

Automotive Aftermarket Retailers

Independent Automotive Repair Garage Survey: November 2012

Overview

- According to the survey responses of nearly 250 independent garage owners, demand trends in the DIFM channel remained severely pressured in November relative to the prior year. In fact, our Current Sales Index finished the month at 35.8, which represented the lowest level we have recorded.
- Lackluster traffic patterns continued to be the major impediment to sales trends across the channel. In fact, the quantitative data that we have on traffic suggests that November was the worst month that we have seen from a car count perspective since April 2012.
- While it is still early in the winter selling season, numerous respondents indicated that their suppliers are offering extremely sharp prices on winter-weather related products, such as wipers, anti-freeze and batteries.
- These promotions appear to be a function of weak demand trends, the lack of significant snowfall thus far, and the warmer-than-expected temperatures that many regions have experienced thus far in December.
- In short, our work suggests that sales in November were extremely soft. Moreover, the weak demand trends appear to have carried over into the first part of December. While we are maintaining our estimates until we gain insight into how the last two weeks of the year finish out, all indications at this time suggest that there is downside risk to our current same-store sales estimates.

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	71.68	NA	N	\$0.79e	\$5.16e	\$5.59e	5,258.7
AZO	\$356.02	NA	N	\$4.85e	\$28.05e	--	\$12,934.7
MNRO	\$34.19	NA	N	\$0.37e	\$1.44e	--	\$1,069.8
ORLY	\$91.80	NA	N	\$1.06e	\$4.67e	\$5.32e	\$10,522.3

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

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INTEGRITY

TRUST

VALUE

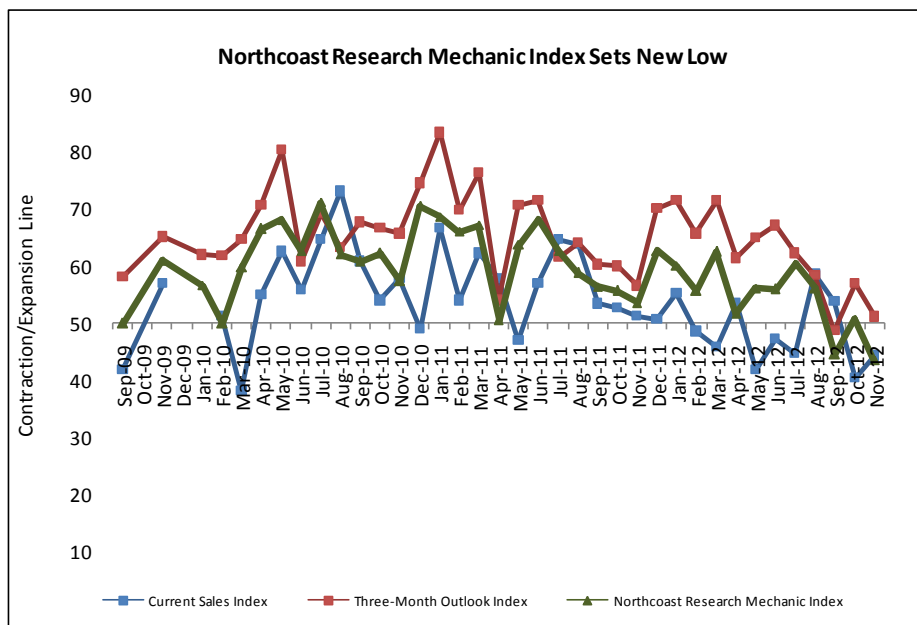
Independent Automotive Repair Garage Survey

Each month we publish the **Northcoast Research Mechanic Index** based on the results of our survey, which encompasses the feedback from 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—November Snapshot

