Automotive Aftermarket

Nick Mitchell, CFA, CMT - Managing Director
216.468.6902
nick.mitchell@northcoastresearch.com
Seth Woolf - Research Analyst
216.468.6927
seth.woolf@northcoastresearch.com

Independent Automotive Repair Garage: May 2015

Overview

- According to the survey responses collected from almost 300 independent garage owners, demand trends in the DIFM channel increased in May relative to the prior year's period. We were encouraged that the sales gains were driven by stronger traffic and ticket trends, and by the fact that operators cited that car owners continued to be more proactive regarding the maintenance of their vehicles. The Current Sales Index rose 8.6 points to 63.9, which was much stronger than the average reading of 56.0 since the inception of the study.
- The technicians in our sample indicated that the sales gains in May were driven by increased ticket and traffic trends. In fact, a net 34.8% of the respondents reported seeing stronger ticket trends in the period. This compares to a net 31.9% and 41.8% of respondents witnessing a benefit from a higher average ticket in April and March, respectively.
- As it relates to traffic trends, a net 7.5% of the survey participants reported that traffic levels were stronger on a year-over-year basis in the period. This performance marked a deceleration from the trends witnessed in April and March when 8.0% and 29.7% of the respondents noted an increase in traffic, respectively.
- Operators cited that car owners continued to be more proactive regarding the maintenance of their vehicles. In fact, the barometer of the collective attitude towards routine maintenance and nonessential repairs finished May at the fourth highest reading that we have recorded since the inception of our study.

Conclusion

Although we remain fairly positive on the underlying fundamentals within the automotive aftermarket industry, including the re-emergence of the expansion in the nation's light vehicle fleet, improving miles driven trends, and an increased willingness and ability for consumers to fund vehicle repairs, we continue to believe that demand trends could be volatile in the near-term as the industry is cycling tough comparisons. Despite a healthy backdrop we are reiterating our NEUTRAL ratings on Advance Auto Parts, AutoZone, Monro, and O'Reilly as we feel the market has adequately priced in the improved demand environment. We continue to think O'Reilly and Genuine Parts (i.e. NAPA) will continue to outperform the industry, as we believe the outperformance is a function of a superior strategy, including the decision to invest heavily in distribution assets over the years.

Symbol:	Price	Target Price	Rating	EPS ($) Cur Qtr	EPS ($) Cur Year	EPS ($) Out Year	Mkt. Cap (M)
AAP	158.99	NA	N	$2.30e	$8.22e	$9.35e	11,634.6
AZO	$673.33	NA	N	$12.93e	$36.22e	$40.62e	$20,787.3
MNRO	$62.86	NA	N	$0.57e	$2.20e	--	$2,000.7
ORLY	$226.22	NA	N	$2.22e	$8.59e	$9.53e	$22,846.0

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

Erieview Tower, 1301 E 9th St, Suite 2400
Cleveland, OH 44114
Phone: 216-468-6900 | Fax: 216-468-6901
www.northcoastresearch.com

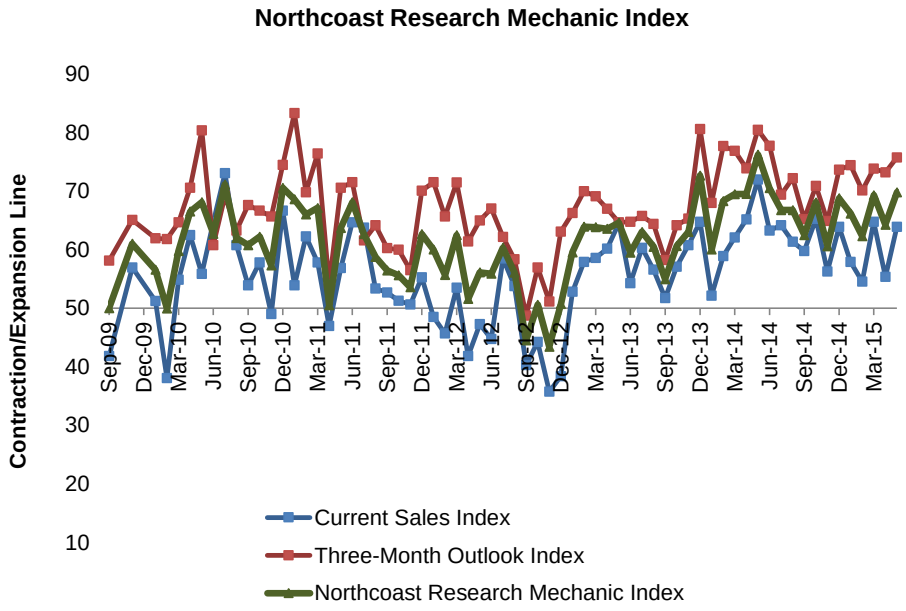
Independent Automotive Repair Garage Survey

