

Automotive Aftermarket Retailers

Independent Automotive Repair Garage Survey: December 2012

Overview

- According to the survey responses of nearly 350 independent garage owners, demand trends in the DIFM channel remained severely pressured in the final month of 2012, as evidenced by the fact that the Current Sales Index finished December at 38.4, which punctuated a less-than-spectacular year for the industry.
- It is important to point out that the weakness moderated from the anemic trends witnessed in November. Additionally, it is important to highlight the fact that the industry faced a tough calendar comp in that Christmas fell on a Tuesday this year, as opposed to a Sunday in 2011. This shift had the effect of shortening the operating calendar, since most garages are already closed on Sunday.
- Despite the fact that the weak traffic results in December were obviously exaggerated by the timing of Christmas, there clearly is a downward trend in the net percentage of garages that are experiencing year-over-year gains in car count.
- Temperature trends through the first two weeks of January have improved significantly from the patterns witnessed in December as temperatures have largely been colder across the country relative to the conditions seen in the prior year. That said, we do not think this development will have a material impact on demand trends.
- The collective outlook of the garage owners in our sample became meaningfully more optimistic as we entered 2013. The most commonly cited reasons for the improved outlook were: (1) easy comparisons; (2) the expectation for a release of pent-up demand for repair work; and (3) the belief that weather can't serve as another material headwind in 2013.

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 ongoing weakness in sales trends. 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 3 to 4 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	74.08	NA	N	\$0.79e	\$5.16e	\$5.59e	5,434.8
AZO	\$353.37	NA	N	\$4.85e	\$28.05e	--	\$12,838.5
MNRO	\$36.04	NA	N	\$0.37e	\$1.44e	--	\$1,127.7
ORLY	\$88.70	NA	N	\$1.06e	\$4.67e	\$5.32e	\$10,167.0

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

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INTEGRITY

TRUST

VALUE

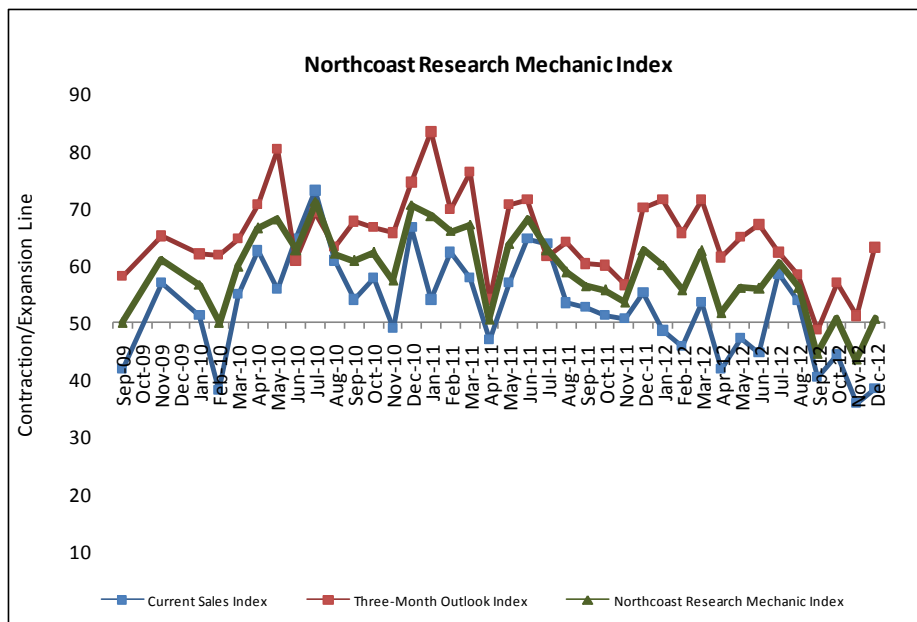
Independent Automotive Repair Garage Survey