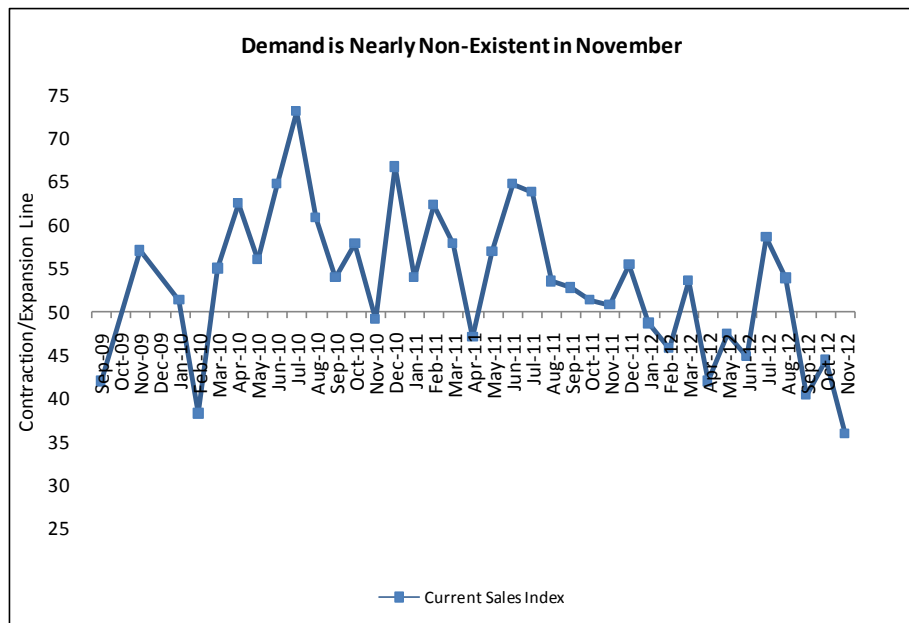


Source: Northcoast Research

According to the survey responses of nearly 250 independent garage owners, demand trends in the DIFM channel remained severely pressured in November relative to the prior year. In fact, our Current Sales Index finished the month at 35.8, which represented the lowest level that we have recorded since the inception of our survey. Moreover, the near-term outlook of the garage owners weakened significantly—Three Month Outlook Index dropped 10.3% sequentially to close at the second lowest level on record—in the face of the soft sales trends in November. These two dynamics resulted in a 14.2% decline in the composite index to 43.5, which represented the lowest close since the origination of our time series. We provide further details on the drivers of the two sub-indices below.

No Post-Election Rebound in Demand

The Current Sales Index plummeted 19.2% sequentially to finish November at 35.8, which is the lowest level that we have recorded since inception. Recall that a reading below 50.0 suggests that end-market demand decreased on a year-over-year basis. Additionally, the performance in the period marked only the second time in more than three years that this measure of current sales trends finished below 40.0. Lackluster traffic patterns continued to be the major impediment to sales trends across the channel. In fact, the quantitative data that we have on traffic suggests that November was the worst month that we have seen from a car count perspective since April 2012. Recall that in the prior instance traffic was understandably weak as the unseasonably warm winter weather pulled-forward some demand and traffic into late February and March (this phenomenon was clearly more pronounced in the DIY channel).



Source: Northcoast Research

It also appears that the negative impact from the weak traffic trends was magnified by additional pressure on the average ticket. As a reminder, our research suggests that the average ticket has been under pressure since July. According to our contacts, the headwind on average ticket has largely been a function of consumers deferring nonessential repairs.

Interestingly, the parts distributors that we have spoken to in recent weeks have also noted that their average tickets are facing headwinds from disinflationary trends in select commodity related parts and supplies categories, as well as from their customers (i.e. the garages) trading down to lower quality/priced parts in an attempt to preserve margins given the anemic demand trends.

All in, the traffic and demand trends in November were discouraging, especially considering many contacts in the channel were hopeful that the consumer would regain confidence following the presidential election (the prior survey was conducted only one week after the election), which many

respondents noted was a common experience in prior election cycles. Ironically, our work suggested that sales momentum actually weakened as the month progressed. Some individuals speculated that the media blitz around the fiscal-cliff talks could have weigh on demand trends late in the month.