Each month we publish the ***Northcoast Research Mechanic Index*** based on the results of our survey, which encompasses the feedback from approximately 200 to 300 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
- Attitudes toward routine maintenance

Northcoast Research Mechanic Index–May Snapshot



Source: Northcoast Research

According to the survey responses collected from almost 300 independent garage owners, demand trends in the DIFM channel increased in May relative to the prior year's period. We were encouraged that the sales gains were driven by stronger traffic and ticket trends, and by the fact that operators cited that car owners continued to be more proactive regarding the maintenance of their vehicles. In fact, the barometer of the collective attitude towards routine maintenance and nonessential repairs finished May at the fourth highest reading that we have recorded since the inception of our study (most favorable reading occurred in March 2015). These positives clearly contributed to the acceleration in the rate of sales growth in the period, as evidenced by the fact that the Current Sales Index rose 8.6 points to 63.9.

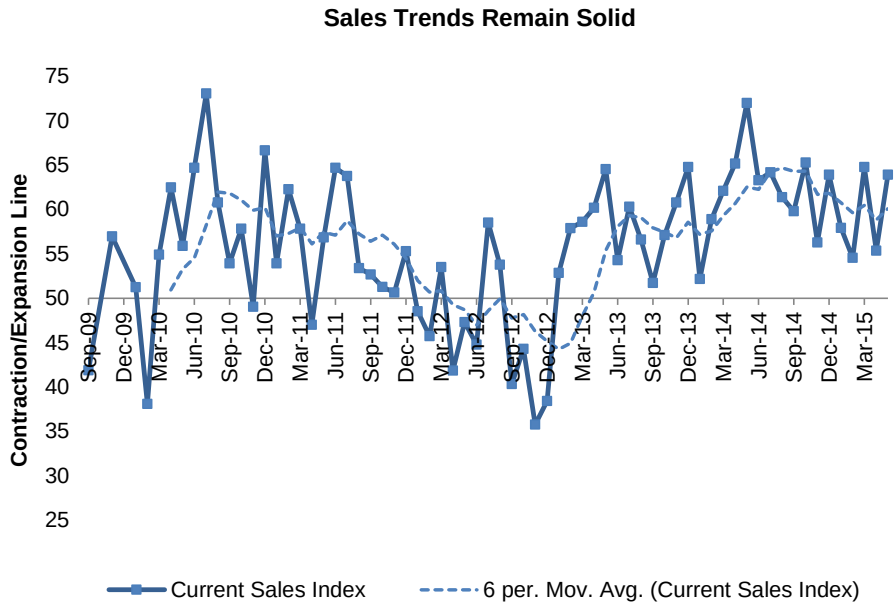
Not surprisingly, respondents noted that the ongoing drop in fuel costs is having a clear positive impact on demand trends in the DIFM channel. Needless to say, vendors indicate that this trend is having a bigger impact in the DIY market given the increased exposure to lower-income customers. More importantly, many contacts continue to

believe that the relief at the pumps will provide a meaningful boost to discretionary repairs and maintenance spending trends in the coming months, as the lower prices should translate into increased driving trends and more disposable income in consumers' wallets, which should make it easier to fund this work.

In light of the solid performance in May, a strong start to June, the projected boon in the coming months from lower gasoline prices, and the fact that intermediate demand trends have remained positive in recent months despite tough comparisons, the technicians' optimism regarding near-term demand trends (i.e. next three months) remained elevated relative to the historical average. Specifically, the Three Month Outlook Index came in at 75.8, which is well above the long-term-average of 67.3.

