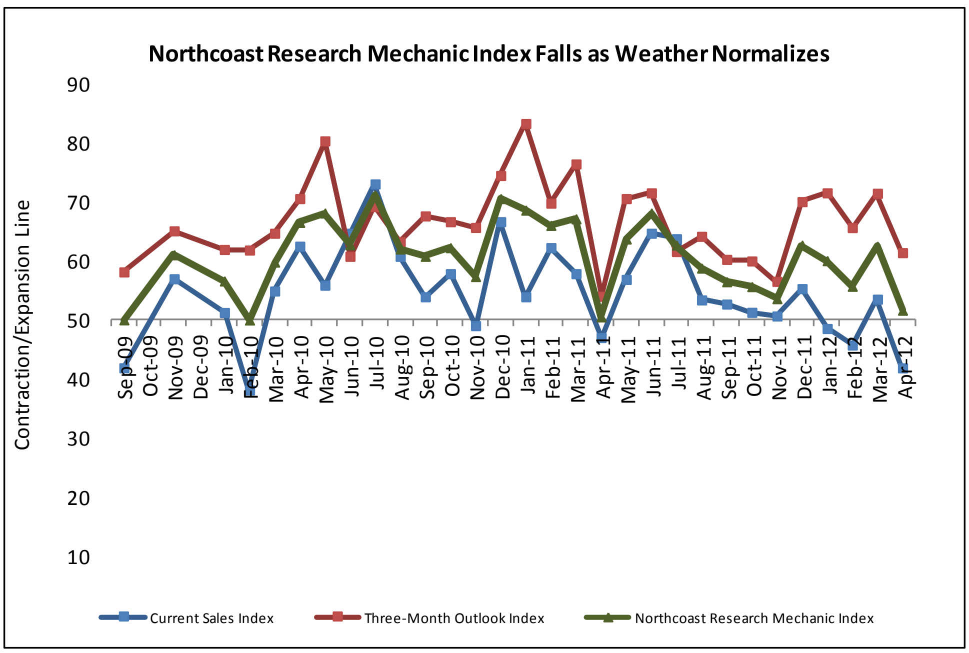
Independent Automotive Repair Garage Survey

Each month we publish the ***Northcoast Research Mechanic Index*** based on the results of our survey, which encompasses 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–April Snapshot



Source: Northcoast Research

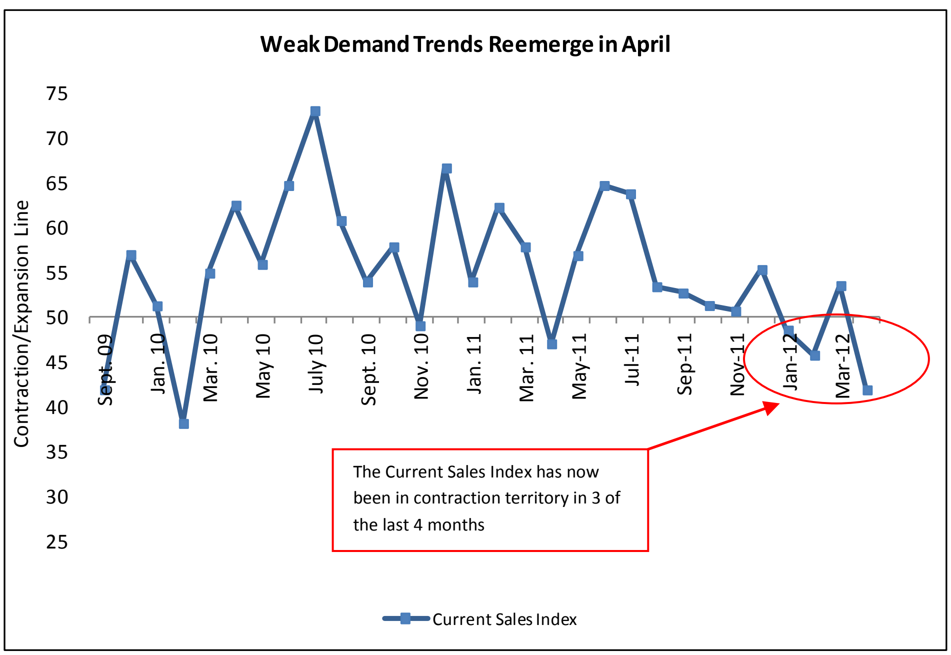
According to the results of our survey, sluggish sales trends returned to the industry in April after a brief respite in March, as the Current Sales Index dropped to 41.8. Recall that with the exception of March, business conditions in the DIFM channel have been lackluster since the end of 2011. Furthermore, the print below 50.0 implies that year-over-year demand trends in the DIFM channel contracted during the period. Additionally, the aggregate outlook for future demand also deteriorated in conjunction with the weakness in the month. All in, the softer sales trends coupled with the tempered outlook resulted in a

