

Automotive Aftermarket Retailers

Independent Automotive Repair Garage Survey: July 2012

Overview

- According to the survey results of nearly 250 independent garage owners, sales in the DIFM channel increased in July relative to the prior year. Specifically, our Current Sales Index finished the month at 58.5, which was well into expansion territory and 30.7% higher on a sequential basis.
- Not surprisingly, our research suggests that the sudden acceleration in demand during July was largely a function of above average temperatures.
- That said, we think it is worth noting that even though the improvement in sales trends was relatively broad-based, garage operators indicated that they were surprised that they didn't experience a larger sales increase given how high the temperatures were during the month.
- This belief is supported by recent commentary from our vendor contacts. Specifically, our contacts noted that they have not seen a significant recovery in demand trends at the point-of-sale during July or the first two weeks of August (i.e. the breadth of the improvement was wide but the magnitude was rather tepid).
- Despite the fact that our survey respondents noted that July was the strongest period in a number of months, the Three Month Outlook Index dropped 7.3% to close at 62.2. The two most commonly cited reasons for a slightly more pessimistic outlook were: (1) August trends have gotten off to a slow/choppy start; and (2) weather-related work aside, the traffic trends underpinning industry demand in July were relatively weak.

Conclusion

While we continue to appreciate the opportunity that the publically 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 | 71.96 | NA | N | \$1.36e | \$5.38e | \$5.88e | 5,290.1 |
| AZO | \$363.26 | NA | N | \$8.54e | \$23.58e | \$27.55e | \$13,598.2 |
| MNRO | \$35.17 | NA | N | \$0.38e | \$1.58e | \$2.02e | \$1,090.3 |
| ORLY | \$86.46 | NA | N | \$1.26e | \$4.62e | \$5.15e | \$10,279.2 |

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

Nick Mitchell, CFA, CMT - Senior Vice President
216.468.6902
nick.mitchell@northcoastresearch.com
Seth Woolf - Research Associate
216.468.6927
seth.woolf@northcoastresearch.com

INTEGRITY
TRUST
VALUE

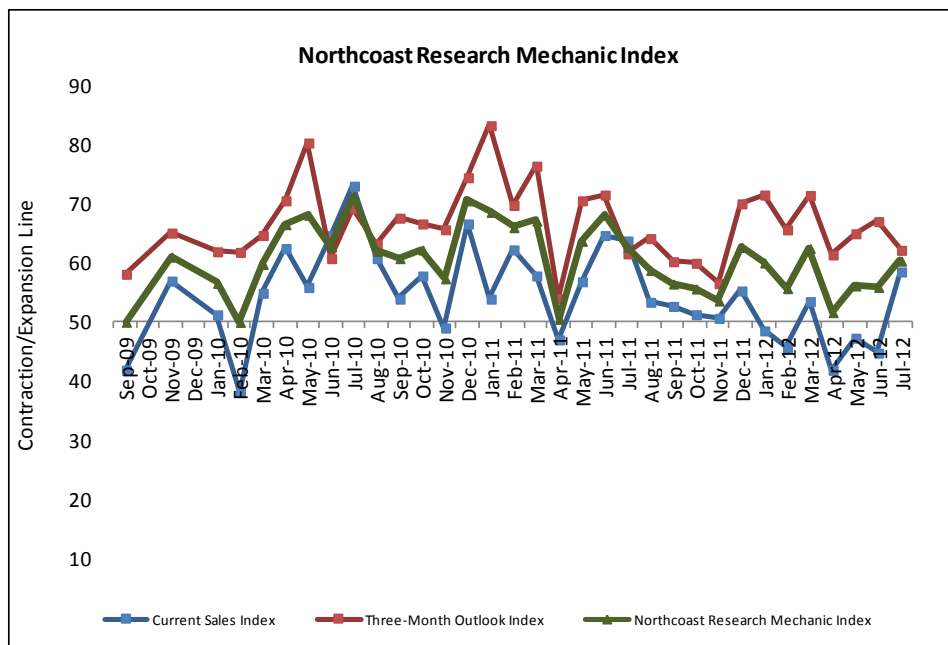
Independent Automotive Repair Garage Survey