Sales Trends Remain Solid in May Despite a Tough Comparison; Rate of Growth Accelerates

Our recent channel work suggests that demand trends in the DIFM channel remained positive in May, as high failure rates related to previously deferred maintenance and an aging car parc were supplemented by solid results in the routine maintenance category. Specifically, the Current Sales Index (CSI) finished the period at 63.9. This performance marked an acceleration from the rate of growth recorded in April (55.4), and was much stronger than the average reading of 56.0 since the inception of the study. Recall that a print above 50.0 implies that the market expanded relative to the prior year's period.



Source: Northcoast Research

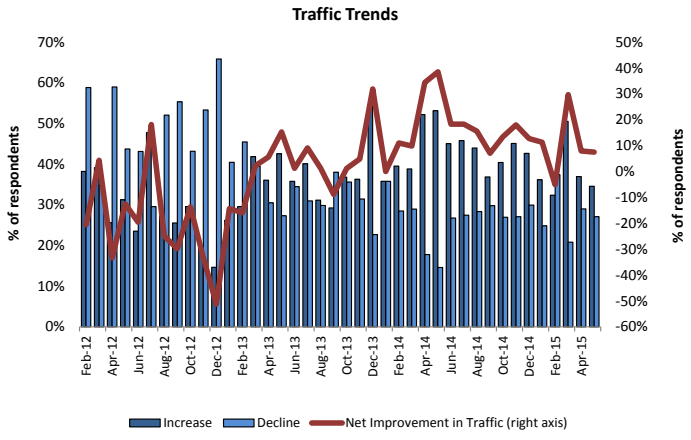
Needless to say, we were very pleased to learn that the sales gains were driven by both higher traffic and a larger average ticket, as the aging car parc continued to manifest itself in the form of more medium-and heavy-duty repair work, which typically carry higher ticket sizes (combination of more expensive parts and more labor hours). While traffic trends decelerated modestly in the period against extremely tough comparisons, the dealers remained optimistic that car count will remain positive throughout the summer selling season due to favorable trends in the routine maintenance category, especially given the fact that increased miles driven trends are leading to an uptick in oil changes and tire volumes. The latter are two important touch points for service providers.

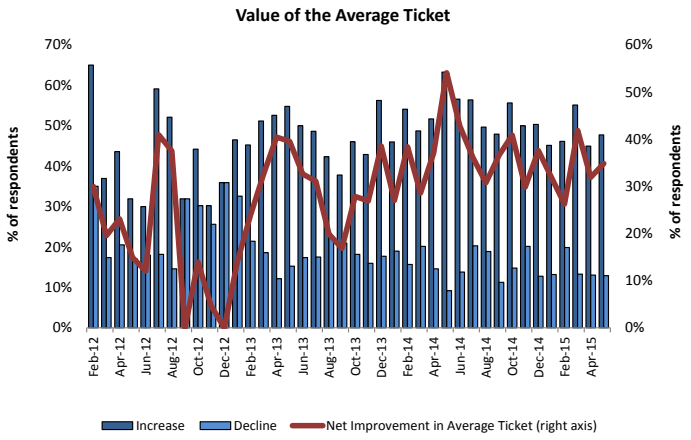
Ticket and Traffic Trends Remain Positive

As noted earlier, the technicians in our sample indicated that the sales gains in May were driven by increased ticket and traffic trends. In fact, a net 34.8% of the respondents reported seeing stronger ticket trends in the period. This compares to a net 31.9% and 41.8% of respondents witnessing a benefit from a higher average ticket in April and March, respectively (average reading since inception is 28.7%). Anecdotal commentary from the channel suggests that the value of the average repair order continued to benefit from a higher mix of medium-and heavy-duty repair work (partially caused by an aging car parc), which typically require higher-priced hard parts, and more parts per job (clearly a positive read-through for volumes at commercial delivery programs). The trend of more technologically advanced parts in late model vehicles is also helping to support the average ticket despite the fact that core inflationary pressures remain fairly muted in the channel. In fact, the slide in oil prices relative to the prior year will likely keep inflationary pressures at bay, especially in the maintenance category.

As it relates to traffic trends, a net 7.5% of the survey participants reported that traffic levels were stronger on a year-over-year basis in the period. This performance marked a deceleration from the trends witnessed in April and March when 8.0% and 29.7% of the respondents noted an increase in traffic. Needless to say, we are very encouraged by the fact that this metric remains positive after rebounding nicely from the weakness seen in February, with traffic trends much healthier than the long-term average of 1.7% of the garages reporting positive car count.