17.4% decline in the composite index to 51.6. We provide further details on the drivers of the two sub-indices below.

Demand Trends Slip in April

The Current Sales Index fell 21.8% in April to close at 41.8, which was the second lowest reading that we have recorded since the inception of our survey. Furthermore, with last month's reading coming in below 50.0, the index has now been in contraction territory for 3 of the past 4 months. In our view, this strongly suggests that the DIFM channel is experiencing demand pressure relative to recent quarters. Moreover, we believe that the weakness is also reflected in a more promotional pricing environment over the past month as many aftermarket parts resellers are attempting to take market share with sharper pricing, especially on fast turning parts like break pads. In fact, while we do not publish the results of our questions regarding the pricing environment, the responses in April imply that the level of promotional activity in period was the most intense that we have seen in the past 12 months.

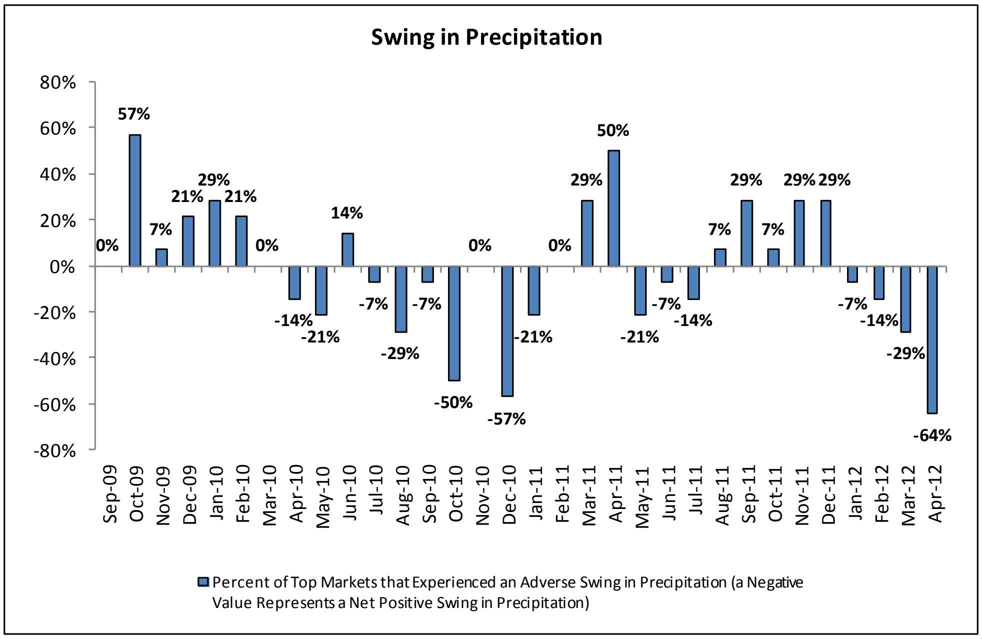
According to our research, the sales pressure can be attributed to a sequential drop off in year-over-year traffic trends at the garages, which more than offset the benefit of solid ticket trends that continued to benefit from a mix shift to failure work (higher average ticket than maintenance jobs), as well as rising product costs, which are being passed through to consumers. While the DIY channel was obviously the primary beneficiary of the pull-forward in demand that occurred in March due to the unseasonably warm weather in March, we think that the modest uptick in demand that we picked up during our last survey was also partially a function of the warmer weather. Additionally, we think it is worth pointing out that the readings in the Current Sales Index during the January through April period represented the weakest four-month moving average since we began our survey in 2009.



