Automotive Aftermarket Retailers

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Independent Automotive Repair Garage Survey: May 2012

Overview

- According to the results of our survey, sales trends in the DIFM channel during May continued to be somewhat weak, as our Current Sales Index rose 13.0% in May to close at 47.3.
- With last month's reading coming in below 50.0, the index has now been in contraction territory for 4 of the past 5 months. In our view, this strongly suggests that the DIFM channel is experiencing demand pressure relative to recent quarters.
- The sales weakness appears to have been a function of soft traffic trends at the garages, which has been a recurring theme for several months now. This dynamic offset the benefit of a year-over-year gain in the average ticket.
- Furthermore, respondents noted that the environment continued to be very promotional, which we believe is symptomatic of the underlying weakness in industry demand.
- According to our contacts, sales and traffic trends during May were inhibited by consumers deferring preventative maintenance; however, the magnitude was not as severe as was the case in April.
- The Three Month Outlook Index rose 5.8% to close the month at 65.0, as there was a sequential increase in the number of respondents who anticipate year-over-year sales gains during the next three months (June, July and August).

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 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 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	70.69	NA	N	$1.41e	$5.69e	$6.22e	5,196.7
AZO	$386.73	NA	N	$8.54e	$23.58e	$27.55e	$14,476.8
ORLY	$101.48	NA	N	$1.15e	$4.62e	$5.11e	$12,795.7

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

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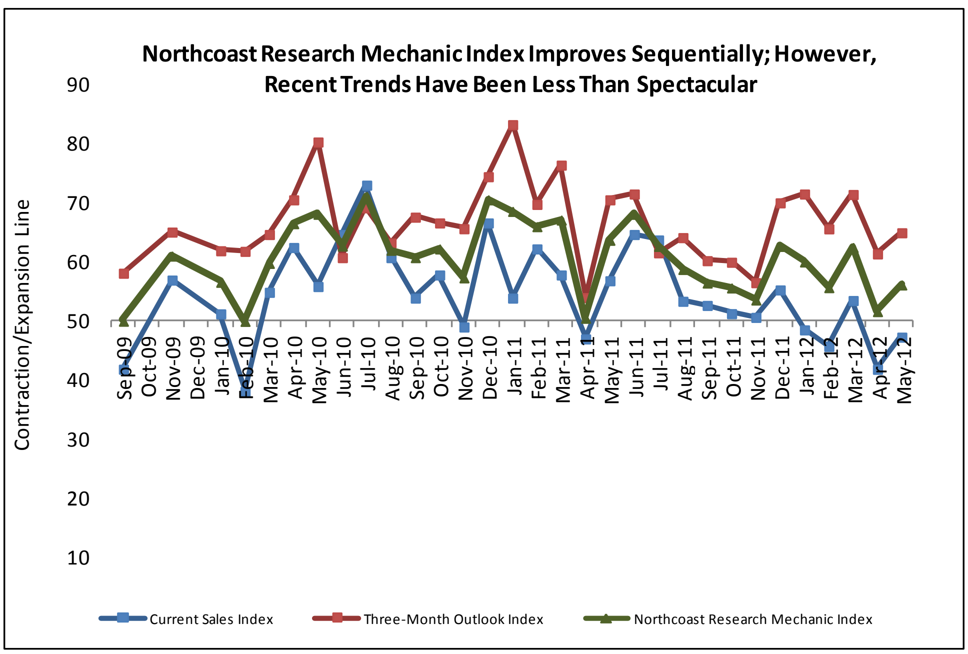
Independent Automotive Repair Garage Survey