In short, the positive results in May leave us feeling confident in the outlook for traffic trends in the coming quarters. This upbeat assessment is consistent with the technicians' bullish outlook; however, we will keep a close eye on traffic trends going forward given the difficult comparisons in June and July. The charts below highlight the percentage of respondents that saw 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.

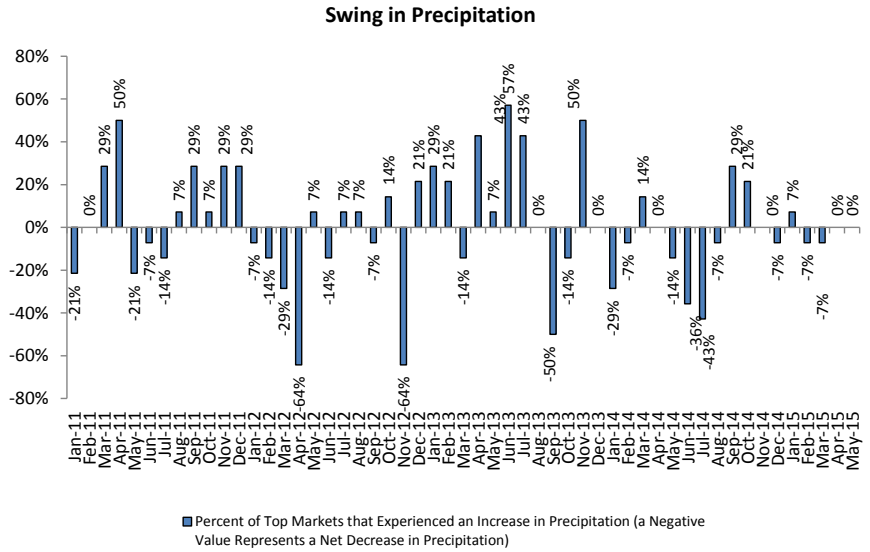




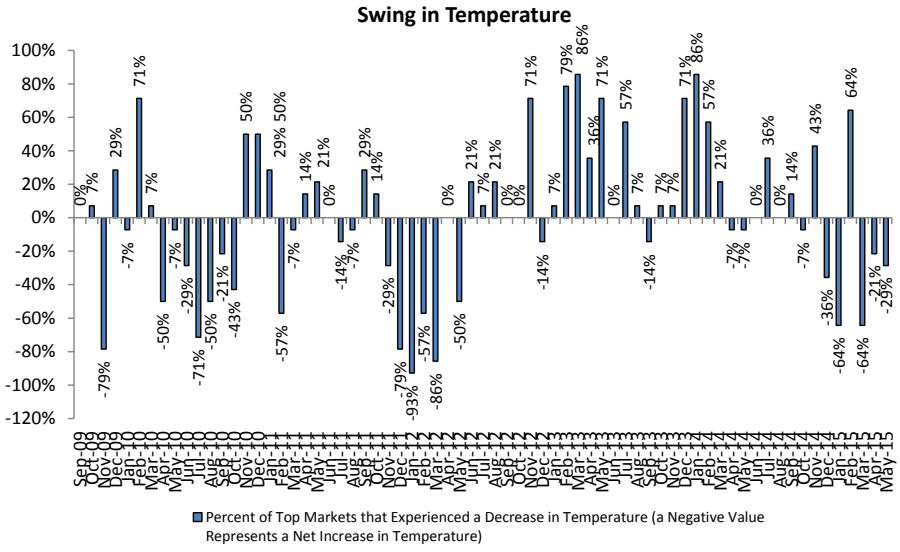
Source: Northcoast Research

Warmer Weather in Key Markets during May 2015 Helped Demand Trends

According to our proprietary weather screen, the key markets in our survey witnessed temperatures that were warmer than the prior year's period. On the flipside, precipitation levels were unchanged. Specifically, the first chart illustrates that precipitation levels were virtually on par with the prior year's period, as a net 0% of the markets witnessed increased precipitation levels. The second chart highlights the fact that temperatures were warmer, as a net 29% of the markets witnessed a higher average temperature during the month compared to the prior year.