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–July Snapshot



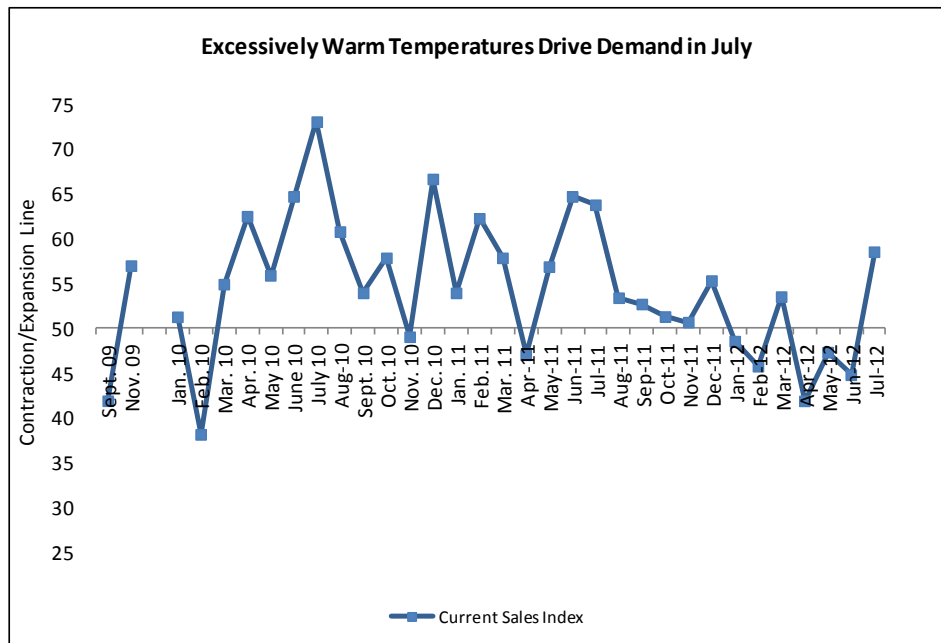
Source: Northcoast Research

According to the survey results of nearly 250 independent garage owners, sales in the DIFM channel increased in July relative to the prior year. Specifically, our Current Sales Index finished the month at 58.5, which was well into expansion territory and 30.7% higher on a sequential basis. That said, the pickup in sales trends was partially offset by a more pessimistic outlook among the survey respondents. Consequently, the composite moved up 8.0% to 60.4 despite the recovery in current demand trends. We provide further details on the drivers of the two sub-indices below.

Scorching Temperatures Boost Demand in July

As we noted earlier, the Current Sales Index jumped 30.7% sequentially to 58.5 during July. This print represented the first increase since March 2012, which was a month that benefited from a pull-forward in demand due to the early onset of spring-like weather. Not surprisingly, our research suggests that the sudden acceleration in demand during July was largely a function of above average temperatures. Specifically, the mechanics that we spoke with indicated that their business witnessed a sharp increase in traffic trends during July as consumers were forced to address vehicle issues brought about by the intense heat throughout the month. Accordingly, many of the mechanics that we spoke with experienced a sharp increase in the amount of work tied to cooling systems, radiators and thermostats.

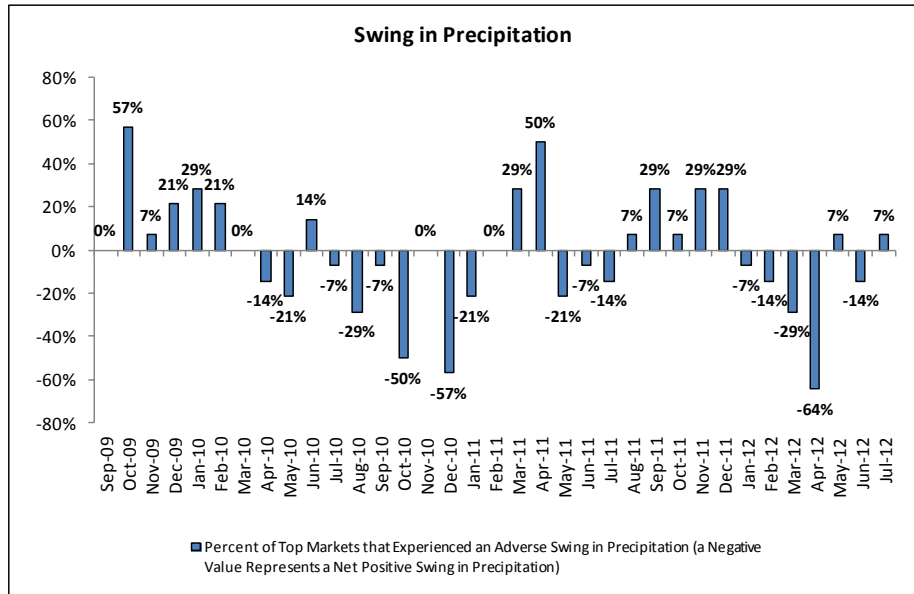
In addition to the sequential surge in year-over-year traffic patterns, the recent trend of a higher average ticket continued through July (the benefit from ticket appeared to be stronger on a year-over-year basis than in June). We think it is worth noting that even though the improvement in sales trends was relatively broad-based, contacts indicated that they were surprised that they didn't experience a larger sales increase given how high the temperatures were during the month. Moreover, numerous garage owners expressed frustration that sales growth was not more robust given that fuel prices continued to recede. As a result, we think the sharp move in the index exaggerates the true magnitude of the recovery. This belief is supported by recent commentary from our vendor contacts. Specifically, our contacts noted that they have not seen a significant recovery in demand trends at the point-of-sale during July or the first two weeks of August (i.e. the breadth of the improvement was wide but the magnitude was rather tepid). Additionally, many of the vendors are becoming increasingly more concerned with the duration of the slowdown.



