

Automotive Aftermarket Retailers

Independent Automotive Repair Garage Survey: September 2012

Overview

- According to the survey responses from nearly 250 independent garage owners, demand trends in the DIFM channel were severely pressured in September relative to the prior year, as our Current Sales Index finished the month at 40.3.
- In our view, this performance confirms our belief that the positive data from July, and to a lesser extent August, was largely driven by above-average temperatures and increased promotional activity—without which demand trends would have suffered.
- While consumers' tendency to defer non-essential work has been an obstacle to demand trends for a number of quarters, the pain from this trend was particularly acute in September. This development clearly pressured traffic trends during the period.
- Garage owners noted that they anticipate a decline in sales during 4Q CY12, as the Three Month Outlook Index fell below 50.0 for the first time in the three years that we have been conducting the survey. More specifically, the Three Month Outlook Index fell 16.6% to close at 48.7.
- While the print is just under 50, we would be remiss not to point out the fact that the group is typically very optimistic. For example, the average reading of the Three Month Outlook Index is more than 20% higher than the actual readings in the Current Sales Index since the inception of our survey.
- The three most commonly cited reasons for the bleak outlook were: (1) October has gotten off to a very slow start; (2) recent traffic trends have been very anemic despite the increased promotional activity; and (3) gasoline prices have been moving in the wrong direction.

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 continue to have 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. 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	66.15	NA	N	\$1.21e	\$5.17e	\$5.69e	4,862.9
AZO	\$365.80	NA	N	\$5.32e	\$27.31e	\$31.27e	\$13,509.7
MNRO	\$33.29	NA	N	\$0.38e	\$1.58e	\$2.02e	\$1,032.0
ORLY	\$80.32	NA	N	\$1.25e	\$4.60e	\$5.21e	\$9,549.2

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

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INTEGRITY

TRUST

VALUE

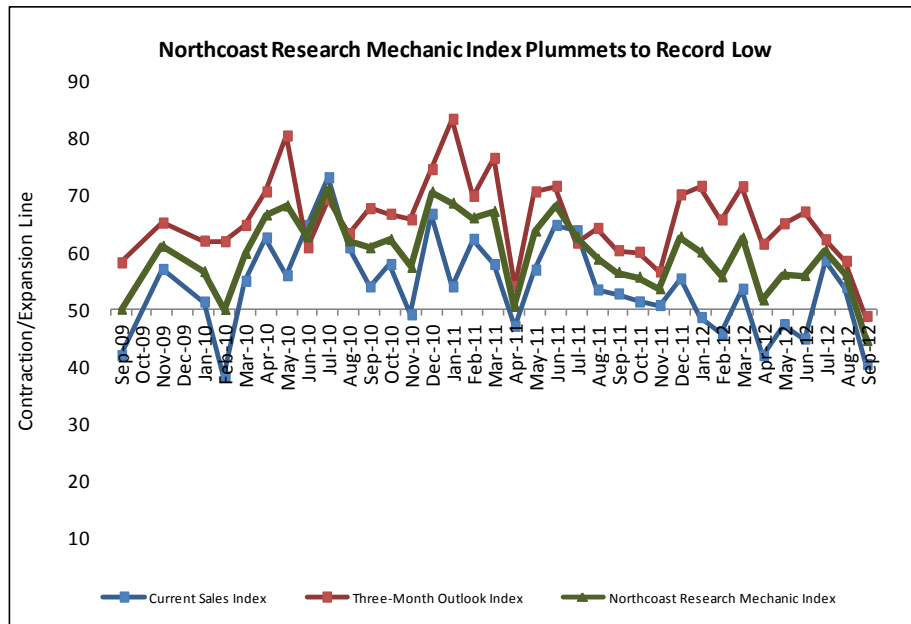
Independent Automotive Repair Garage Survey

Each month we publish the **Northcoast Research Mechanic Index** based on the results of our survey, which encompasses the feedback from almost 250 independent repair shops across the country. 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—September Snapshot