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



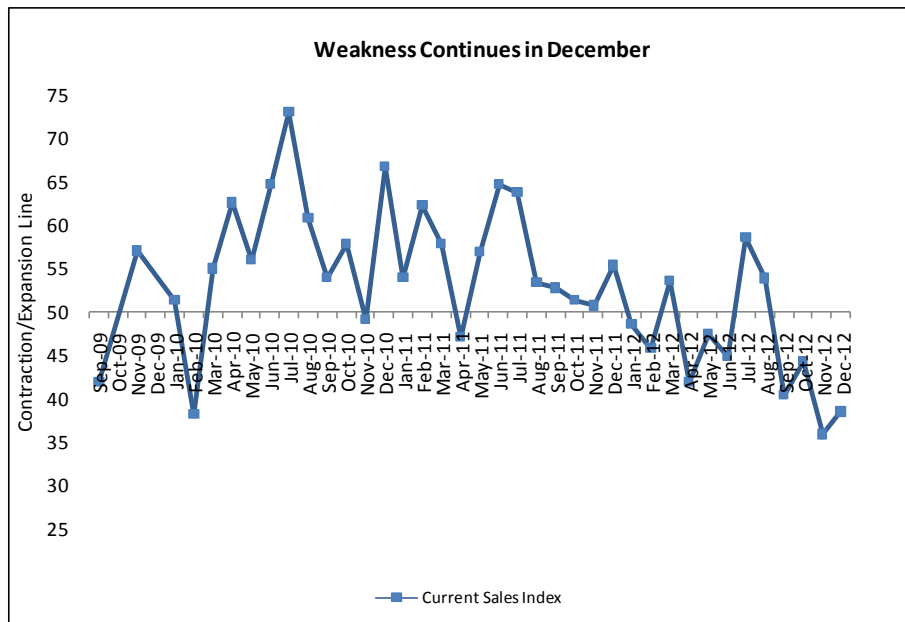
Source: Northcoast Research

According to the survey responses of nearly 350 independent garage owners, demand trends in the DIFM channel remained severely pressured in the final month of 2012, as evidenced by the fact that the Current Sales Index finished December at 38.4. Despite the weak operating environment at the end of the year, the near-term outlook of the garage owners improved dramatically—Three Month Outlook Index surged 23.4% sequentially to close at 63.1—which pushed the composite index above the

expansion/contraction line (rose 16.8% to 50.7). We provide further details on the drivers of the two sub-indices below.

A Fitting End to 2012

The Current Sales Index only increased 7.4% sequentially to finish December at 38.4, which was well below the expansion/contraction line. In fact, the reading at the end of 2012 marked the third lowest level that we have recorded since the inception of our survey, and the second consecutive print below 40.0. The extremely soft results in December punctuated a less-than-spectacular year for the industry. Specifically, the Current Sales Index had an average reading of 46.1 during 2012, versus 55.8 during 2011 and 57.4 in 2010. Recall that a reading below 50.0 suggests that end-market demand decreased on a year-over-year basis. The nearly 10 point drop in the average reading during 2012 illustrates just how challenging the past year was for players in the automotive aftermarket.



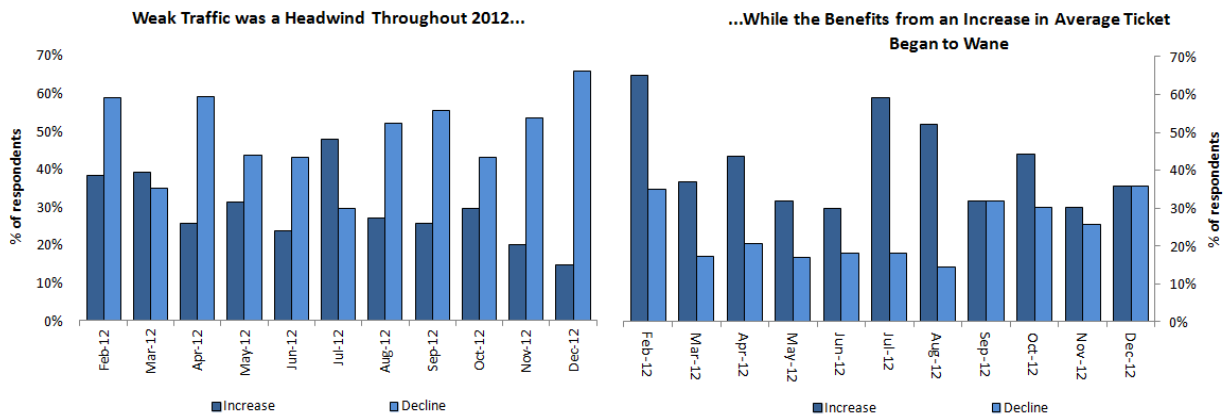
Source: Northcoast Research

While the data for December obviously implies that demand trends were weaker on a year-over-year basis, it is important to point out that the weakness moderated from the anemic trends witnessed in November. Additionally, it is important to highlight the fact that the industry faced a tough calendar comp in that Christmas fell on a Tuesday this year, as opposed to a Sunday in 2011. This shift had the effect of shortening the operating calendar, since most garages are already closed on Sunday. Additionally, the fact that Christmas Eve and New Year's Eve fell on Monday, which is a period that all garages are open, versus a Saturday last year, which is a day that some facilities are closed, likely provided a slight headwind to sales trends to the extent that garages opted to close for a 3-day window. Recall that O'Reilly noted that this phenomenon represents a 50 basis point headwind to same-store sales in 4Q12.