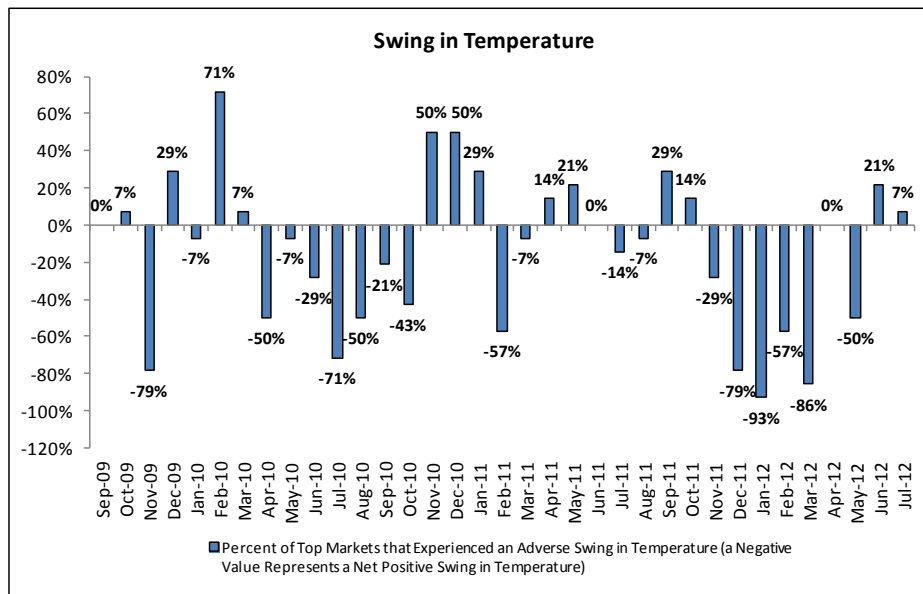
Source: Northcoast Research

Weather Screener

According to our proprietary weather screen, precipitation and temperature trends in the key markets of our survey were relatively unchanged 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 were slightly cooler as a net 7% of the territories experienced cooler weather in July relative to the prior year. Despite the lack of a significant change in weather trends on a year-over-year basis, the average temperature in many parts of the country was well above average, which helped boost demand.



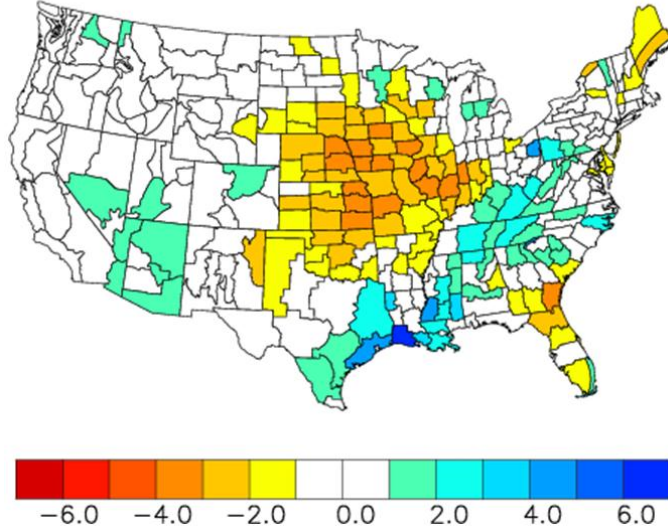
Source: Northcoast Research, U.S. Department of Commerce