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–May Snapshot



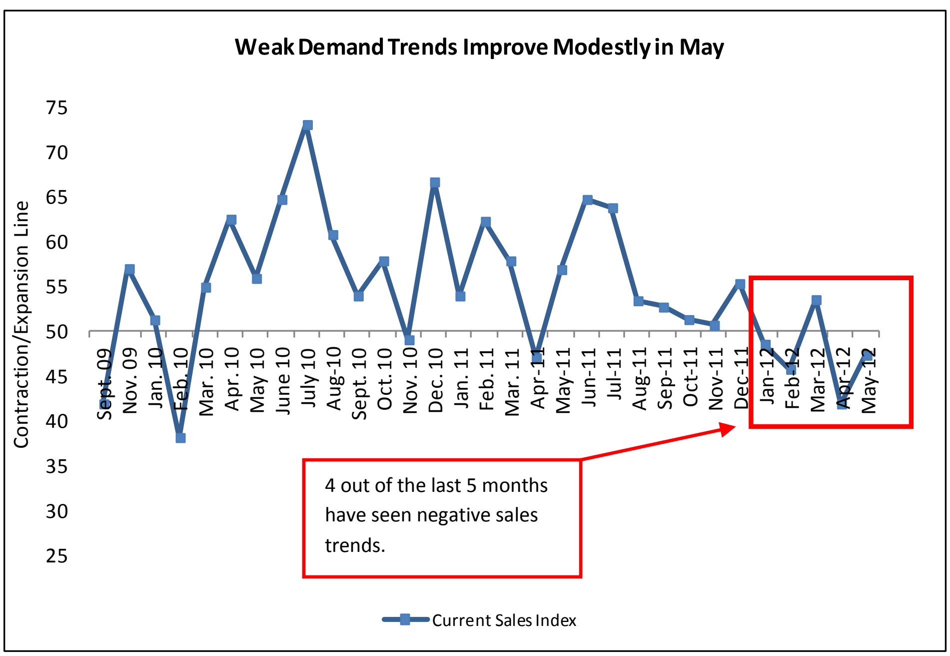
Source: Northcoast Research

According to the results of our survey, sales trends in the DIFM channel during May continued to be somewhat weak, as our Current Sales Index finished at 47.3. While the final print was below 50.0, which implies that year-over-year demand contracted during the period, it does appear that the business environment improved modestly on a sequential basis. Additionally, the aggregate outlook for future demand improved slightly. All in, the slight recovery in current sales trends sequentially, coupled with a modest uptick in the three-month outlook resulted in an 8.8% gain in the composite index to 56.1. We provide further details on the drivers of the two sub-indices below.

The Deterioration in Demand Trends Moderated in May

The Current Sales Index rose 13.0% in May to close at 47.3. While we were encouraged that May's performance represented a sequential improvement from April, a month in which industry demand fell off of a cliff, the final print does indicate that business trends remained relatively weak during the month. Furthermore, respondents noted that the environment continued to be very promotional (at the wholesale level, as well as at the garages), which we believe is symptomatic of the underlying weakness in industry demand. In other words, we believe many aftermarket parts resellers are utilizing sharper pricing in an attempt to drive market share gains in response to the recent weakness in industry-wide sales trends.

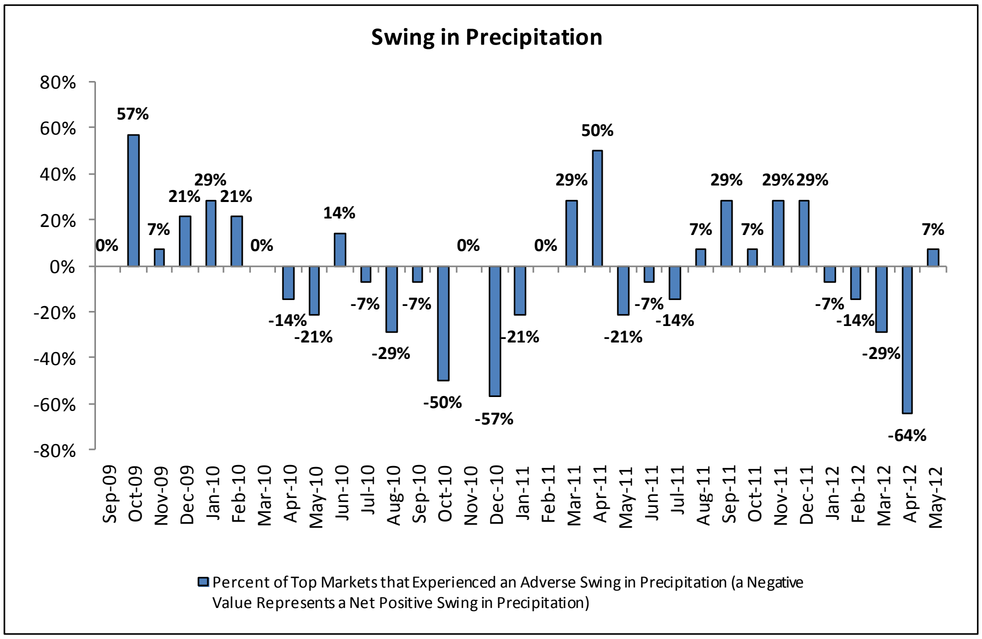
The sales weakness appears to have been a function of soft traffic trends at the garages, which has been a recurring theme for several months now. This dynamic offset the benefit of a year-over-year gain in the average ticket. In our view, the fact that consumers continued to defer routine maintenance during the month was the largest driver of the lackluster traffic trends seen across the industry. That said, we find it encouraging that the traffic declines appear to have moderated sequentially. On the other hand, the proportion of respondents experiencing higher ticket trends was the lowest in months, which is somewhat concerning given that this has been the primary driver of sales in recent months.