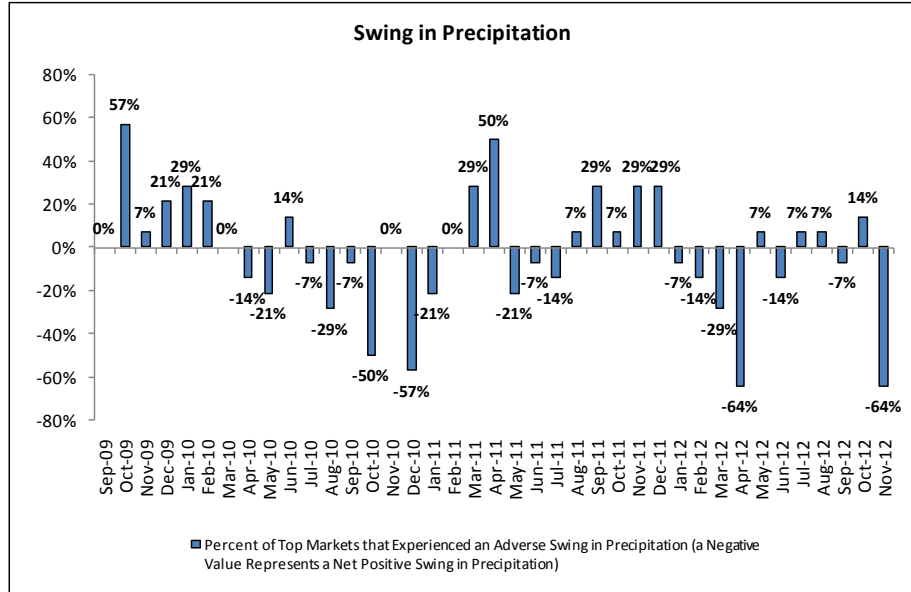
Promotional Activity Intensifies

The weakness in demand evidenced by the poor reading in the Current Sales Index appeared to be broad based, which according to many mechanics, appears to have caused some parts suppliers to ramp up their promotional activity throughout the period. Indeed, the quantitative data that we have compiled since inception suggests that November was easily the most promotional environment in almost two years.

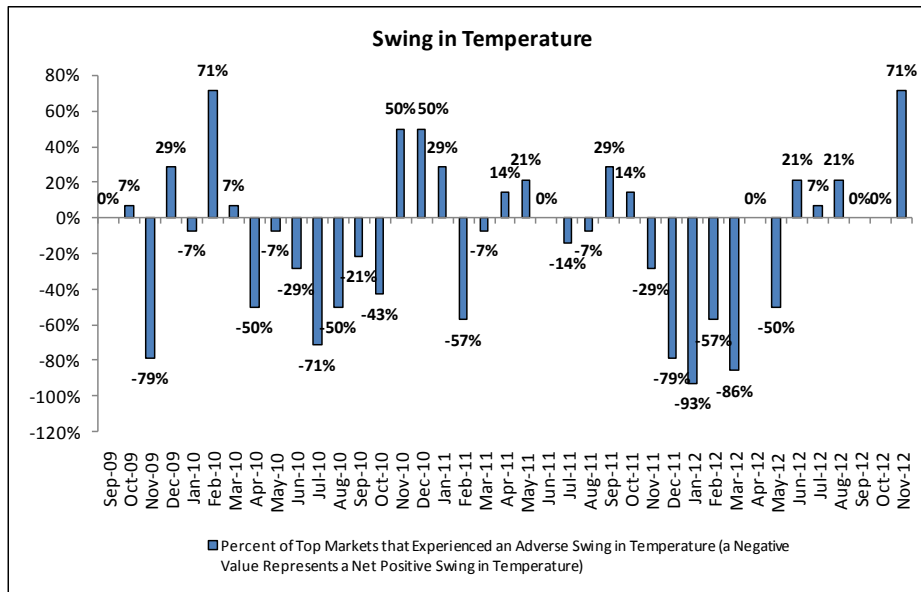
While it is still early in the winter selling season, it is worth noting that numerous respondents in the Northeast indicated that virtually all of their suppliers are currently offering extremely sharp prices on winter-weather related products, such as wipers, anti-freeze and batteries. According to our channel contacts, these promotions are a function of weak demand trends, the lack of significant snowfall thus far, and the warmer-than-expected temperatures that many regions have experienced thus far during the first few weeks of December. These factors appear to be being compounded by significant inventory investments in these categories by the parts suppliers that were expecting a very cold and snowy winter. As a result, we will continue to monitor this trend intently—especially if the trend of low precipitation and above-average temperatures continue in the Midwest and Northeast.

Weather Trends Mixed in November

According to our proprietary weather screen, temperature trends were mixed in the key markets of our survey relative to the prior year. Specifically, the first chart below illustrates that precipitation was significantly less on a year-over-year basis, as a net 64% of the markets witnessed a decrease in precipitation levels during the month. The second chart highlights the fact that temperatures were lower compared to last November, as a net 71% of the markets witnessed cooler weather during the month.