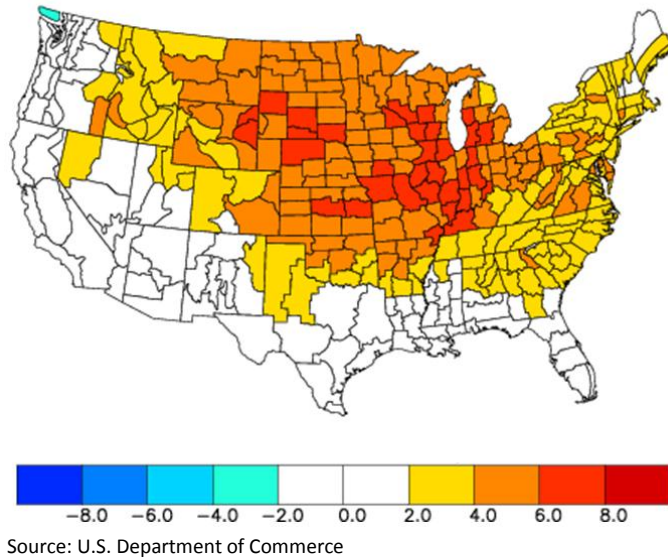
Source: Northcoast Research, U.S. Department of Commerce

The following maps illustrate temperature trends during July 2012 relative to the long-term averages.

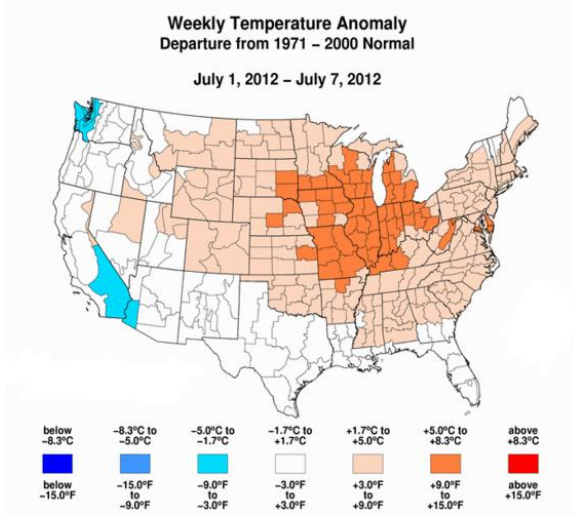
Precipitation Anomalies (inches)
Jul 2012
Versus 1950–2007 Longterm Average



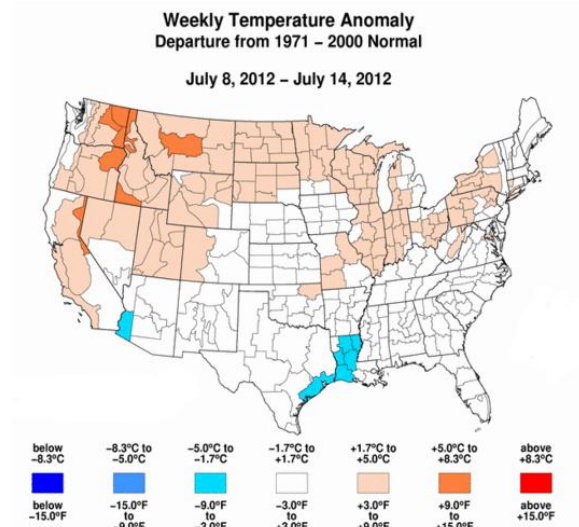
Temperature Anomalies (F)
Jul 2012
Versus 1950–2007 Longterm Average



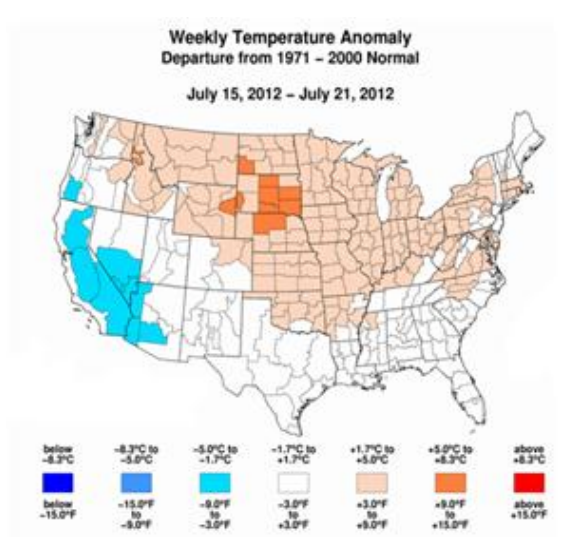
The following maps illustrate weekly temperature trends during July 2012 relative to the long-term averages. We would note that the most favorable trends were seen in the Midwest and Southeast.