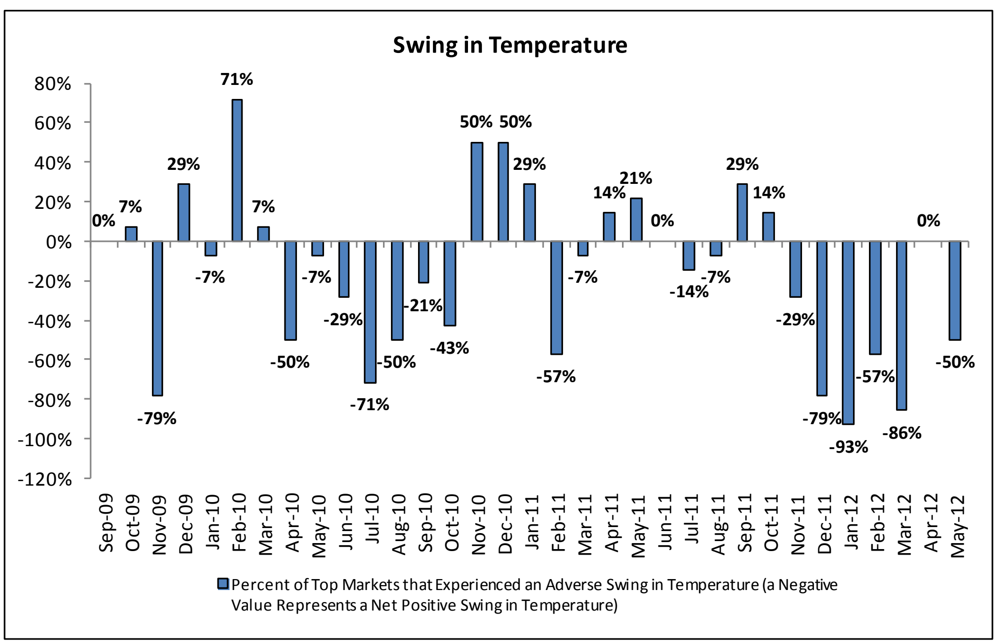
Source: Northcoast Research

Favorable Temperature Trends Return

According to our proprietary weather screen, precipitation trends in the key markets of our survey were unchanged relative to the prior year's period. That said, warmer-than-usual weather clearly reappeared in May. Specifically, the first chart below illustrates that precipitation was only modestly heavier, as just 7.0% of the markets witnessed more precipitation during the month, on a net basis. The second chart highlights the fact that temperatures increased from the prior year, as a net 50.0% of the territories experienced warmer weather.