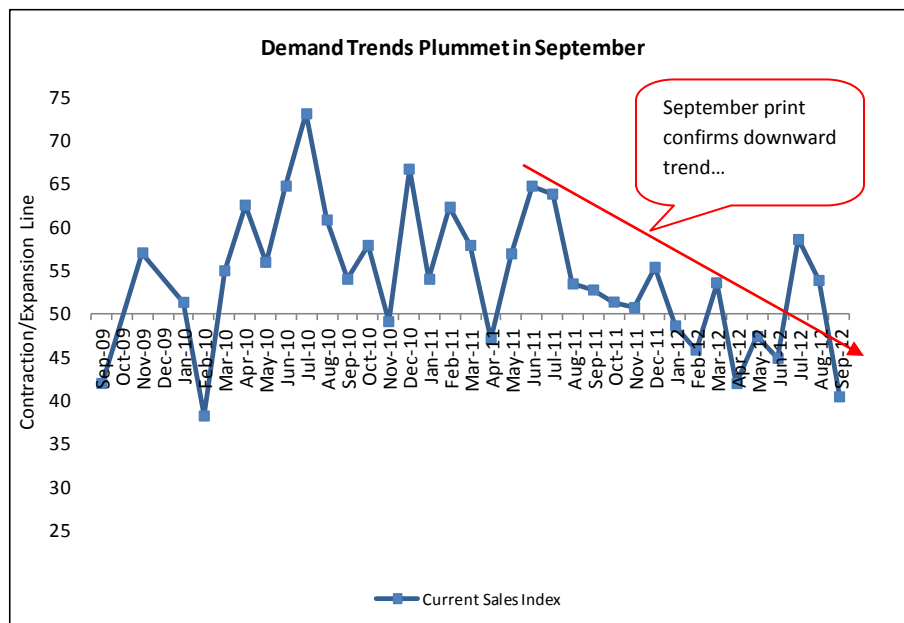


Source: Northcoast Research

According to the survey responses from nearly 250 independent garage owners, demand trends in the DIFM channel were severely pressured in September relative to the prior year, as our Current Sales Index finished the month at 40.3. Furthermore, the respondents’ optimism dropped significantly as the Three Month Outlook Index plummeted to 48.7. These two performances led to a 20.6% drop in the composite index to 44.5, which was the lowest reading that we have ever recorded. We provide further details on the drivers of the two sub-indices below.

Sales Trends Continue to Weaken

During September, the Current Sales Index slid 25.1% sequentially to finish the month at 40.3, which was the second lowest reading that we have ever recorded. In our view, this performance confirms our belief that the positive data from July, and to a lesser extent August, was largely driven by above average temperatures and increased promotional activity—without which demand trends would have suffered. Not surprisingly, soft traffic trends were cited as the largest headwind to sales trends. In fact, our survey respondents indicated that year-over-year traffic trends during the month were the weakest seen since April 2012—a month that was hampered by a pull-forward of demand into late February and March. More importantly, sales trends during September did not benefit from gains in the average ticket, which was a departure from recent trends. Recall that average ticket trends in recent months have benefited from a mix shift to repair work (away from maintenance work) and inflationary pressures on hard parts.