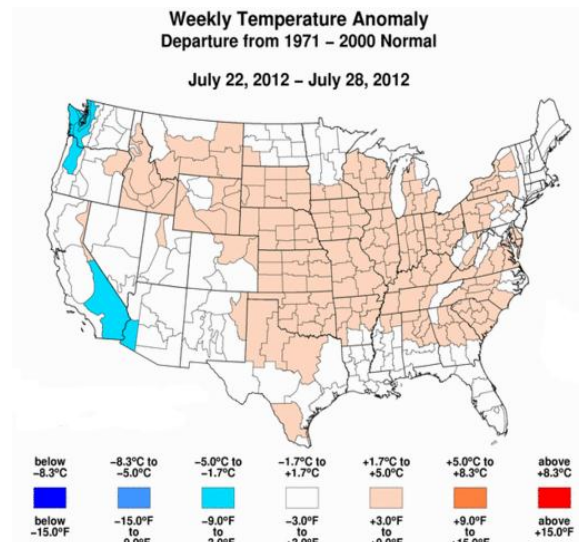
Source: U.S. Department of Commerce



Source: U.S. Department of Commerce



Source: U.S. Department of Commerce

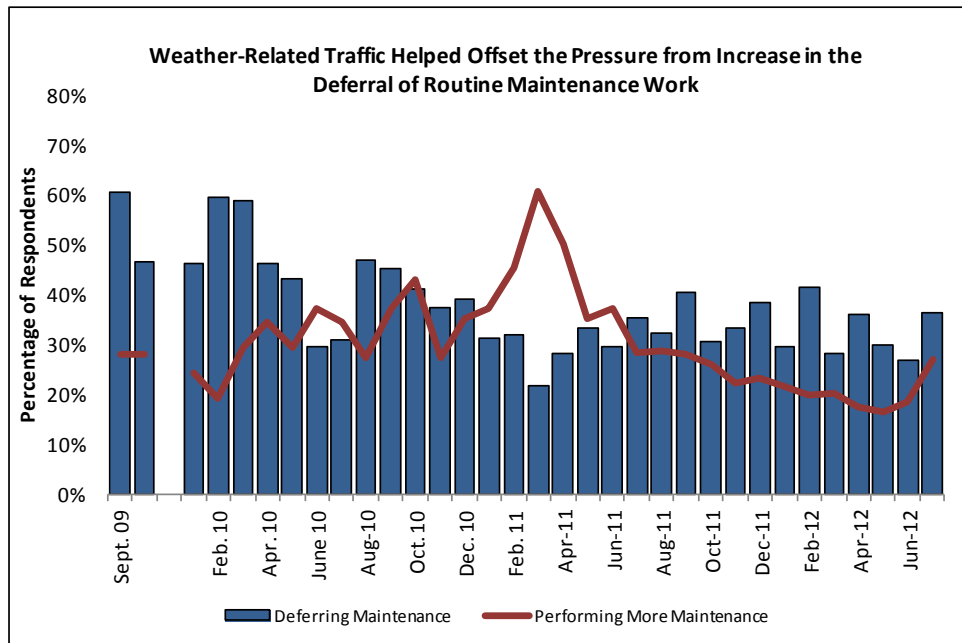


Source: U.S. Department of Commerce

Deferred Maintenance Remains a Headwind

According to our contacts, the behavior toward routine maintenance continued to be a headwind to sales and traffic trends during July. As we mentioned previously, the increased traffic during the month was largely a function of weather-related repair work that compelled/forced consumers to have their vehicles serviced. In fact, the proportion of garage owners that reported seeing their customers delaying preventative maintenance actually rose during July. Specifically, 9.5% of the respondents, on a net basis, reported that their customer base was deferring routine maintenance versus a net 8.1% in June. Consequently, we cannot help but walk away from this most recent survey believing that the uptick in traffic during July was largely a function of favorable weather patterns and that the underlying demand trends in the industry remain relatively anemic. Based on our research, we estimate that the excessive summer temperatures had the largest favorable impact in the Midwest and Southeast.