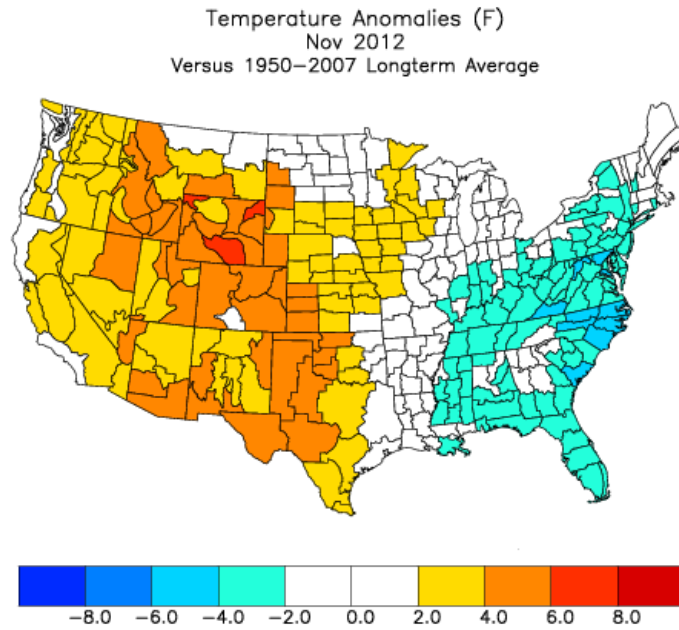


Source: Northcoast Research, U.S. Department of Commerce

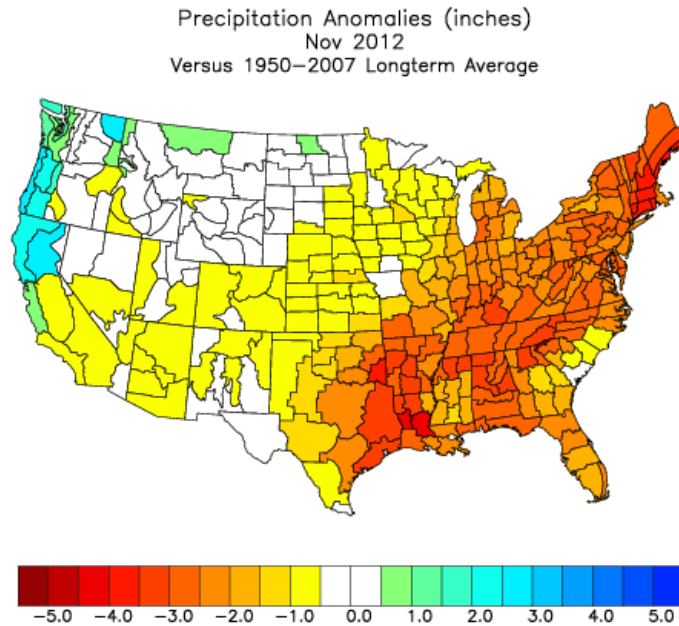


Source: Northcoast Research, U.S. Department of Commerce

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

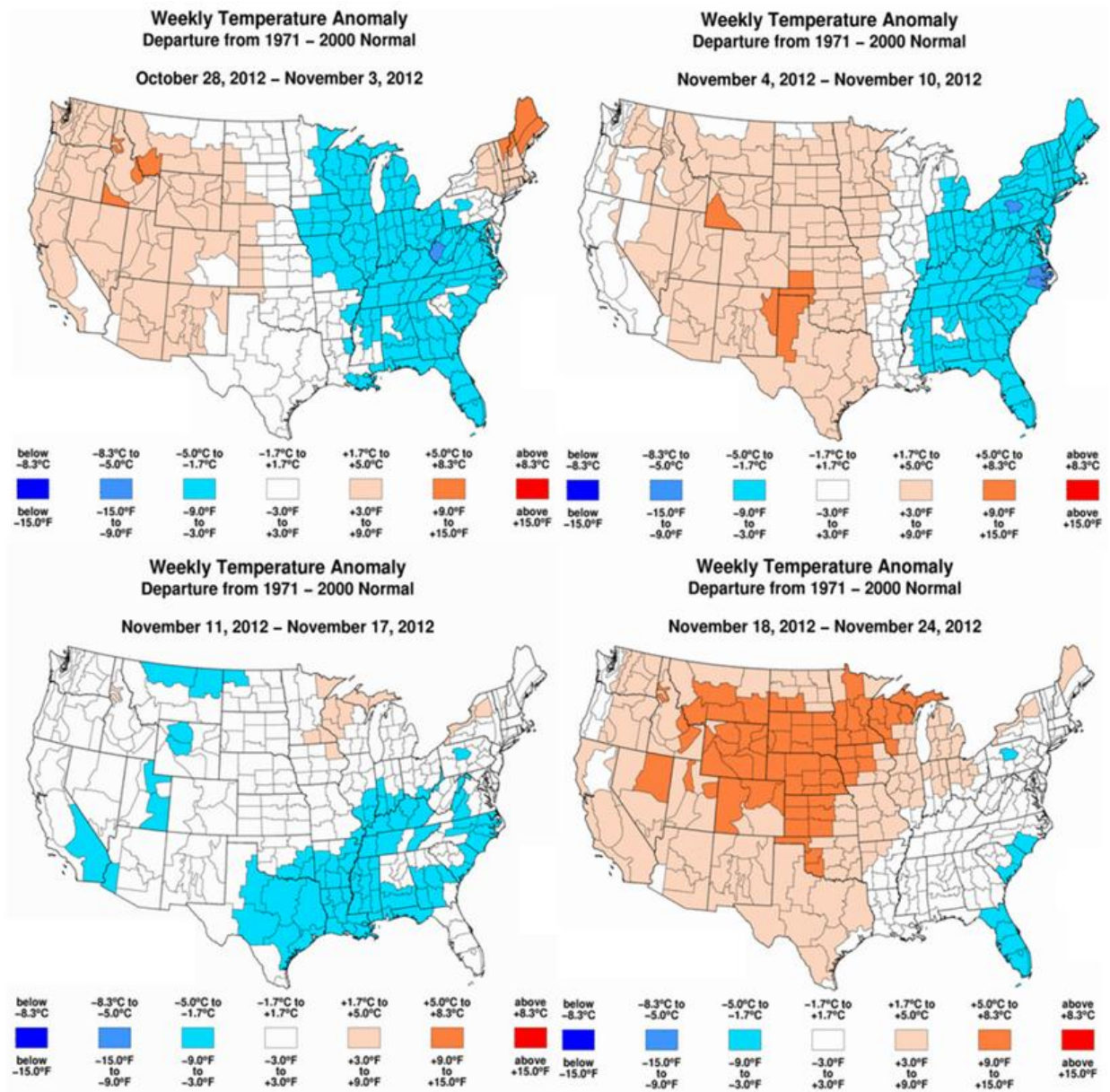


Source: U.S. Department of Commerce



Source: U.S. Department of Commerce

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



Source: U.S. Department of Commerce

Warm Temperatures in December are Not Helping Matters

Although the table below shows that temperature trends were mixed on a year-over-year basis during the last three weeks of November, most of the weather sensitive territories experienced cooler temperatures. That said, the first two weeks of December have clearly gotten off to a much warmer start than the prior year's period. The result of this cadence is that there have been