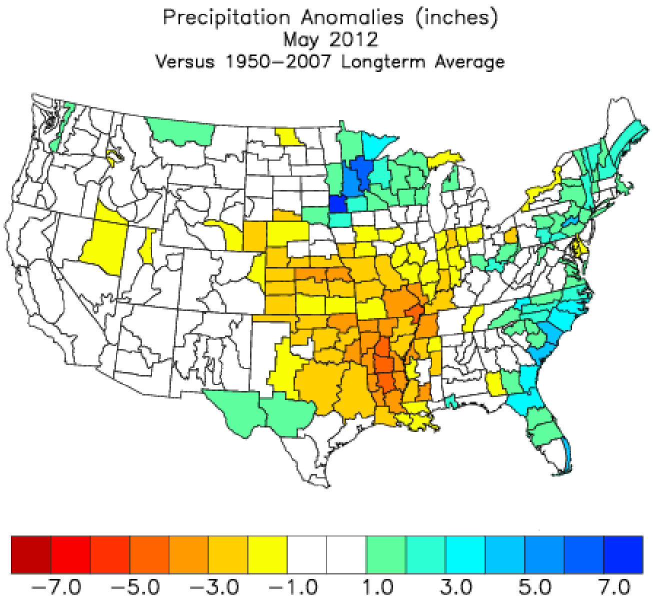


Source: Northcoast Research, U.S. Department of Commerce

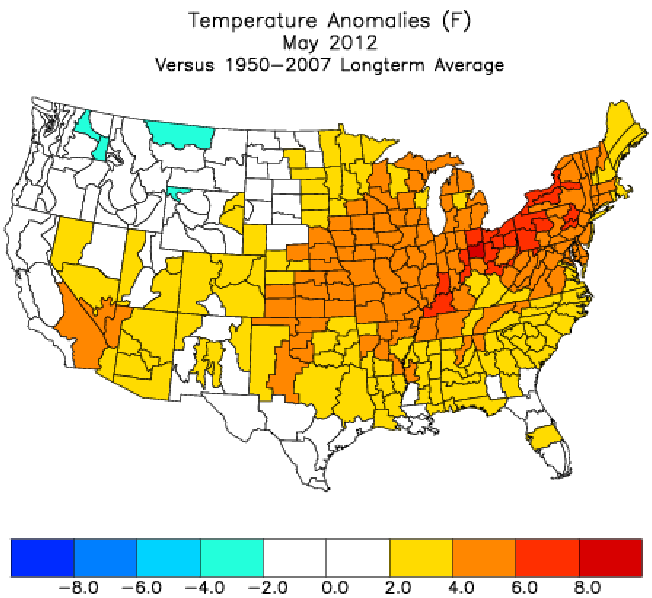


Source: Northcoast Research, U.S. Department of Commerce

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



Source: U.S. Department of Commerce



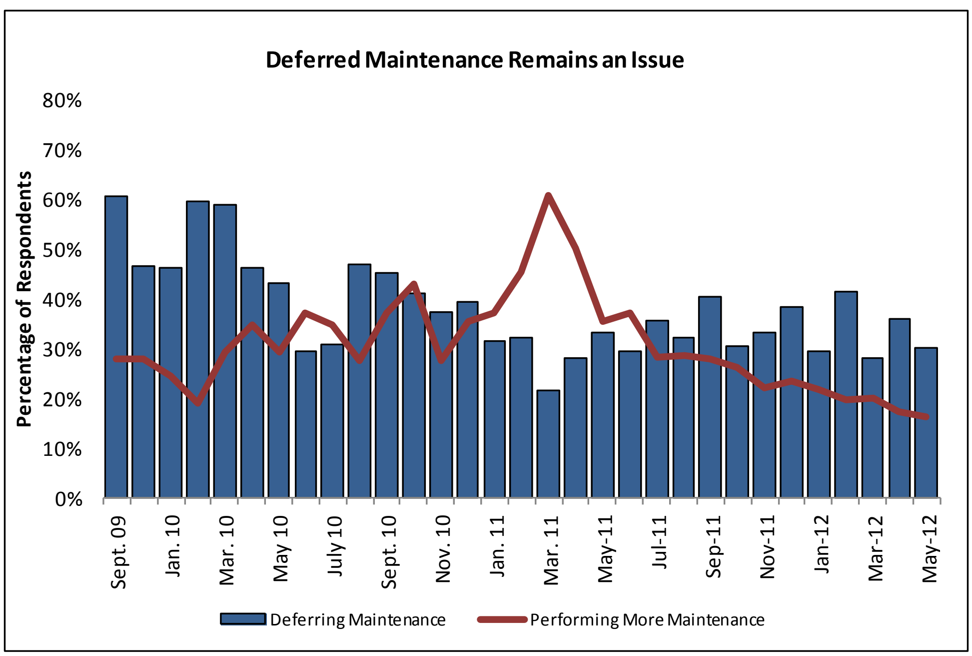
Source: U.S. Department of Commerce

Headwind from Deferred Maintenance Moderates Slightly, but Still Remains an Issue