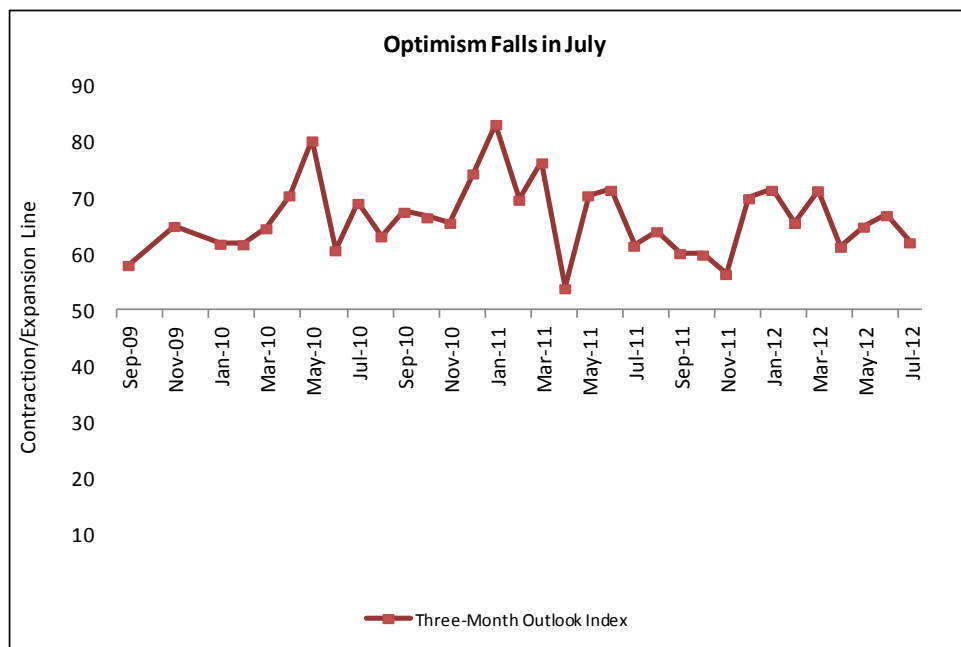
We continue to believe this behavior represents a headwind for the automotive aftermarket parts retailers as the maintenance category represents a significant portion of their sales mix. Specifically, we estimate that the average store generates 35% to 45% of its revenue from maintenance-related merchandise.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



Source: Northcoast Research

An Improvement in Demand Doesn't Lead to Increased Optimism

Despite the fact that our survey respondents noted that July was the strongest period in a number of months, the Three Month Outlook Index dropped 7.3% to close at 62.2. The deterioration was driven by a decline in the number of respondents expecting to generate a year-over-year sales increase during the next three months, as well as a modest increase in the number of garage owners anticipating a sales decline over the same period. The two most commonly cited reasons for a slightly more pessimistic outlook were: (1) August trends have gotten off to a slow/choppy start; and (2) weather-related work aside, the traffic trends underpinning industry demand in July were relatively weak (i.e. maintenance trends are still soft). In our view, the latter factor is particularly concerning given the fact that the industry has had the benefit of lower year-over-year gas prices since May .



Source: Northcoast Research

While we were disappointed to see the Three Month Outlook Index drop, especially given the more robust traffic trends in July, we were not surprised, as our work in the space continues to suggest that the consumer is weak and that demand trends remain anemic and volatile. In our opinion, the soft demand trends that have been witnessed across the industry this year are emblematic of a structural change in the demographics of the nation's light vehicle fleet, which is pressuring the underlying traffic trends. As a result, we anticipate the operators' outlook will continue to moderate as we move deeper in the structural change.

A Quick Look at Same-Store Estimates

While our research indicates that year-over-year demand trends in the DIFM channel improved during July for the first time since March 2012, we believe that the pickup will prove to be relatively short lived as we think demand benefited significantly from the extremely warm temperatures. In sum, we continue to believe that underlying demand trends across the DIFM channel are relatively weak, as our Current Sales Index has finished in negative territory in 5 of the past 7 months. Furthermore, many of our contacts have noted that business trends during August have gotten off to a slow start as the benefit from the excessive heat unwinds. As a result, we are maintaining our current 3Q CY12 and 4Q CY12 estimates for Advance Auto Parts, AutoZone, O’Reilly and Monro until we get a clearer picture of demand trends in August as that will help us better understand if the pickup is sustainable or if it was largely driven by a short-term tailwind from weather. The table below summarizes our comparable-store sales estimates:

| Comparable-Store Sales Trends | | | | | | |
|-------------------------------|---------|--------|--------|--------|----------|---------|
| Retailer | | | | | | |
| Advance Auto Parts (AAP) | Oct-11 | Dec-11 | Apr-12 | Jul-12 | Oct-12E | Dec-12E |
| Northcoast Research Estimates | 2.2% | 2.9% | 2.1% | (2.7%) | (1.3%) | (0.1%) |
| Consensus | | | | | (1.0%) | (0.3%) |
| AutoZone (AZO) | Aug-11 | Nov-11 | Feb-12 | May-12 | Aug-12E | Nov-13E |
| Northcoast Research Estimates | 4.5% | 4.6% | 5.9% | 3.9% | 4.6% | 4.3% |
| Consensus | | | | | 3.6% | 3.6% |
| Monro Muffler Brake (MNRO) | Sept-11 | Dec-11 | Mar-12 | Jun-12 | Sept-12E | Dec-12E |
| Northcoast Research Estimates | (0.8%) | 0.0% | 0.7% | (7.2%) | (4.5%) | 2.5% |
| Consensus | | | | | (5.3%) | 2.9% |
| O’Reilly (ORLY) | Sept-11 | Dec-11 | Mar-12 | Jun-12 | Sept-12E | Dec-12E |
| Northcoast Research Estimates | 4.8% | 3.3% | 6.1% | 2.5% | 2.3% | 3.2% |
| Consensus | | | | | 2.3% | 3.7% |

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.

- “Weather really helped the business, especially as the month went on.” (Illinois)
- “Not only was my traffic stronger in July, but I also got the added benefit of a 5.0% increase in my shop’s labor rate, which I put into effect last month.” (Tennessee)
- “There is no doubt that weather-related work, especially air conditioning jobs, drove traffic into my shop during July. However, sales trends have been volatile through the first two weeks of August, and I have concerns about where my results will shake out when it is all said and done.” (New York)

- “While my business was up a little bit in July, my main parts supplier is telling me that business across the region is still not very good.” (Missouri)
- “I’m worried about business trends going forward because the summer is almost over and August is off to a slow start, and I can’t count on the weather to bail me out in September.” (Alabama)

Conclusion and Investment Thesis

While we continue to appreciate the opportunity that the publically 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

Research is produced by Northcoast Research Partners, LLC Member FINRA (www.finra.org) and SIPC (www.sipc.org). Research is for institutional investor use only. 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

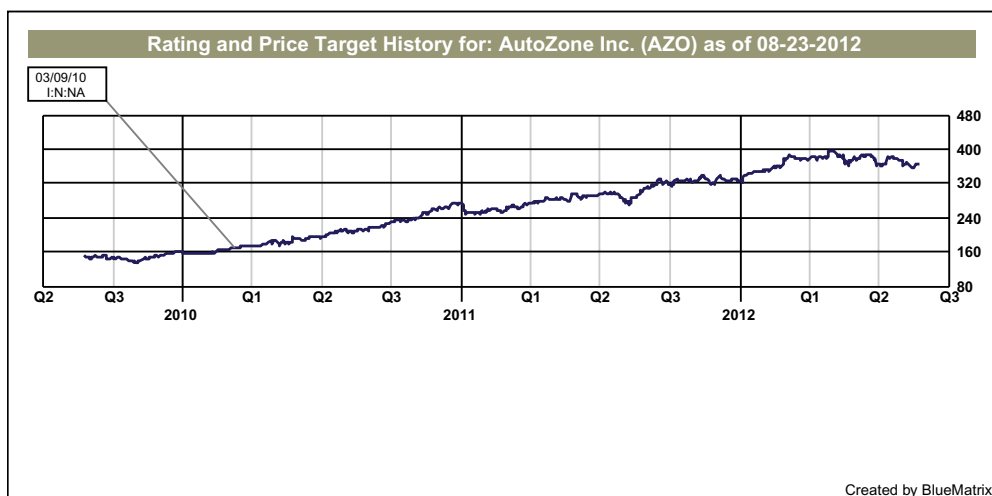
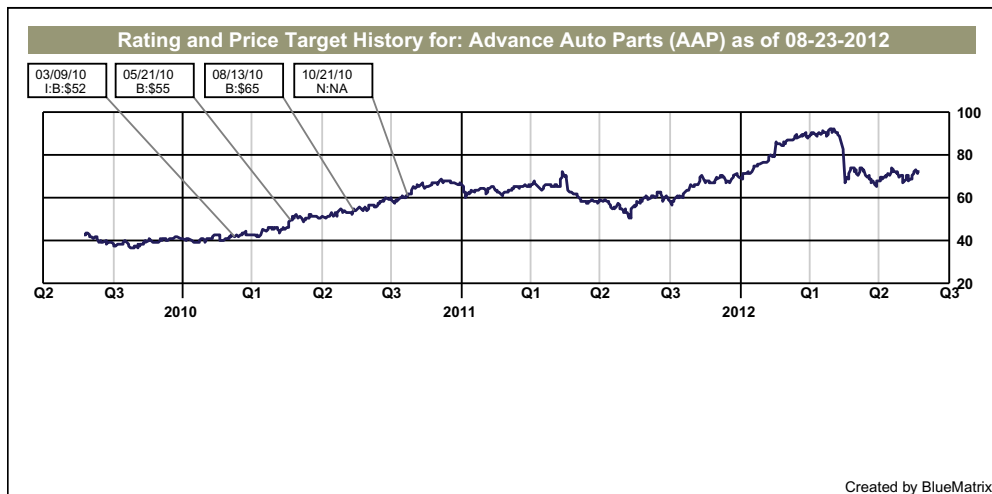
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