fewer weeks with an average temperature below freezing, which is a headwind for failure rates in the near-term as extreme cold temperatures can accelerate part failure.

Mother Nature isn't helping the winter selling season thus far in 2012, as key weather sensitive regions are warmer y/y thus far in December (on top of warm 2011)

Tempratures in December Have Been Warmer Y/Y for the Second Consecutive Year...

	Northeast	Upper Midwest	Central	Southeast	Plains	South	Southwest	Northwest	West
November '11	7.2%	2.0%	4.7%	2.8%	(3.1%)	0.6%	(2.4%)	(4.7%)	(3.7%)
December '11	41.4%	36.2%	33.2%	29.2%	(3.0%)	(3.6%)	(21.5%)	(11.3%)	(12.8%)
November '12	(9.7%)	(0.7%)	(6.6%)	(3.3%)	8.0%	2.8%	11.1%	12.8%	10.1%
December '12	3.3%	37.7%	26.5%	9.4%	44.7%	30.0%	35.3%	24.9%	19.2%

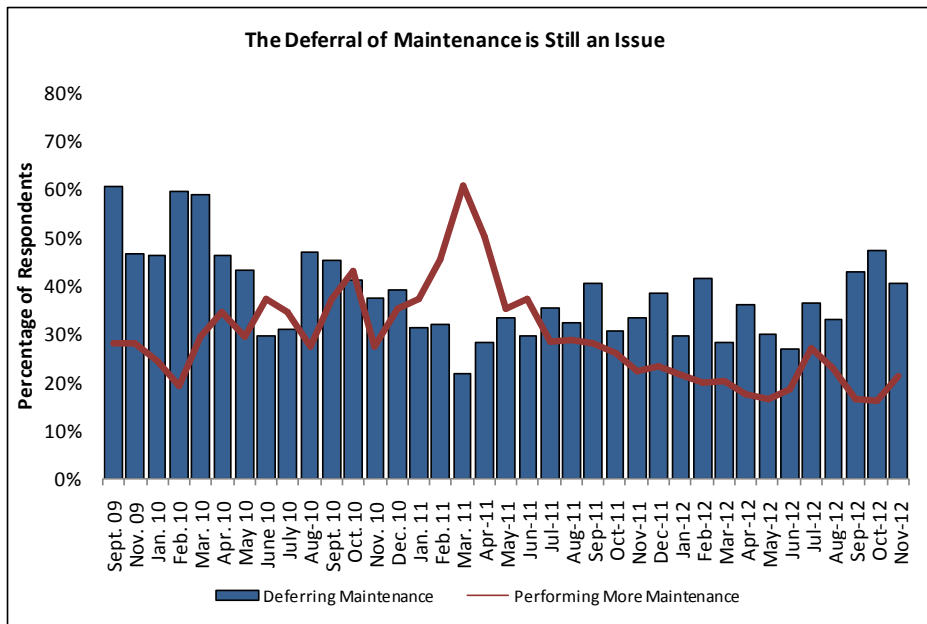
...Which Has Resulted in Fewer Weeks Below the Crucial Freezing-Temperature Threshold