Soft Traffic Trends Continue to Plague the Industry

It is important to note that while the weakness in demand trends appear to have moderated modestly at the end of 2012 despite the aforementioned calendar headwind, we did not hear anything from the channel in December or early January that leads us to believe that the industry is on the verge of experiencing a sustainable recovery in underlying demand trends.

Namely, traffic patterns continue to pose a headwind to sales trends across the channel. More importantly, the benefits related to a higher average ticket continued to moderate in the final month of 2012. The charts below highlight the percentage of respondents that cited an increase or decrease in traffic trends (left chart), as well as the percentage of technicians that experienced an increase or decrease in the value of their average ticket (right chart) since we formally began tracking this data.

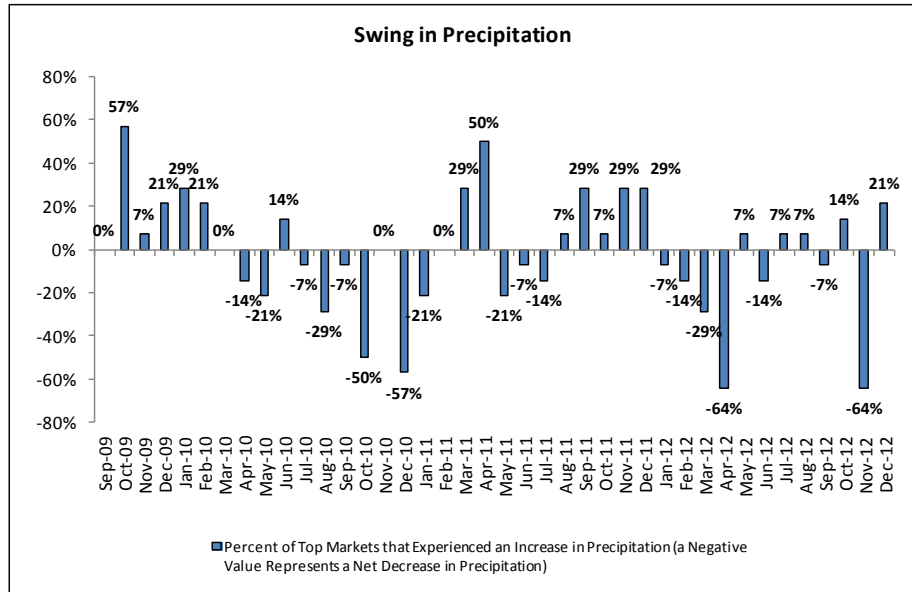


Source: Northcoast Research

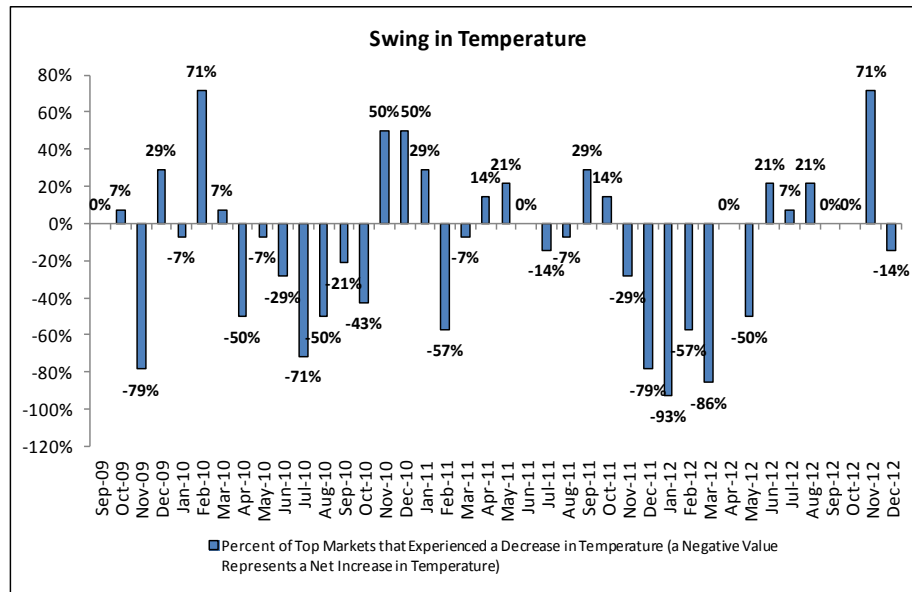
While the weak traffic results in December were obviously exaggerated by the timing of Christmas, there clearly is a downward trend in the net percentage of garages that are experiencing year-over-year gains in car count. We continue to believe that this is related to the fact that consumers have been deferring maintenance for the past 12 months.