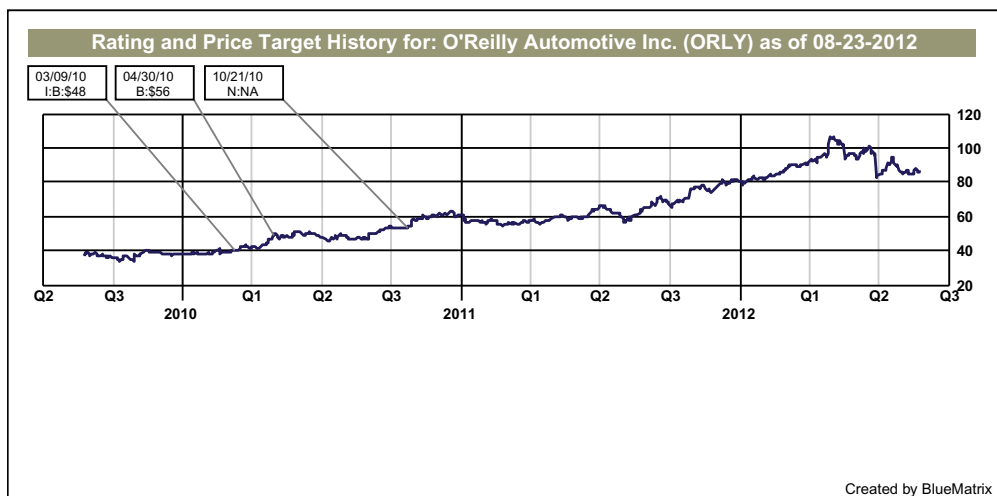
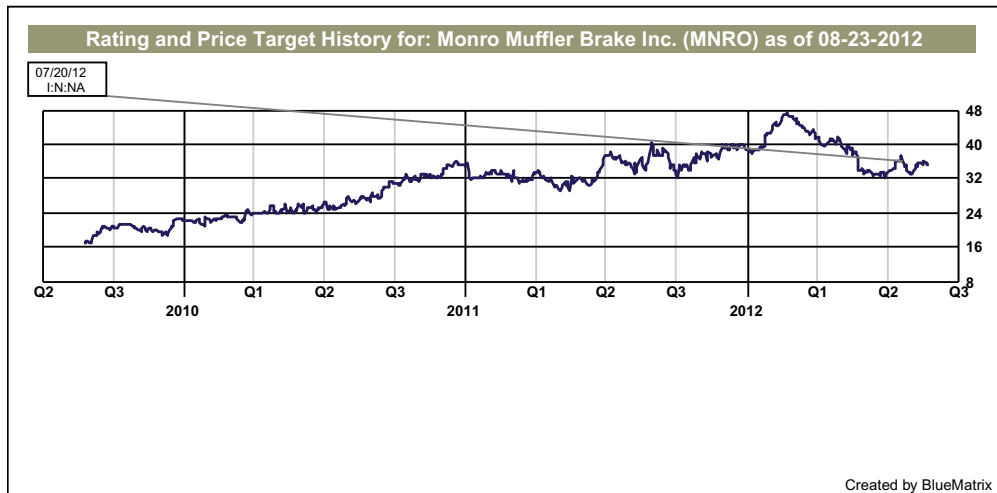
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

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) | 75 | 50.00% |
| NEUTRAL(N) | 75 | 50.00% |
| SELL(S) | 0 | 0.00% |
| Total | 150 | |

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.

Copyright © Northcoast Research Partners, LLC