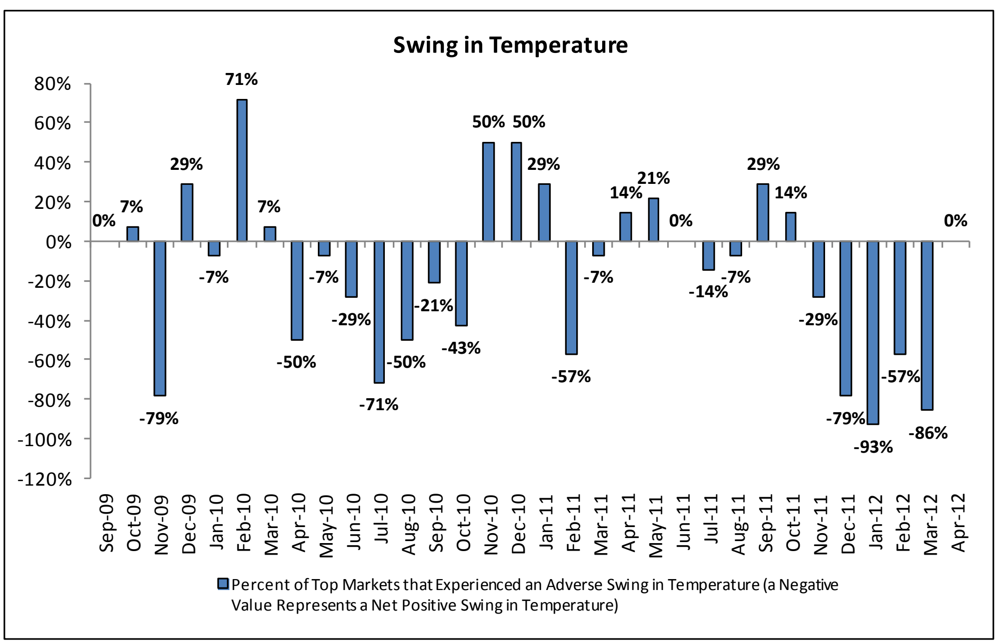
Source: Northcoast Research

Temperature Trends Normalize

According to our proprietary weather screen, precipitation trends in the key markets of our survey were much drier than in the prior year's period. That said, the tailwind from unseasonably warm weather clearly disappeared as temperature trends normalized. Specifically, the first chart below illustrates that precipitation was lighter, as a net 64% of the markets witnessed less precipitation during the month. The second chart highlights the fact that temperatures were virtually unchanged from the prior year, as a net 0% of the territories experienced warmer weather.