According to our contacts, sales and traffic trends during May were inhibited by consumers deferring preventative maintenance; however, the magnitude was not as severe as was the case in April. Specifically, 13.6% of respondents, on a net basis, reported that their customer base was deferring routine maintenance versus a net 18.5% in the prior month. While it is obviously more beneficial than not to see deferred maintenance trends improve sequentially, we would be remiss not to point out the fact that with the exception of December 2011, February 2012 and April 2012, May was the worst month for deferred maintenance since August 2010. In short, this metric needs to see significant improvement before the overhang on demand subsides.

The chart below illustrates that the proportion of contacts noting that consumers are putting off preventative maintenance fell to 30.0%, versus 35.9% in April. Additionally, the percentage of respondents reporting that their customers were performing more preventative maintenance was essentially flat at 16.4% versus 17.4% in April. We would point out that 16.4% represents the lowest level that we have recorded in the nearly three years that we have been conducting our survey. As we have said in the past, we believe that deferred maintenance behavior needs to improve in order for sustainable gains in traffic to occur.

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.

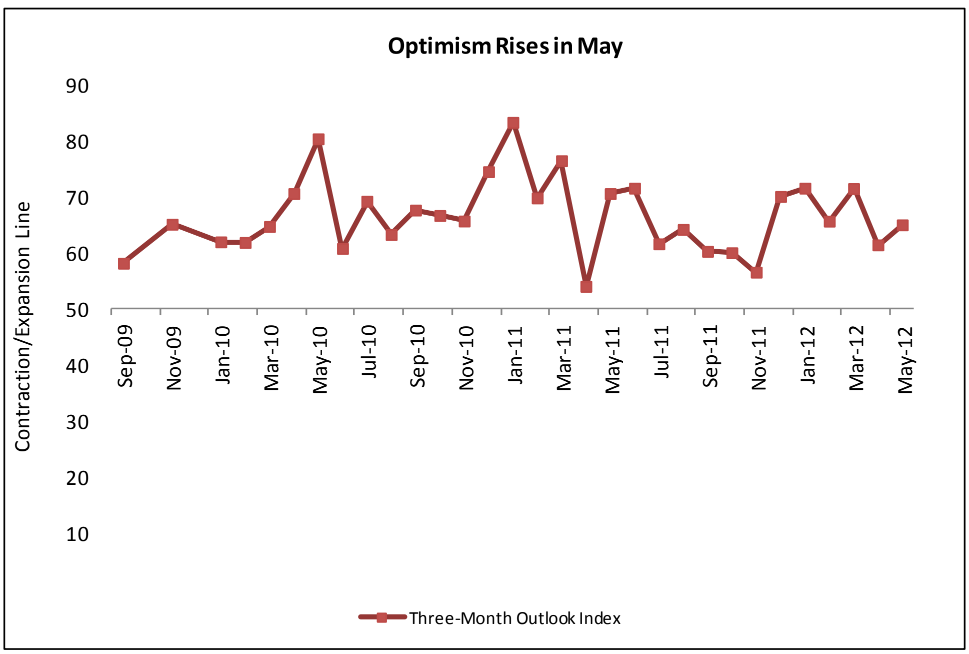


Source: Northcoast Research

Optimism Rises Slightly in May, but Remains Well Off its High

The Three Month Outlook Index rose 5.8% to close the month at 65.0, as there was a sequential increase in the number of respondents who anticipate year-over-year sales gains during the next three months (June, July and August). The overriding theme among the respondents that envision stronger year-over-year sales trends in the near-term was that the soft demand trends of recent months should result in a short-term release of pent-up demand. Additionally, many garage owners expressed optimism that the warmer-than-usual temperature trends that have characterized much of the year-to-date period will continue into the summer. Recall that intense heat in the summer can be a huge driver of demand, as it can accelerate the failure of select parts and provide a benefit to sales of items related to temperature control (e.g. radiators, hoses, air conditioning components, etc.).