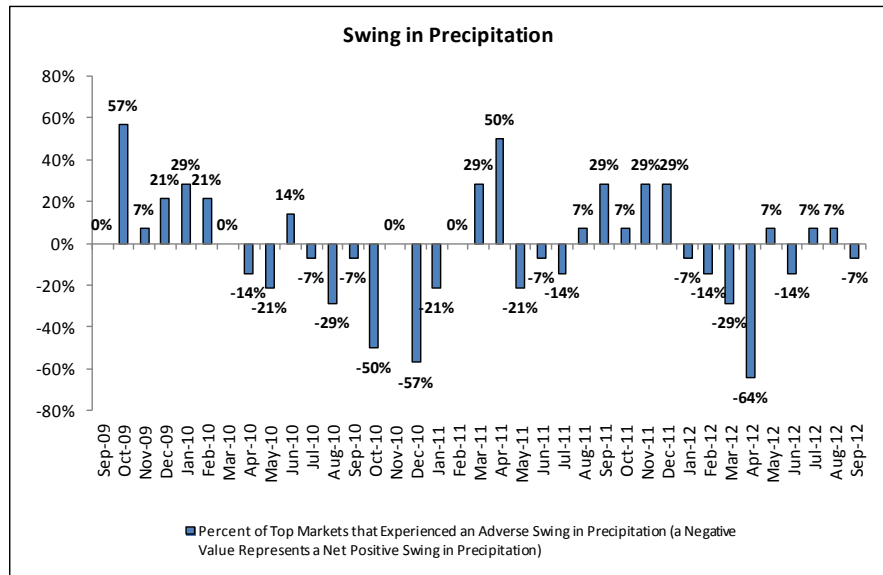
Source: Northcoast Research

In summary, we believe that demand plummeted in September, as evidenced by one of the lowest readings that we have ever recorded, after being propped up during July and August by favorable temperature trends and increased promotional activity. In our view, the sales performance last month was more reflective of true industry demand, which we believe has been relatively weak for months. Furthermore, it appears that the competitive environment has become decidedly more promotional over the past few weeks. However, anecdotal commentary from our contacts suggests that consumers are not as receptive to promotions as they were earlier in the summer. In our view, consumers that were on the fence regarding obtaining maintenance work or repairs have likely already been enticed to bring their vehicles in to be serviced. While the auto parts retailers and distributors have historically been very effective at having their vendors fund promotional activity for short periods of time, we do

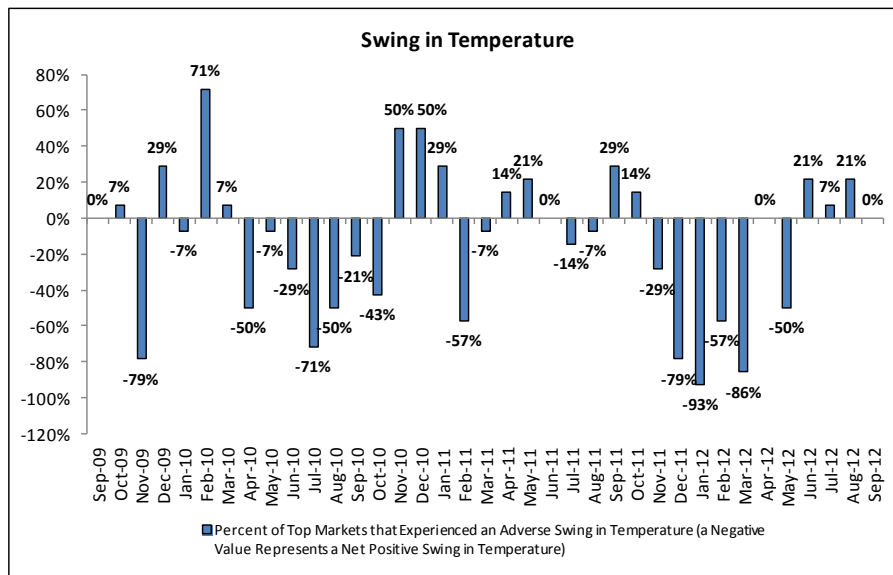
not think that they will be able to perpetually lean on the vendor community. Indeed, the commentary from Advance Auto Parts this morning speaks to this fact.

Zero Benefit from Weather Trends

According to our proprietary weather screen, precipitation and temperature trends in the key markets of our survey were little changed from the prior year's period. Specifically, the first chart below illustrates that precipitation was only slightly lower, as only a net 7% of the markets witnessed lower precipitation levels during the month. The second chart highlights the fact that temperatures were unchanged from last September as net 0% of the markets witnessed warmer weather during the month.