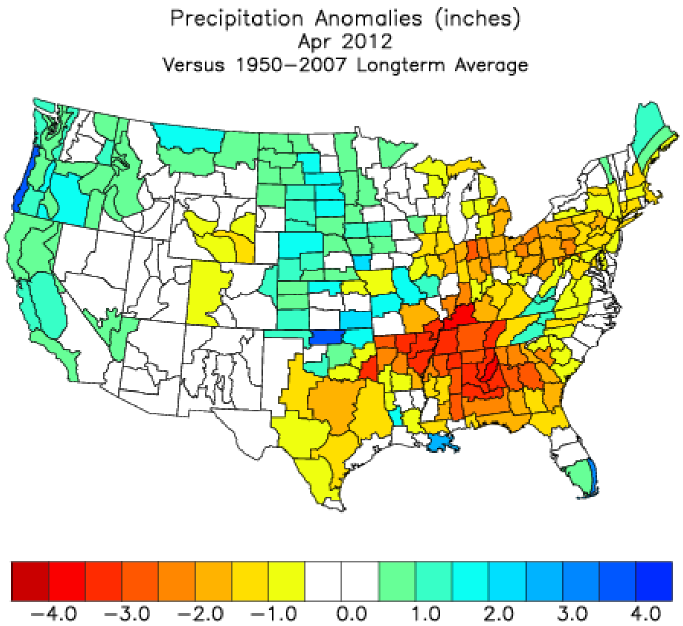


Source: Northcoast Research, U.S. Department of Commerce

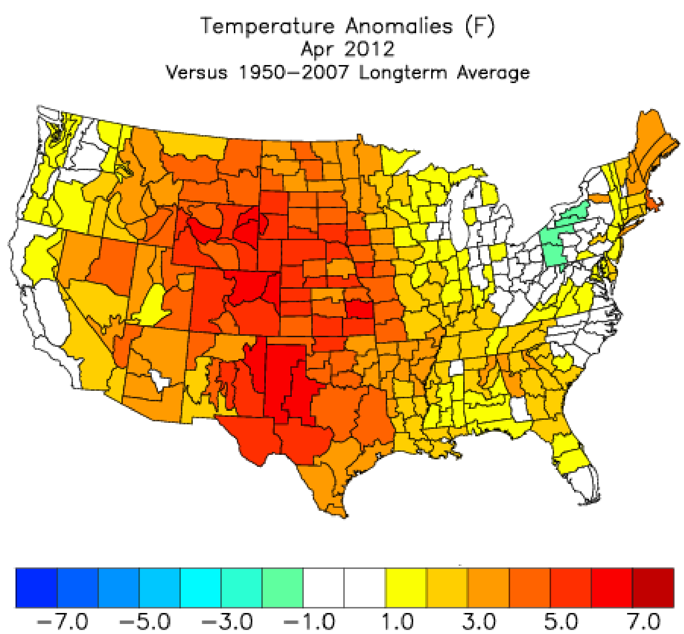


Source: Northcoast Research, U.S. Department of Commerce

The following two maps illustrate the most unusual precipitation and temperature trends during April 2012 relative to the long-term averages.



Source: U.S. Department of Commerce



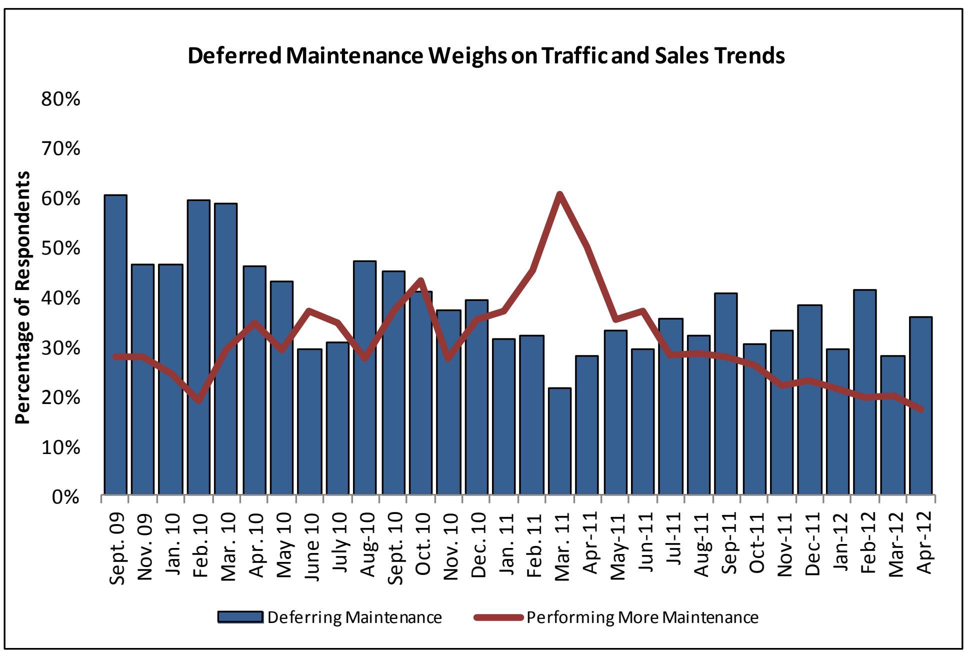
Source: U.S. Department of Commerce

Headwind from Deferred Maintenance Intensifies

According to our contacts, consumers' deferral of preventative maintenance was a major contributor to the soft traffic trends during April, which clearly depressed demand. Specifically, 18.5% of respondents, on a net basis, reported that their customer base was deferring routine maintenance versus a net 7.9% in the prior month. With the exception of February, this is the worst level for our deferred maintenance indicator that we have seen since 2010. We were clearly disappointed to see that deferred maintenance trends deteriorated sequentially, and we believe this performance suggests that the underlying fundamentals in the industry are far from healthy.

The chart below illustrates that the proportion of contacts noting that consumers are putting off preventative maintenance rose to 35.9%, versus 28.1% in March. Additionally, the percentage of respondents reporting that their customers were performing more preventative maintenance fell to 17.4% from 20.2% in March. It should be noted that this represents the lowest level that we have recorded in the nearly three years that we have been conducting our survey.