Weather Trends Were Mixed in December

According to our proprietary weather screen, weather 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 higher on a year-over-year basis, as a net 21% of the markets witnessed an increase in precipitation levels during the month. The second chart highlights the fact that temperatures were actually warmer compared to last December, as a net 14% of the markets witnessed warmer weather during the month.



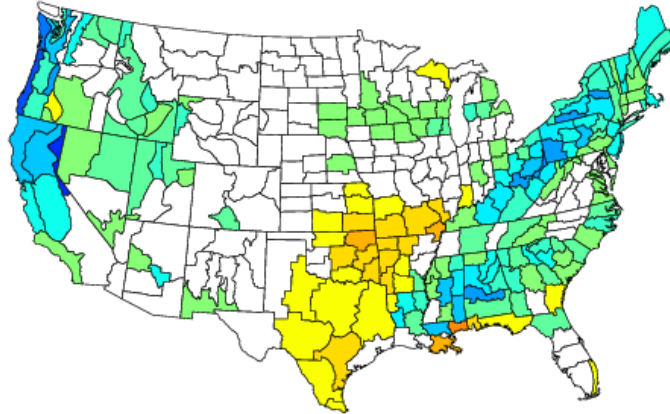
Source: Northcoast Research, U.S. Department of Commerce



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

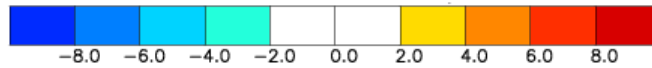
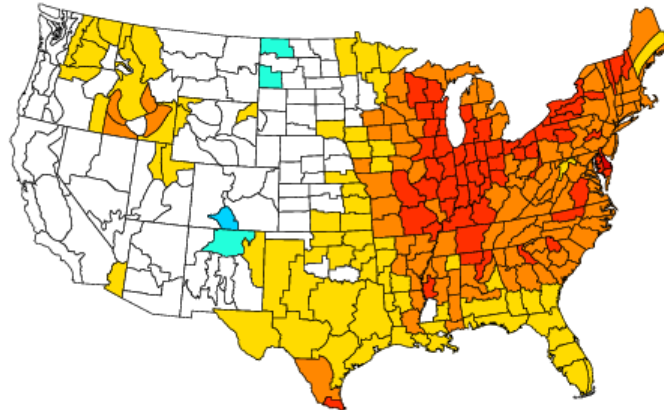
The following maps illustrate the weather trends during December 2012 relative to the long-term averages:

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



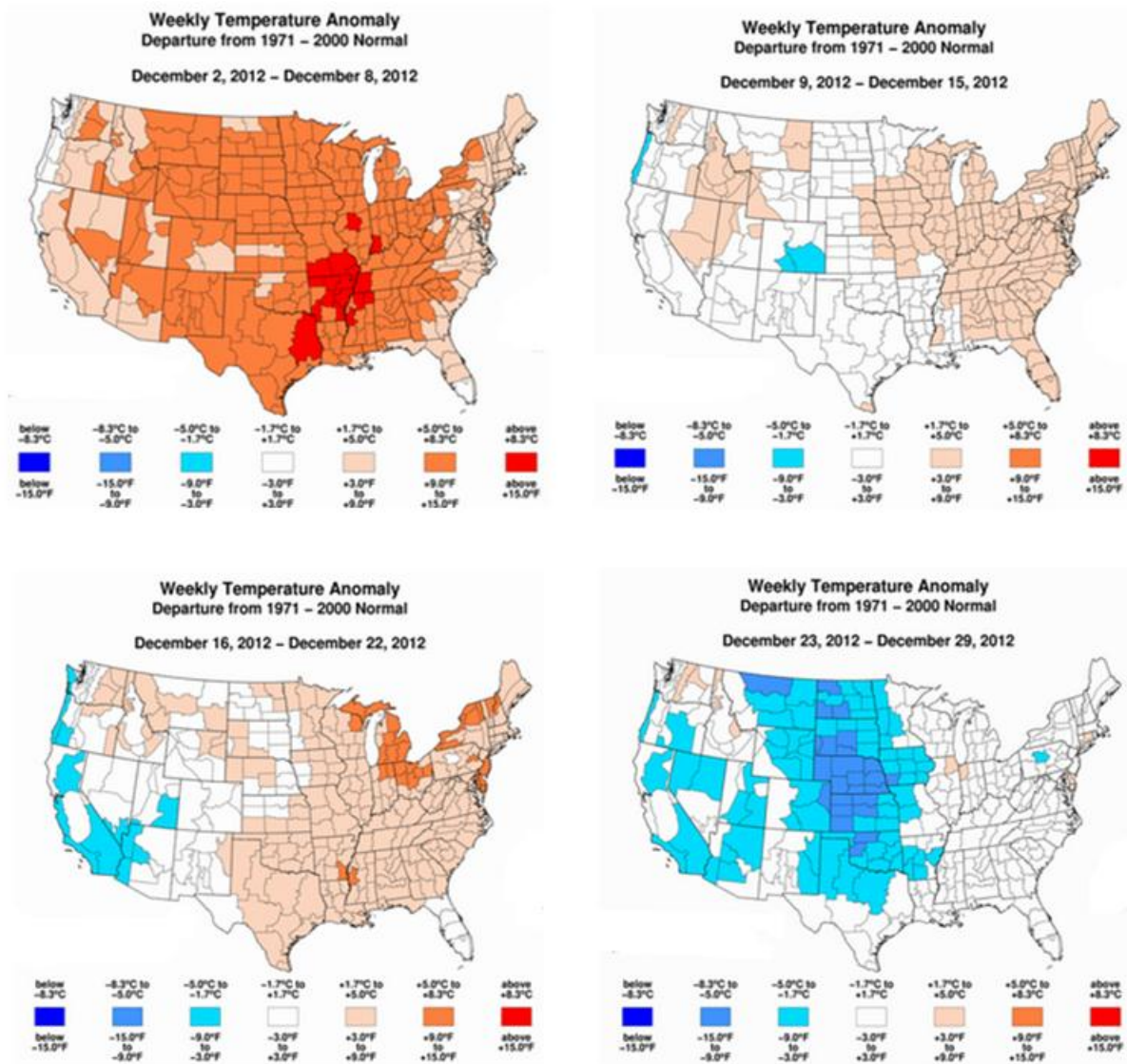
Source: U.S. Department of Commerce

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



Source: U.S. Department of Commerce

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



Source: U.S. Department of Commerce

Winter Weather Finally Arrives...However it Might Not be Enough

The table below shows that temperature trends through the first two weeks of January have improved significantly from the patterns witnessed in December as temperatures have largely been colder across the country relative to the conditions seen in the prior year. That said, we do not think this development will have a material impact on demand trends as there have actually been fewer periods in recent weeks with an average weekly temperature below freezing relative to the prior year's period. This fact is important as freezing temperatures increase near-term failure rates as extreme cold temperatures can accelerate parts failure. The important question is obviously: Will the recent trend continue? We aren't smart enough to predict the weather; however, as it stands now, we would still say that weather has been more of a headwind to the 2012/2013 winter selling season than an opportunity.

The year-over-year change in temperatures through the first two weeks of January have been much better than the performance in December; however, there were still fewer periods in recent weeks with an average weekly temperature below 32° relative to the prior year.