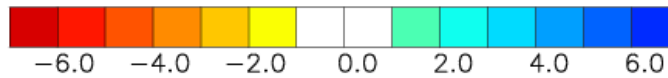
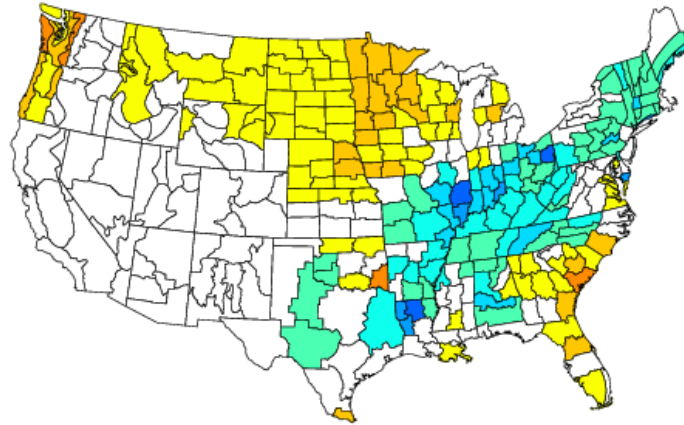
Source: Northcoast Research, U.S. Department of Commerce



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

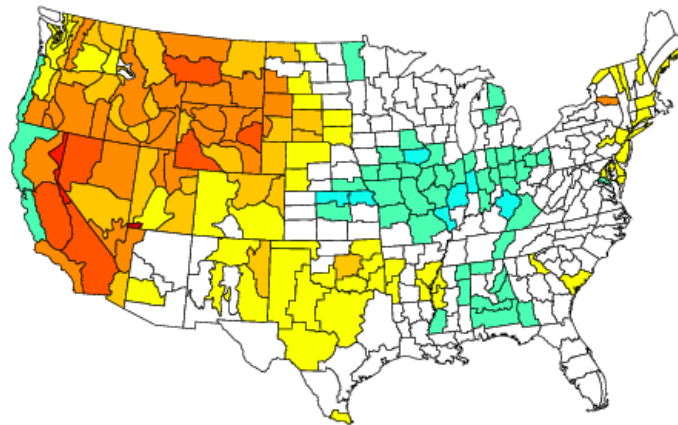
The following maps illustrate weather trends during September 2012 relative to the long-term averages:

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



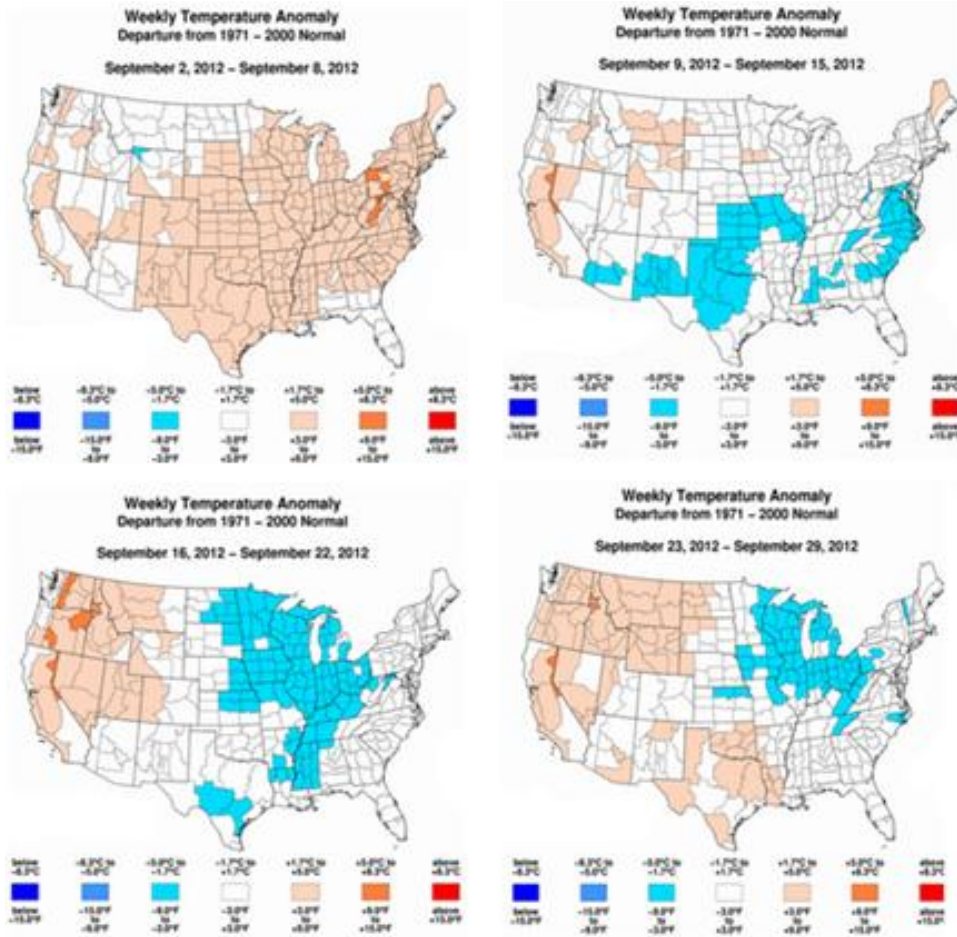
Source: U.S. Department of Commerce

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



Source: U.S. Department of Commerce

The following maps illustrate weekly temperature trends during September 2012 relative to the long-term averages:



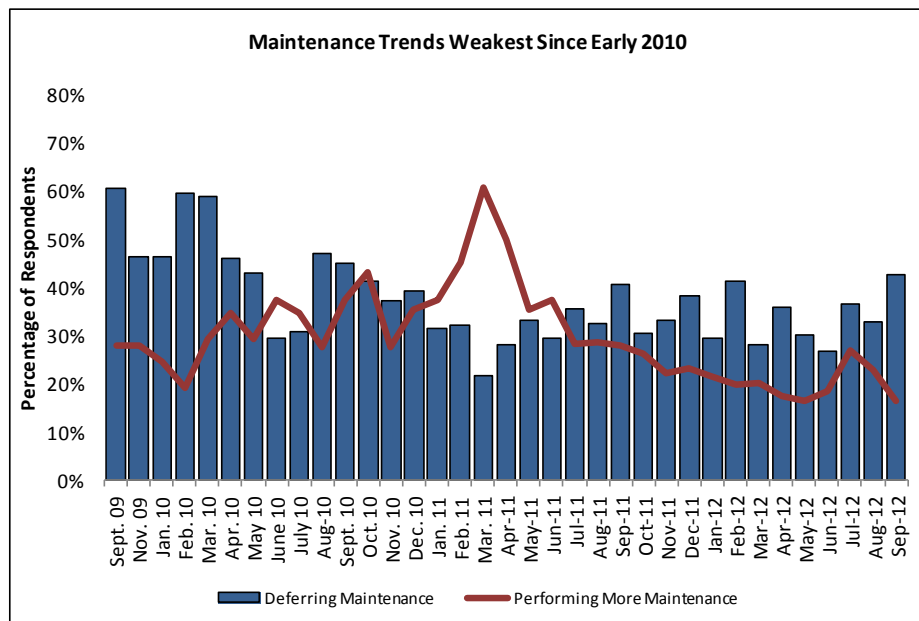
Source: U.S. Department of Commerce

Sharp Rise in Deferred Maintenance

While consumers' tendency to defer non-essential work has been an obstacle to demand trends for a number of quarters, the pain from this trend was particularly acute in September. This development clearly pressured traffic trends during the period. Specifically, 26.1% of the respondents, on a net basis, reported that their customer base was deferring routine maintenance, which is up sharply from a net 9.9% in August and a net 9.5% in July. The dramatic drop-off in "traffic" corroborates our belief that the consumers that were contemplating making investments in their vehicles were motivated to do so in July and August due to the increased promotional activity during those months, which effectively pulled-forward demand (e.g. people who would have done work in September did it in July or August).

In our view, the underlying drivers of the ongoing shift to defer maintenance are: (1) we believe that the consumer is extremely weak right now; and (2) we continue to think that the broader car parc is reaching an age where vehicle owners are eschewing non-essential/discretionary work. In other words, the current sales weakness in the maintenance and failure categories has no connection to the unseasonably warm weather last winter. For more of our thoughts on this topic see our note entitled: ***Mechanics Weigh In on Winter Weather's Impact on Summer Sales Trends.***