We continue to believe this behavior represents a 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.

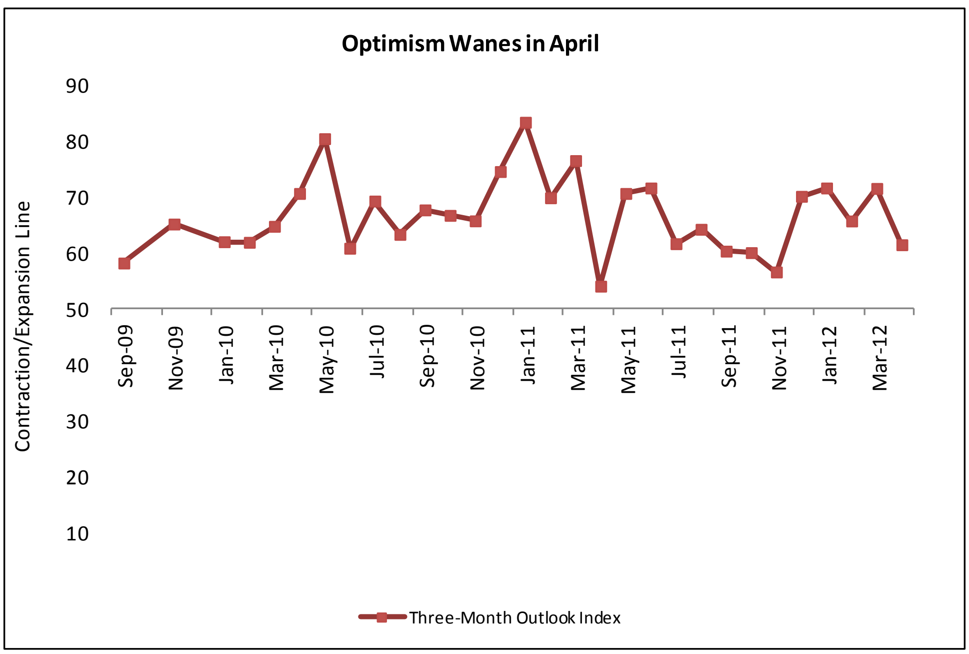


Source: Northcoast Research

Optimism Wanes as Demand Declines

The Three Month Outlook Index fell 14.1% to close the month at 61.4. This decline reflects the fact that a smaller proportion of respondents anticipate year-over-year sales gains during the next 3 months (May, June and July). The less robust outlook was a function of the weak trends in April and the fact that May has gotten off to a soft start for many of the respondents. Anecdotally, many garage owners commented that they believe that the promotional activity by the parts resellers is indicative of a much broader slowdown in the industry. Among the respondents that envision stronger year-over-year sales in the next three months, the overriding theme was that the soft trends of recent months should result in a release of pent-up demand at some point in the future. Additionally, many garage owners expressed optimism that the warmer-than-usual temperature trends that have characterized much of the year thus far will continue into the summer. Recall that intense heat in the summer can be a huge driver of demand.

That said, the Three Month Outlook Index was well below the average reading of 66.8 since its inception. Given the below average level of optimism among our survey respondents, the evidence of an increase in promotional activity and a slowdown in demand trends during April, we have no choice but to maintain our cautious outlook regarding near-term demand trends.



Source: Northcoast Research

Moreover, the fact that demand continued to be soft in light of the fact that the headwind related to higher gasoline prices was essentially flat with the year-ago period is somewhat disconcerting. In April, the average price of retail gasoline increased $0.05 per gallon from March to $3.93 a gallon, which was only 2.8% higher than the prior year's period. We estimate that on an annualized basis, the drag on the average household from higher fuel prices was a merely $120.

A Quick Look at Same-Store Estimates

Our recent research indicated that industry-wide demand trends in the DIFM channel were weak in April following a slight recovery in sales trend during March. Generally speaking, we continue believe that industry-wide DIFM sales trends are far from robust, especially as our Current Sales Index has finished in negative territory in 3 of the past 4 months. At this point, we are maintaining our 2Q CY12 estimates for Advance Auto Parts (revised following 1Q FY12 results) and O'Reilly Automotive until we gain more insight into trends in May and June. As for AutoZone's 3Q FY13 results, our research suggests that an acceleration of trends on the DIY side of the business that took place in the quarter due to the warmer-than-normal weather provided a huge tailwind during the period, and was a natural offset to the industry-wide slowdown in April. As a result, we are maintaining our recently revised estimate of 5.7%.