That said, the Three Month Outlook Index was a little below the average reading of 66.6 since the inception of our survey. We continue to have a cautious outlook for near-term demand trends given the slightly below average level of optimism among our survey respondents, combined with the evidence of increased promotional activity and ongoing weak sales trends.



Source: Northcoast Research

All things being equal, we would have liked to see a bigger surge in the mechanics' outlook given the favorable decline in gasoline prices in recent weeks. Specifically, the average price of retail gasoline declined $0.17 per gallon from April to $3.79 in May; this represented a year-over-year decline of 4.3%. We estimate that on an annualized basis, the average household benefitted from lower fuel prices by $192, which is the first time consumers have had more money in their pockets as a result of falling gas prices on a year-over-year basis since October 2009.

A Quick Look at Same-Store Estimates

While our research indicated that the soft sales trends that characterized the DIFM channel in April firmed somewhat in May, we continue to believe that underlying demand trends remain soft across the DIFM channel, as our Current Sales Index has finished in negative territory in 4 of the past 5 months this year. At this point, we are maintaining our current 2Q CY12 and 3Q CY12 estimates for Advance Auto Parts, AutoZone and O'Reilly Automotive until we gain more insight into trends in June as it has historically been the most important month of the second quarter. The table below summarizes our comparable-store sales estimates:

Comparable-Store Sales Trends

Retailer						
	Oct-11	Dec-11	Apr-12	Jul-12E	Oct-12E	Dec-12E
Advance Auto Parts (AAP)	2.2%	2.9%	2.1%			
Northcoast Research Estimates				-1.2%	2.0%	2.4%
Consensus				-1.0%	2.2%	2.1%
	Aug-11	Nov-11	Feb-12	May-12	Aug-12E	Nov-13E
AutoZone (AZO)	4.5%	4.6%	5.9%	3.9%		
Northcoast Research Estimates					4.6%	4.3%
Consensus					3.9%	3.8%
	Sept-11	Dec-11	Mar-12	Jun-12E	Sept-12E	Dec-12E
O'Reilly (ORLY)	4.8%	3.3%	6.1%			
Northcoast Research Estimates				4.3%	4.7%	4.5%
Consensus				4.3%	4.6%	4.9%

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.

- "Customers' cars are trashed when they bring them in and they are requiring serious repairs. Consequently, this has really increased the dollar value of my average repair order." (Illinois)
- "Our sales were down because our fleet business has taken a big hit. One of our fleets that we service went out of business, while a few other fleets are extending maintenance intervals" (Georgia)
- "I am standing around at the end of the day looking for ways to drive traffic because my car count continues to be weak." (Ohio)
- "Parts suppliers stated that sales have been extremely soft in my area. They have been very promotional, particularly on brakes. In addition, they are bundling parts together as a part of a discounted package." (New York)
- "Business is starting to pick up around me. I had a very strong May, and June is off to a really solid start." (Tennessee)

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 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 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.

NORTHCOAST RESEARCH

DISCLOSURES

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

Ratings

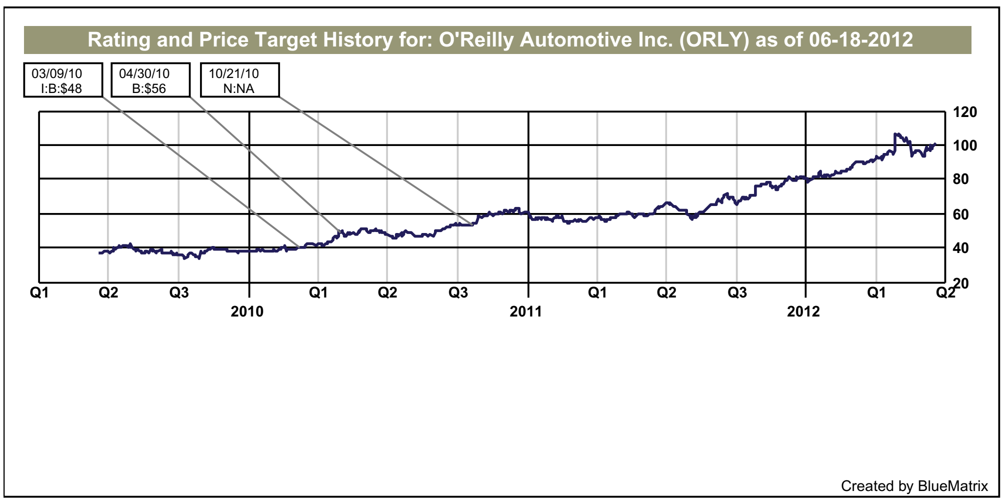
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