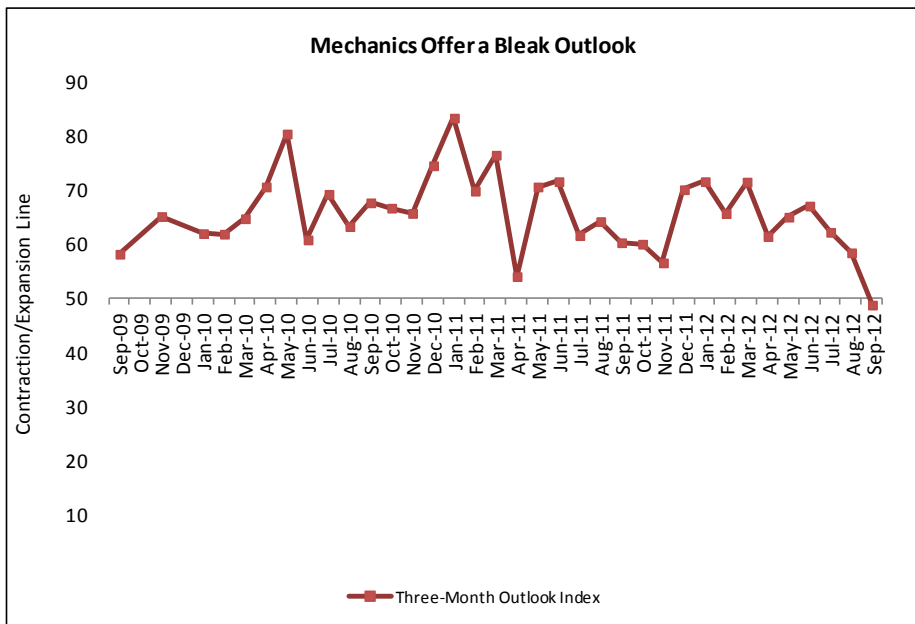
We continue to believe this behavior characteristic represents a formidable headwind for the automotive aftermarket parts retailers as the maintenance category represents a significant portion of their sales mix. Specifically, we estimate that the average store generates 35% to 45% of its revenue from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



Source: Northcoast Research

Garage Owners Have a Bleak Outlook for 4Q CY12

Garage owners noted that they anticipate a decline in sales during 4Q CY12, as the Three Month Outlook Index fell below 50.0 for the first time in the three years that we have been conducting the survey. More specifically, the Three Month Outlook Index fell 16.6% to close at 48.7. While the print is just under 50, we would be remiss not to point out the fact that the group is typically very optimistic. For example, the average reading of the Three Month Outlook Index is more than 20% higher than the actual readings in the Current Sales Index since the inception of our survey. In our mind, this makes the print of 48.7 particularly relevant (e.g. market conditions must be very soft for the mechanics to expect sales to decline in the coming quarter). Furthermore, it reinforces our belief that the current weakness has little to do with the unseasonably warm weather witnessed last winter. The three most commonly cited reasons for the bleak outlook were: (1) October has gotten off to a very slow start; (2) recent traffic trends have been very anemic despite the increased promotional activity; and (3) gasoline prices have been moving in the wrong direction, which mechanics fear will cause the consumer to retrench further.



Source: Northcoast Research

While we had expected to see a moderation in the Three Month Outlook Index as our channel checks in the space continue to suggest that the consumer is weak and that demand trends across the industry remain relatively anemic and very volatile, we were very surprised to see it finish in contraction territory. 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 demand trends. As a result, we anticipate the operators’ outlook will remain depressed.

A Quick Look at Same-Store Estimates

Our latest channel checks suggested that sales trends decelerated sharply in September after demand stabilized in July and August. All in, we think that the underlying demand trends across the DIFM channel were less than stellar during 3Q CY12—a trend that appears to have continued into October. While we think that the current Street estimates take into account the soft demand trends in 3Q FY12, we believe there could be some risk to 4Q FY12 estimates. The table below highlights our 3Q FY12 same-store sales estimates for O’Reilly (recently revised downward) and Monro:

Comparable-Store Sales Trends						
Retailer	Dec-11	Apr-12	Jul-12	Oct-12	Dec-12E	Apr-12E
Advance Auto Parts (AAP)	2.9%	2.1%	(2.7%)	(1.8%)		
Northcoast Research Estimates					(1.0%)	2.9%
Consensus					(0.5%)	1.6%
	Nov-11	Feb-12	May-12	Aug-12	Nov-13E	Feb-14E
AutoZone (AZO)	4.6%	5.9%	3.9%	2.1%		
Northcoast Research Estimates					2.8%	2.9%
Consensus					2.4%	2.8%
	Dec-11	Mar-12	Jun-12	Sept-12E	Dec-12E	Mar-12E
Monro Muffler Brake (MNRO)						
Northcoast Research Estimates	0.0%	0.7%	(7.2%)	(4.5%)	2.5%	4.0%
Consensus				(5.3%)	2.2%	2.0%
	Dec-11	Mar-12	Jun-12	Sept-12E	Dec-12E	Mar-12E
O’Reilly (ORLY)	3.3%	6.1%	2.5%			
Northcoast Research Estimates				2.0%	2.8%	3.5%
Consensus				2.2%	3.8%	3.3%

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.

- “My shop’s sales were down 10% last month. October has actually gotten worse as month to date I’m off 15%.” (California)
- “Last month wasn’t very good, and what is worse is that this month has gotten off to a rotten start as well. I just don’t see the fourth quarter topping last year’s results.” (New York)
- “I’ve been running a lot of advertisements and I’m practically giving away oil changes, but it’s just not having the effect that it normally would.” (Pennsylvania)
- “My shop’s sales were down double digits in September, as my car count [traffic] and average repair order [ticket] were equally bad. People just don’t have any money, and if they do they aren’t putting it into their cars. My parts reps are constantly approaching me with new promos, because everyone in the area is struggling and they want to move inventory.” (Georgia)

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 continue to have 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. 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

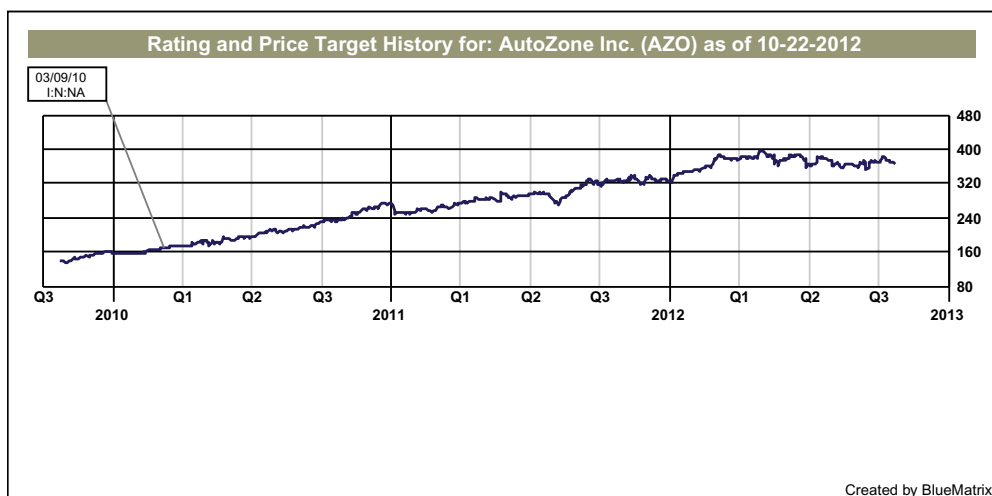
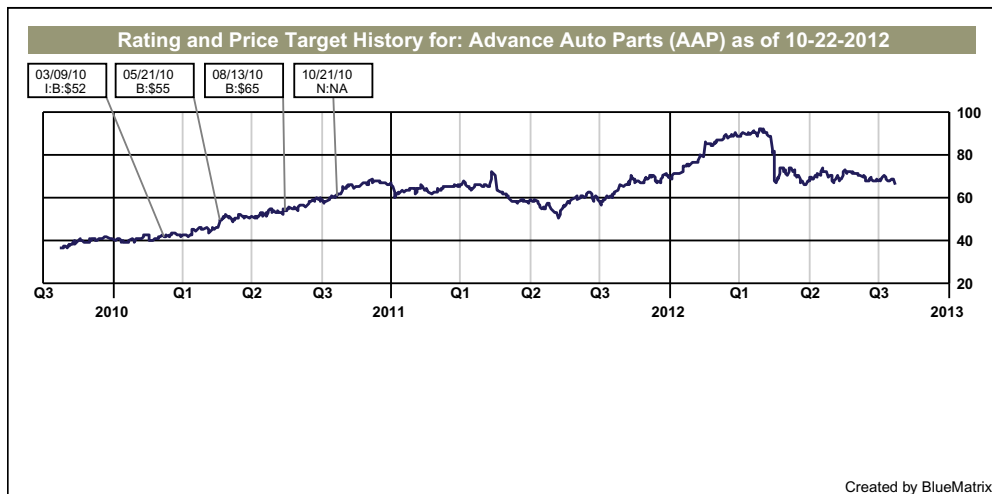
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