Comparable-Store Sales Trends

Retailer						
	Jul-11	Oct-11	Dec-11	Apr-12	Jul-12E	Oct-12E
Advance Auto Parts (AAP)	2.5%	2.2%	2.9%	2.1%		
Northcoast Research Estimates					-1.2%	2.0%
Consensus					2.1%	2.5%
	May-11	Aug-11	Nov-11	Feb-12	May-12E	Aug-12E
AutoZone (AZO)	5.3%	4.5%	4.6%	5.9%		
Northcoast Research Estimates					5.7%	4.8%
Consensus					4.7%	4.5%
	Jun-11	Sept-11	Dec-11	Mar-12	Jun-12E	Sept-12E
O'Reilly (ORLY)	4.4%	4.8%	3.3%	6.1%		
Northcoast Research Estimates					4.3%	4.7%
Consensus					4.3%	4.6%

Source: Company Reports, Northcoast Research estimates

Anecdotal Comments

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

- "If we don't get a really hot summer around here, I'm afraid that my sales will decline on a year-over-year basis as customer traffic has been a real problem for me." (Pennsylvania)
- "My monthly revenue took a big hit because the local cable company [biggest business account] recently decided to stretch the maintenance intervals on their entire fleet." (Alabama)
- "All of the suppliers seem to be really promotional right now. It transcends just prices, the sales reps have been really aggressive lately touting their brands; I've heard that the whole region has been pretty slow." (Ohio)
- "Advance Auto Parts just brought back a package deal on brakes and rotors that it was running back in the fall. According to my sales rep, the company reintroduced the promotion because business has been very slow over the past 6 weeks." (Ohio)
- "As has been the case over the past 6 months, my traffic was really soft. Fortunately, I had a couple of really expensive repairs bail me out and my shop ended up having a slightly better month than in 2011. I would assume that people would start coming in to get their

maintenance work done sooner than later, so they can avoid big-ticket repairs down the road, but it hasn't happened yet." (Missouri)

Conclusion and Investment Thesis

While we continue to appreciate the opportunity that the national automotive parts retailers have to gain market share in the DIFM channel, current valuations are not attractive enough for us to dip our toes back into the water, especially given the decelerating sales trends and signs that the consumer remains under 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 note entitled ***ORLY: Change in Light Vehicle Mix Likely to be a Headwind in Coming Years*** for more details. As a result, we are maintaining our NEUTRAL ratings on Advance Auto Parts, AutoZone, and O'Reilly Automotive.

DISCLOSURES

Research is produced by Northcoast Research Partners, LLC Member FINRA(www.finra.org) and SIPC (www.sipc.org). Although we believe this information has been obtained from reliable sources, we don't guarantee its accuracy, and it may be incomplete or condensed. Past performance is not indicative of future results. A change in any assumptions may have a material effect on the projected results.

Securities are offered through Ancora Securities, Inc. Member FINRA (www.finra.org) and SIPC (www.sipc.org).

Ratings

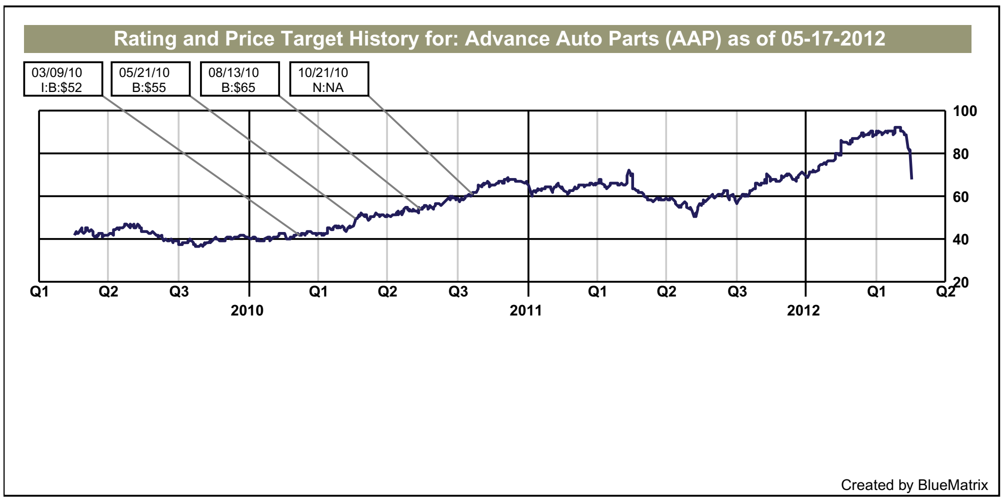
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