Temperatures Have Been Cooler Thus Far in January

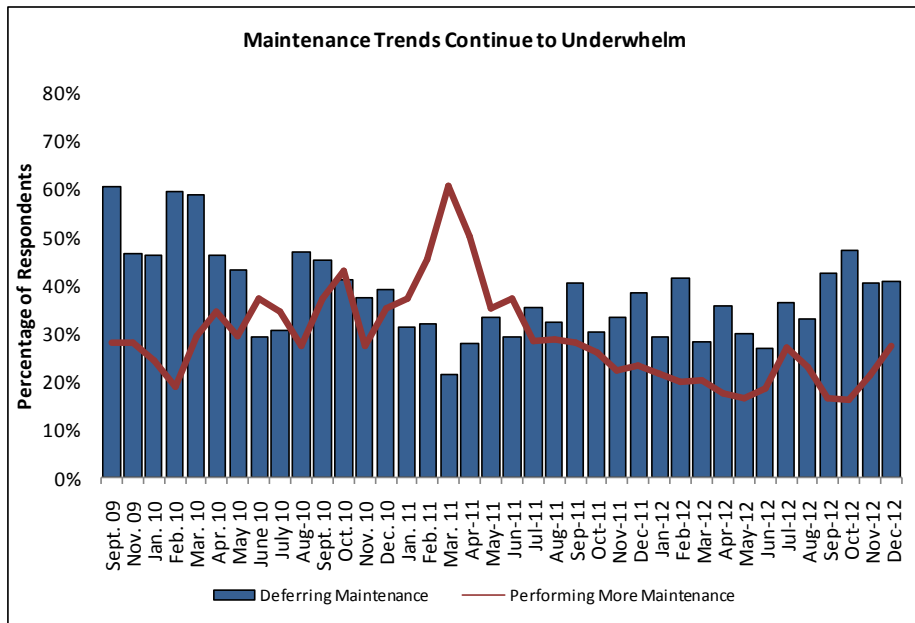
	Northeast	Upper Midwest	Central	Southeast	Plains	South	Southwest	Northwest	West
December '11	36.0%	43.1%	30.6%	24.5%	9.4%	(2.1%)	(17.4%)	(7.8%)	(9.8%)
January '12	22.2%	105.9%	36.0%	15.0%	55.7%	17.0%	21.7%	16.0%	14.7%
December '12	3.6%	19.7%	18.0%	6.2%	20.6%	21.7%	24.3%	18.1%	12.9%
January '13	(9.1%)	(22.4%)	(10.4%)	0.5%	(32.2%)	(12.6%)	(28.1%)	(25.4%)	(24.1%)

However, There Have Been Fewer Periods in Recent Weeks Below Freezing

	Northeast	Upper Midwest	Central	Southeast	Plains	South	Southwest	Northwest	West
Last Year:									
December '11	2	4	-	-	4	-	4	4	-
January '12	2	2	-	-	1	-	-	-	-
Total	4	6	-	-	5	-	4	4	-
This Year:									
December '12	1	3	-	-	3	-	-	1	-
January '13	2	2	1	-	2	-	2	2	-
Total	3	5	1	-	5	-	2	3	-
y/y Δ	(1)	(1)	1	-	-	-	(2)	(1)	-

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 December. That said, the net number of respondents to cite deferred maintenance as a headwind to sales patterns moderated for the second consecutive month. In fact, only 13.6% of the respondents reported that their customer base was deferring routine maintenance, which was down from a net 19.1% in November.

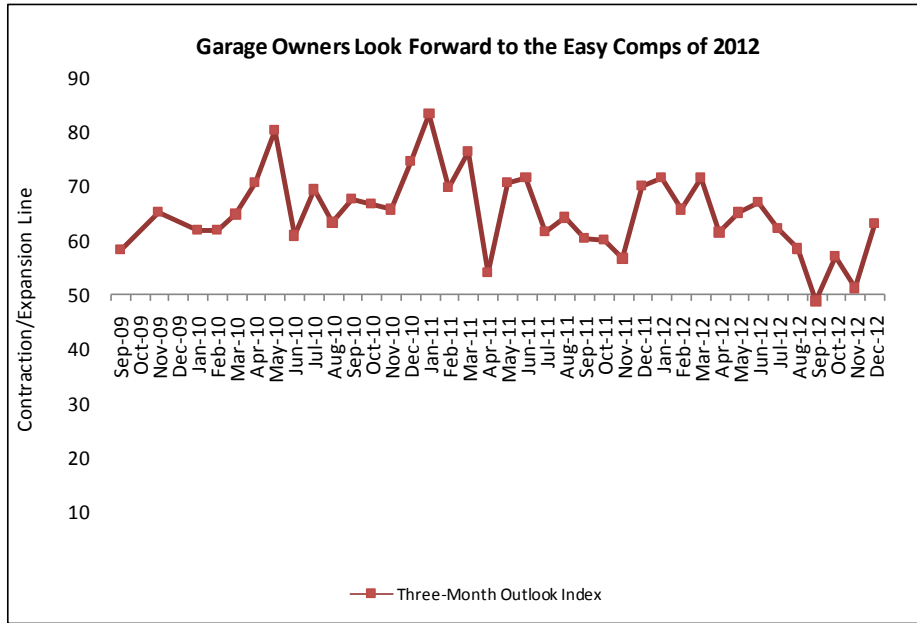


Source: Northcoast Research

We continue to believe that the pressure on maintenance behavior is being driven by macro headwinds and the changing demographics of the car parc—both of which are trends that we expect will continue to weigh on demand in 2013. Additionally, it is important to point out that many mechanics noted that they fear that the higher payroll taxes will pressure maintenance trends in 2013, as households will be left with less real discretionary income absent any significant increase in wages.