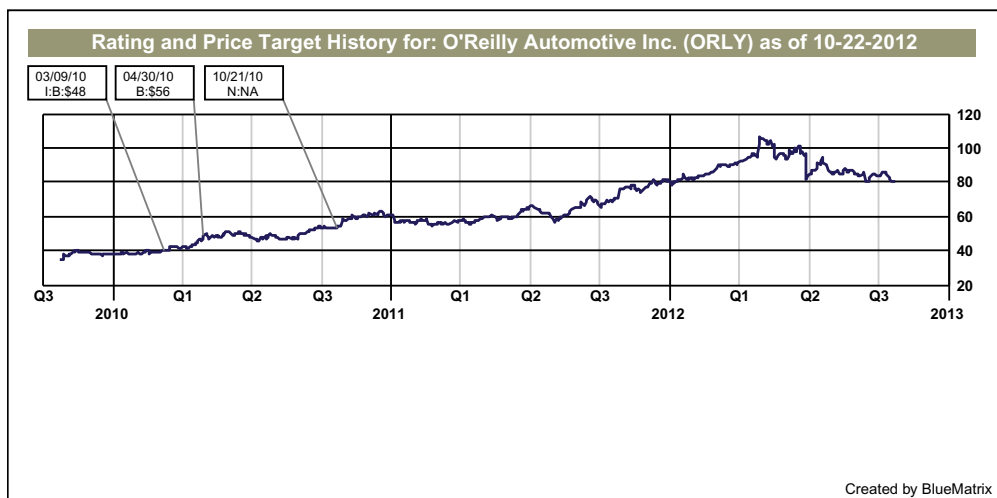
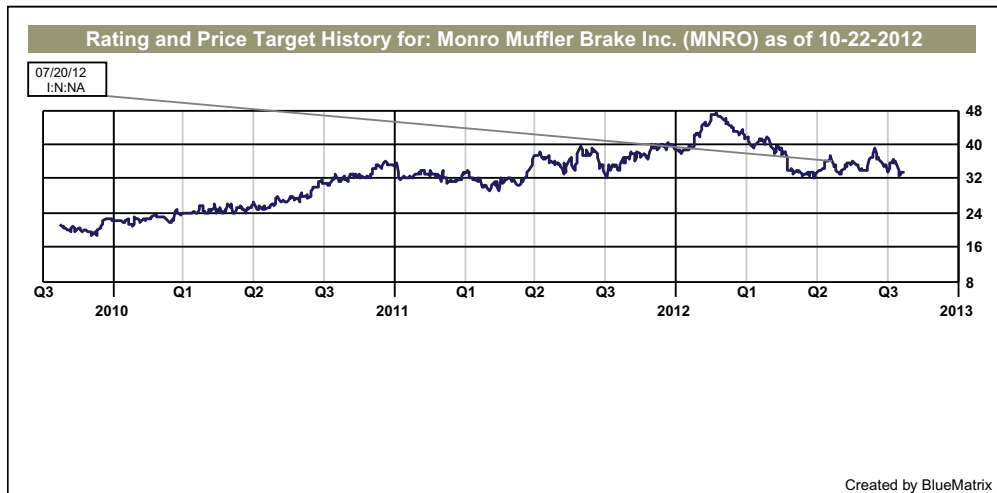
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

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)	70	46.05%
NEUTRAL(N)	79	51.97%
SELL(S)	3	1.97%
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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