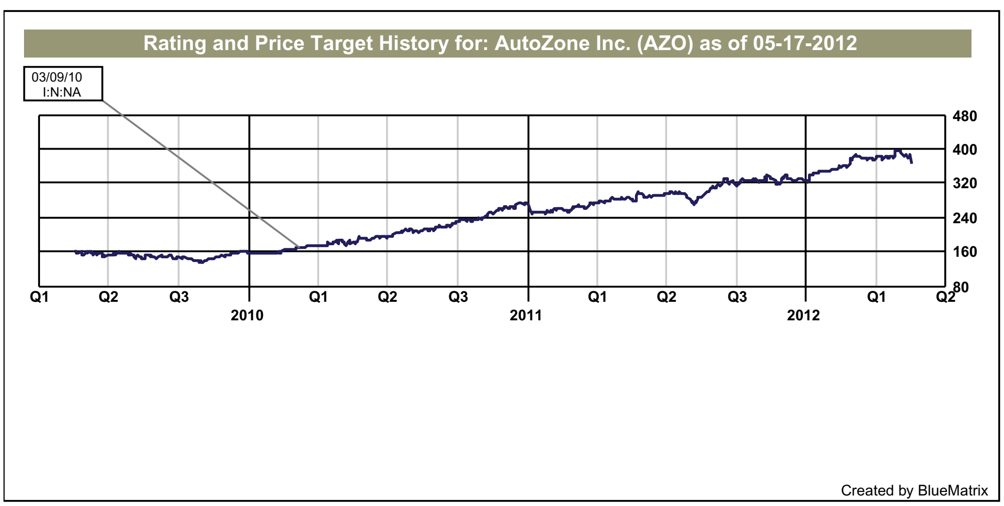
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

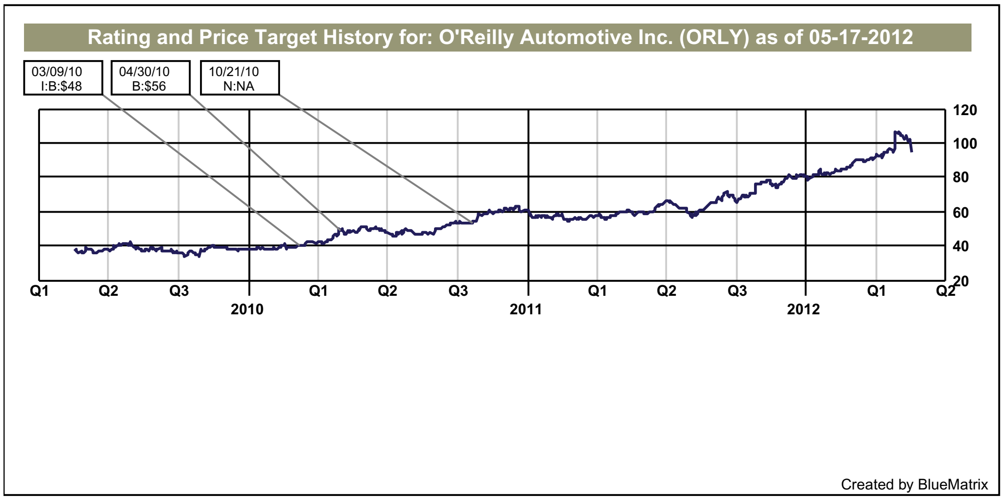
SELL – The stock is expected underperform the S&P 500 index over a twelve-month period.

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)	61	46.21%
NEUTRAL(N)	69	52.27%
SELL(S)	2	1.52%
Total	132	

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.