	Northeast	Upper Midwest	Central	Southeast	Plains	South	Southwest	Northwest	West
2011:									
November '11	-	-	-	-	-	-	-	-	-
December '11	-	2	-	-	2	-	2	2	-
Total	-	2	-	-	2	-	2	2	-
2012:									
November	-	1	-	-	2	-	-	-	-
December	-	1	-	-	1	-	-	-	-
Total	-	2	-	-	3	-	-	-	-
y/y Δ	-	-	-	-	1	-	(2)	(2)	-

Source: NOAA, Northcoast Research estimates

Maintenance Headwind Continues

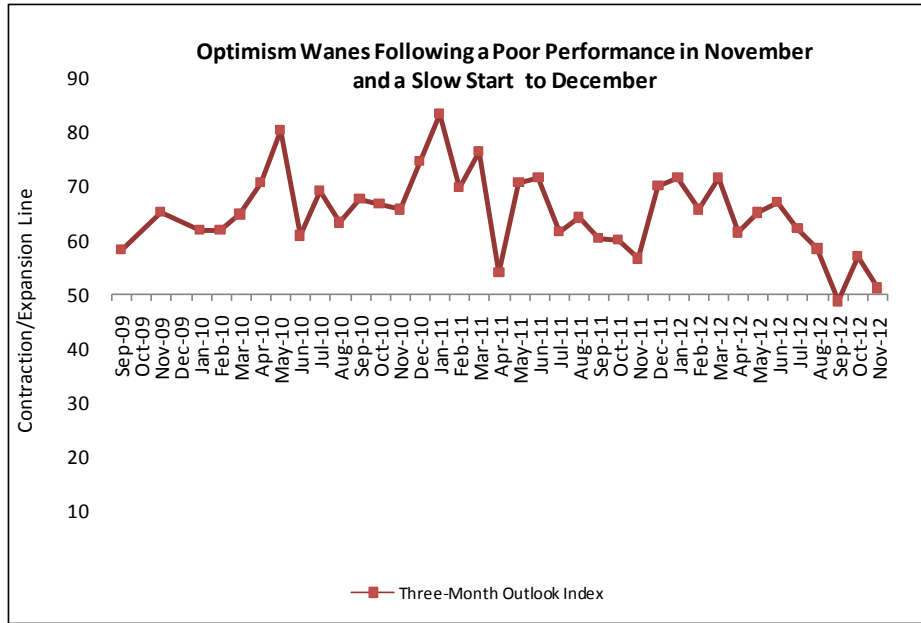
The tendency of consumers to defer nonessential work, which has been an obstacle to demand trends for a number of quarters, continued to pressure traffic trends during November. That said, the net number of respondents to cite deferred maintenance as a headwind to sales patterns moderated somewhat as only 19.1% of the respondents reported that their customer base was deferring routine maintenance, which is down from a net 31.3% in October. Whether this behavior is being driven by macro pressures; the changing car parc, as we believe; or perhaps a combination of both factors, the bottom line is that consumer spending on car care has taken a back seat to other expenses. The net deferral rate of 19.1% in November compared to the average reading of a net 9.0% since inception.



Source: Northcoast Research

Optimism Falters Ahead of Christmas...as We Near the “Fiscal Cliff”

The expectations of garage owners became substantially more pessimistic in November as evidenced by the drop in our Three Month Outlook Index. Specifically, the index fell 10.3% to 51.1, which is the second lowest reading in the history of the time series (September 2012 marked the low point). With the index hovering near 50.0, the implication is that operators—historically a very optimistic bunch—expect sales over the next three months to be approximately flat compared to a year ago. On a more granular level, the general consensus was that December would be a very disappointing month considering that the first few weeks of the period were below expectations and the fact that Christmas falls on a Tuesday compared to Sunday in the prior year. The latter factor is clearly a headwind because many shops are closed on Sunday, which means the holiday had little-to-no impact on demand in 2011, whereas, this year the garage operators will be closed on Tuesday.