Auto Technicians Happily Welcome 2013

The collective outlook of the garage owners in our sample became meaningfully more optimistic as we entered 2013 as evidenced by the jump in the Three Month Outlook Index. Specifically, the index surged 23.4% to 63.1, which was the first time the benchmark has eclipsed 60.0 in five months. Remember that a reading north of 50.0 means that the operators expect to register sales gains over the next three months. The most commonly cited reasons for the improved outlook were: (1) cycling easy comparisons (recall that much of the pull-forward in demand that inflated the results of the parts retailers during 1Q CY12 was driven by the DIY business); (2) deferred maintenance has been so pervasive that there is pent-up demand for repair work; and (3) the weather can't serve as another material headwind in 2013.



Source: Northcoast Research

A Quick Look at Same-Store 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
Northcoast Research Estimates	4.5%	4.6%	5.9%	3.9%	2.1%	0.2%		
Consensus							1.7%	2.9%
							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%)			
Consensus						(1.7%)	2.5%	7.0%
						(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
Northcoast Research Estimates	4.8%	3.3%	6.1%	2.5%	1.3%			
Consensus						2.8%	2.5%	3.5%
						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.

- “We got a storm at the end of the month that helped offset declines earlier in the month.” (Michigan)
- “The promotional activity that characterized the fourth quarter died down at the beginning of 2013. I think that the suppliers realized that the discounts weren't going to jump start demand.” (Georgia)
- “December was my worst month in more than four years. Some of it can be attributed to the fact that Christmas was on a Tuesday this year, but we weren't exactly knocking the cover off of the ball during the first three weeks either.” (New York)
- “People have been putting repairs off for so long that I have to imagine that their cars will give out soon.” (Texas)
- “I think 2013 will be a much better year. If it's not, I can promise you that we won't be having this conversation next year as I don't have the funds to survive another down year.” (Illinois)

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 ongoing weakness in sales trends. 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 3 to 4 years. 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.

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Ratings

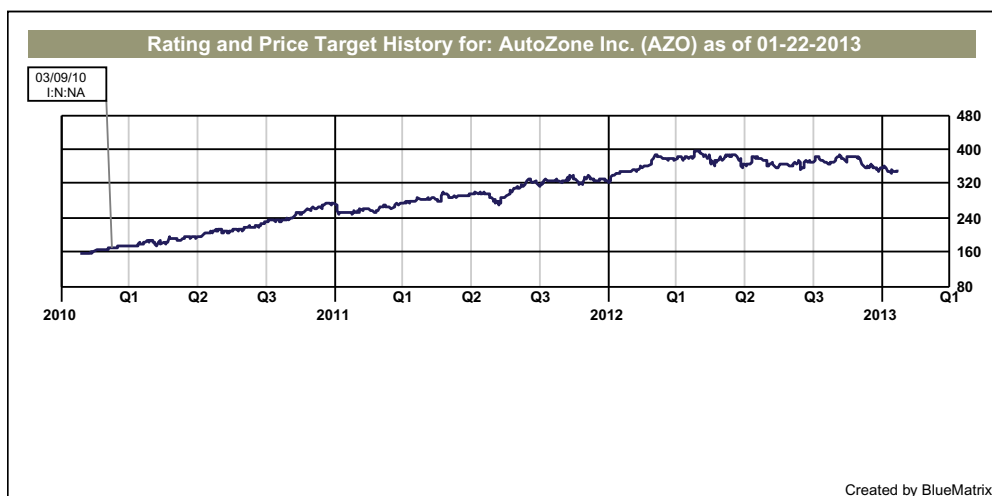
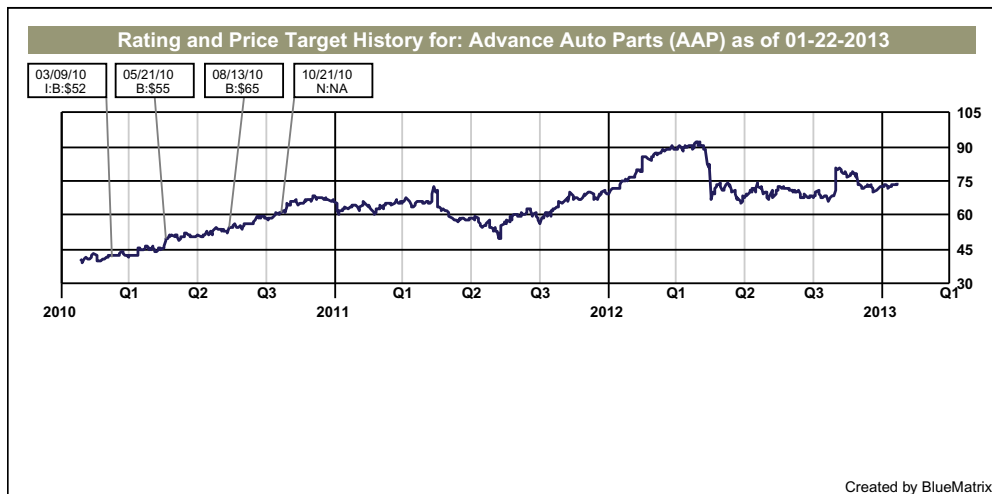
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