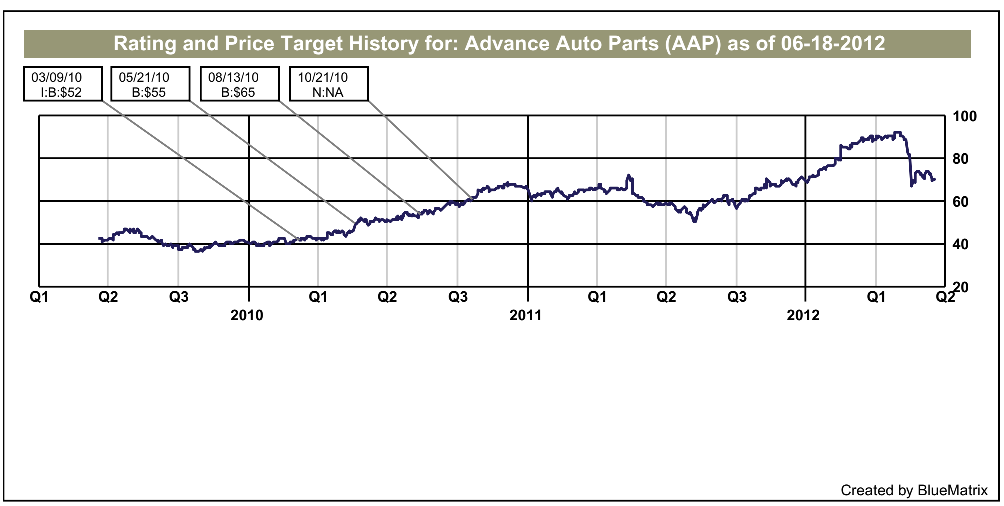
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

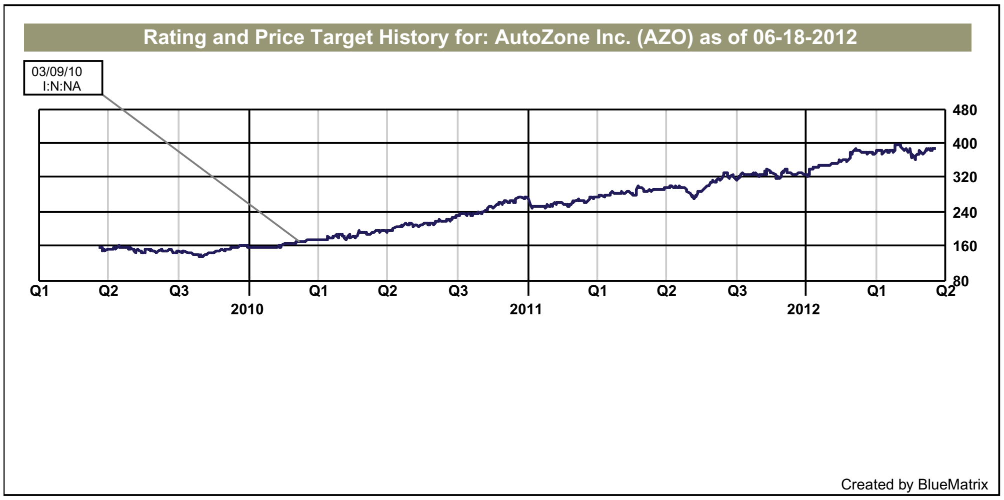
SELL – The stock is expected underperform the S&P 500 index over a twelve-month period.

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)	62	47.69%
NEUTRAL(N)	66	50.77%
SELL(S)	2	1.54%
Total	130	

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.