Source: Northcoast Research

A Quick Look at Same-Store Estimates

Our latest survey suggested that sales trends in November were extremely weak, and the corresponding anecdotal commentary from the garage owners suggests that the weak trends carried over into the first part of December. That said, we are maintaining our estimates until we gain insight into how the last two weeks of the year finish out; however, all indications at this time suggest that there is downside risk to our current same-store sales estimates. The table below highlights our same-store sales estimates for Advance Auto parts, AutoZone, O’Reilly and Monro:

Comparable-Store Sales Trends								
Retailer	Oct-11	Dec-11	Apr-12	Jul-12	Oct-12	Dec-12E	Apr-12E	Jul-12E
Advance Auto Parts (AAP)	2.2%	2.9%	2.1%	(2.7%)	(1.8%)			
Northcoast Research Estimates						(1.5%)	1.3%	4.2%
Consensus						(1.6%)	0.2%	2.5%
AutoZone (AZO)	Aug-11	Nov-11	Feb-12	May-12	Aug-12	Nov-13	Feb-14E	May-14E
	4.5%	4.6%	5.9%	3.9%	2.1%	0.2%		
Northcoast Research Estimates							1.7%	2.9%
Consensus							0.9%	2.5%
Monro Muffler Brake (MNRO)	Sept-11	Dec-11	Mar-12	Jun-12	Sept-12	Dec-12E	Mar-12E	Jun-12E
Northcoast Research Estimates	(0.8%)	0.0%	0.7%	(7.2%)	(4.6%)	(1.7%)	2.5%	7.0%
Consensus						(2.8%)	1.6%	5.7%
O’Reilly (ORLY)	Sept-11	Dec-11	Mar-12	Jun-12	Sept-12	Dec-12E	Mar-12E	Jun-12E
	4.8%	3.3%	6.1%	2.5%	1.3%			
Northcoast Research Estimates						2.8%	2.5%	3.5%
Consensus						3.0%	1.7%	3.6%

Source: Company Reports, Northcoast Research estimates

Anecdotal Comments

The following anecdotal comments best reflect what we heard from the survey respondents during the month.

- “All of my suppliers are slashing prices on winter-related inventory, because it’s been really warm around here this year and they all have the stuff coming out of their ears...especially Advance Auto Parts.” (Michigan)
- “I’m starting to think that people are never going to fix their cars again because the ones that can afford it are going to be buying newer cars soon.” (Michigan)
- “I’m not expecting business to turn around anytime soon. In my area, people just don’t have much money and I have no reason to believe that anything is going to change.” (New York)
- “Business is absolutely terrible...in November my average repair order increased 2% year-over-year, but my car count was off 10%.” (California)
- “December has started very slow, which is amazing given the fact that I struggled last December. Additionally, the last week is going to be challenged with Christmas coming on a Tuesday rather than a Sunday.” (Texas)

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, Monroe Muffler Brake and O’Reilly Automotive.

DISCLOSURES

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Ratings

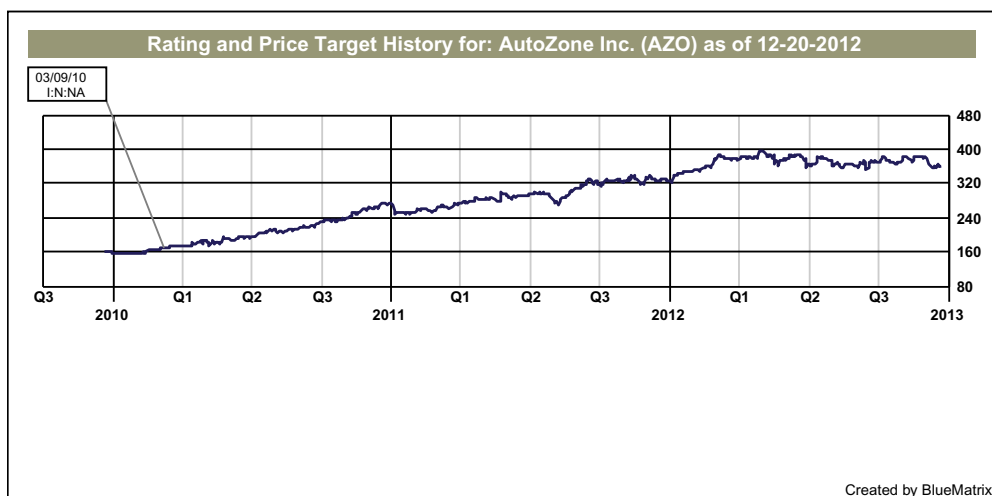
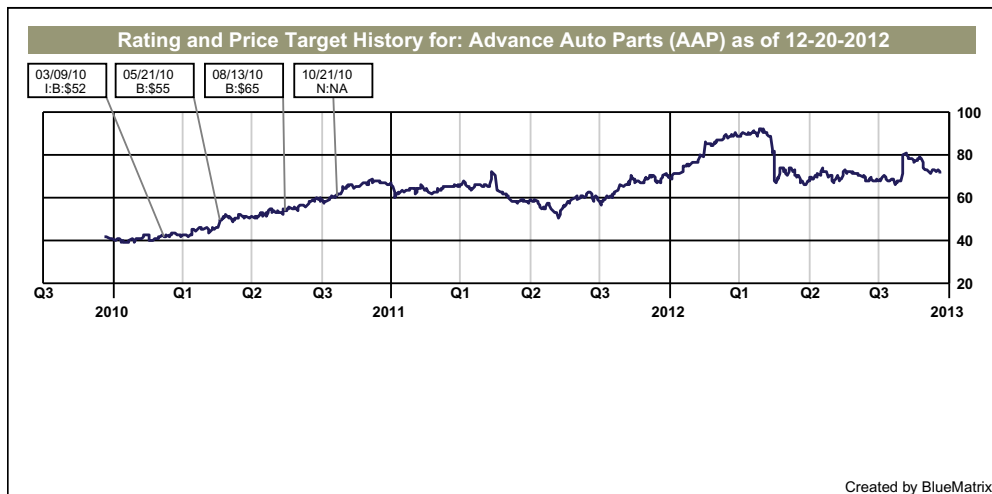
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