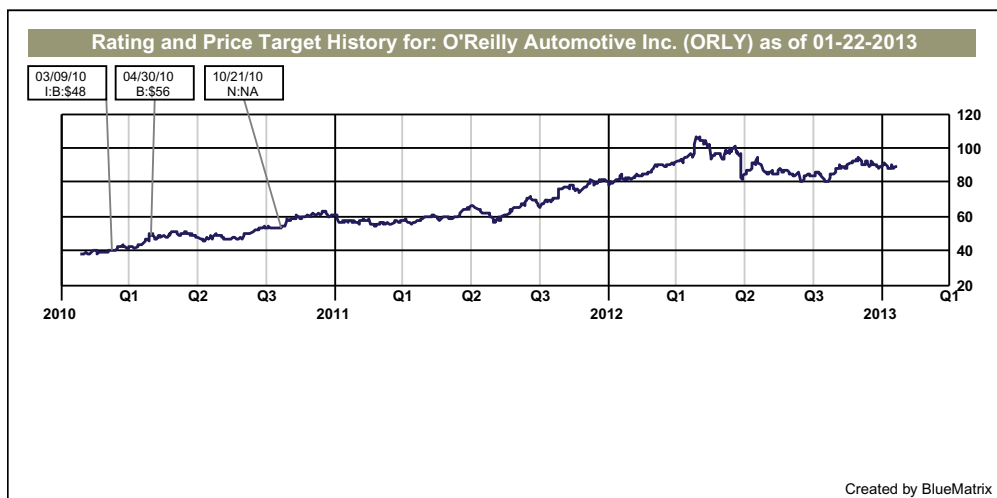
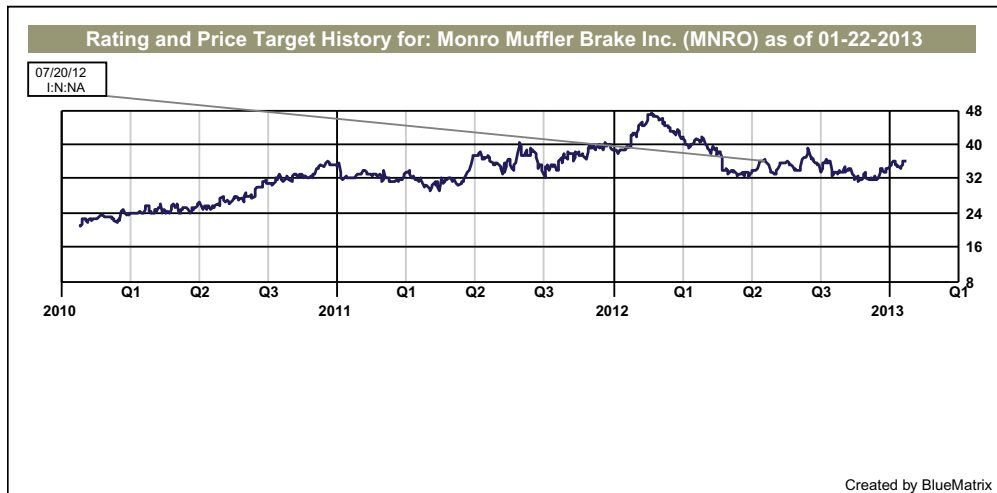
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

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)	68	44.74%
NEUTRAL(N)	78	51.32%
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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