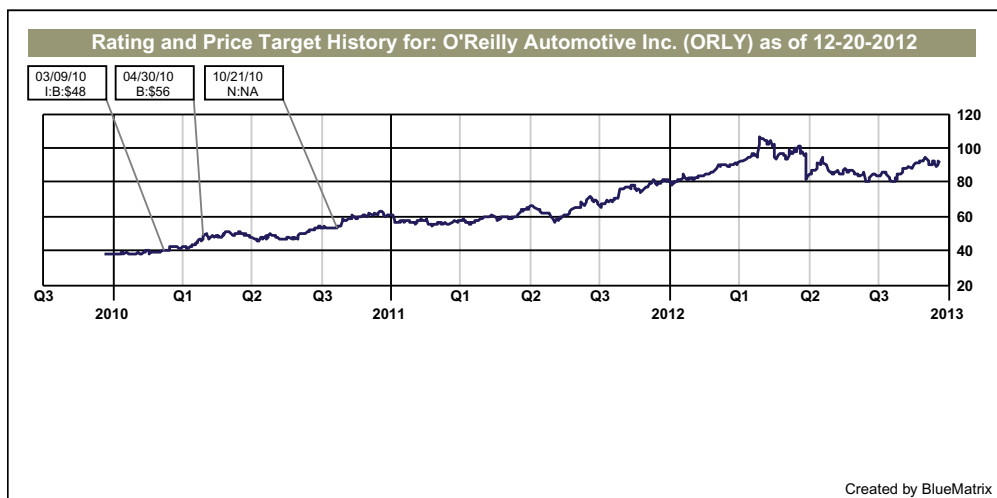
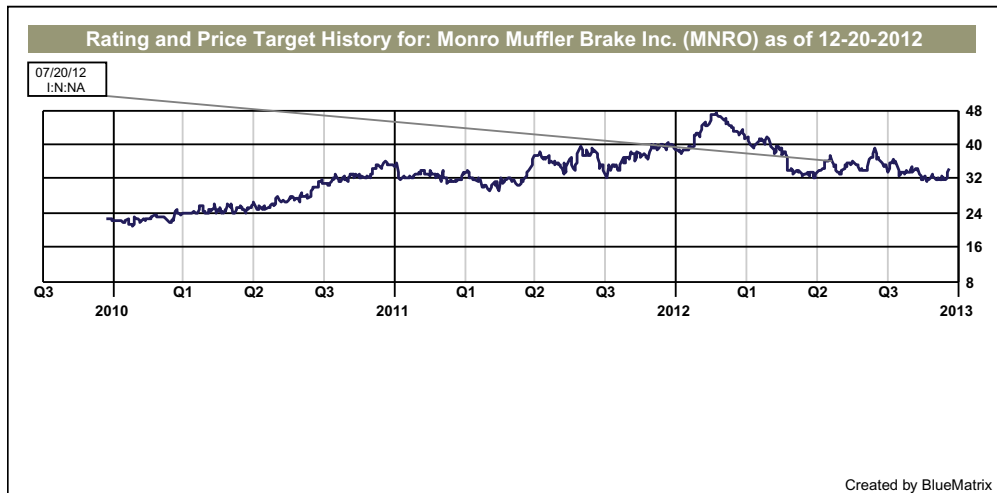
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

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)	76	50.00%
SELL(S)	6	3.95%
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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