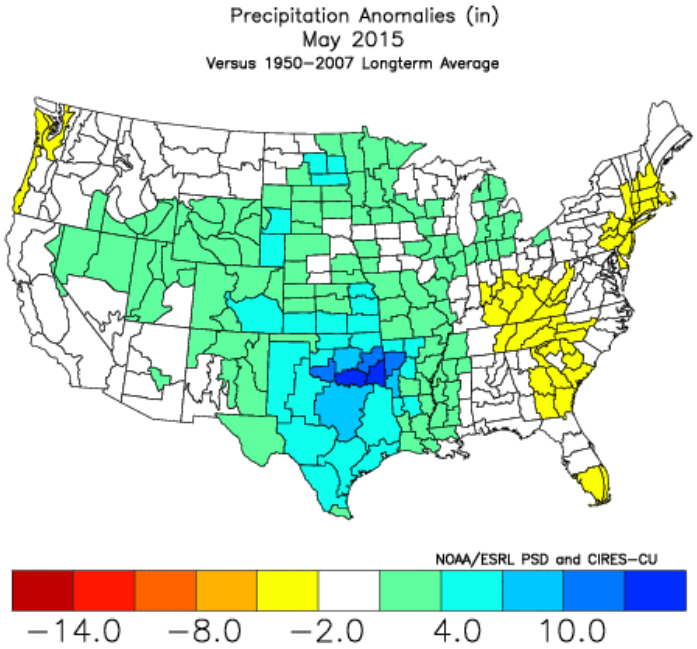


Source: U.S. Department of Commerce

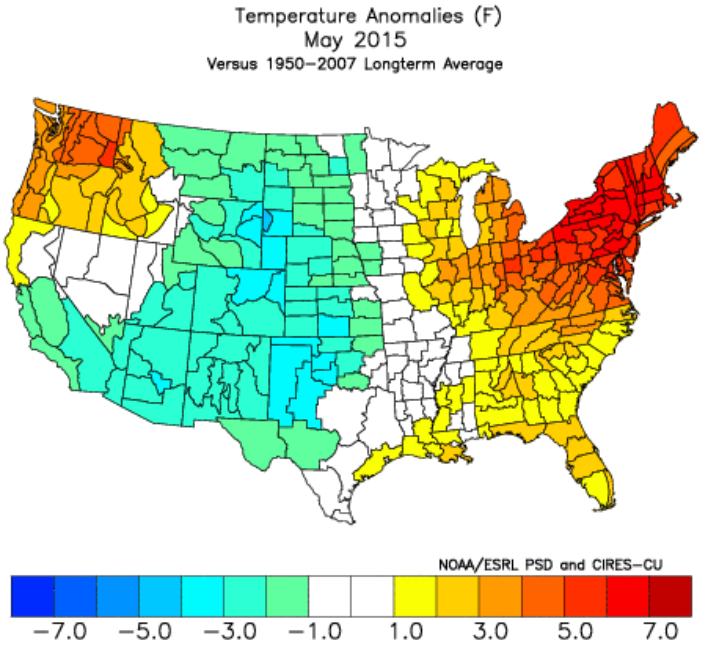


Source: U.S. Department of Commerce

The following maps illustrate the weather trends during May 2015 relative to the long-term averages:

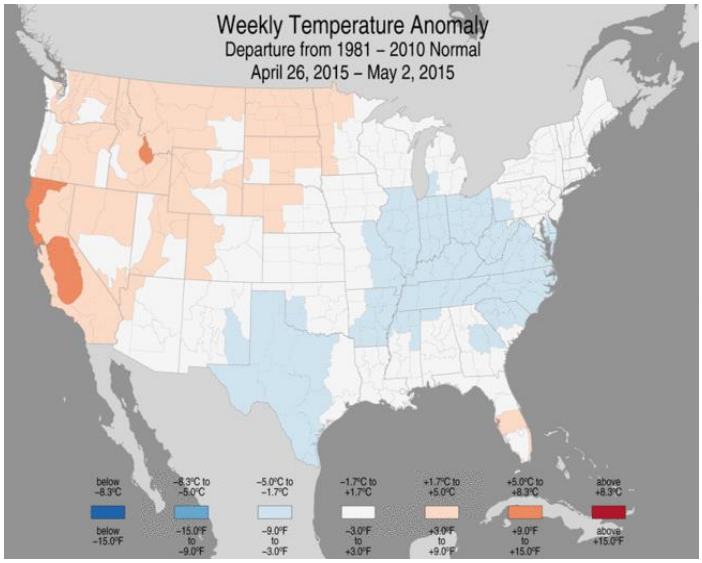


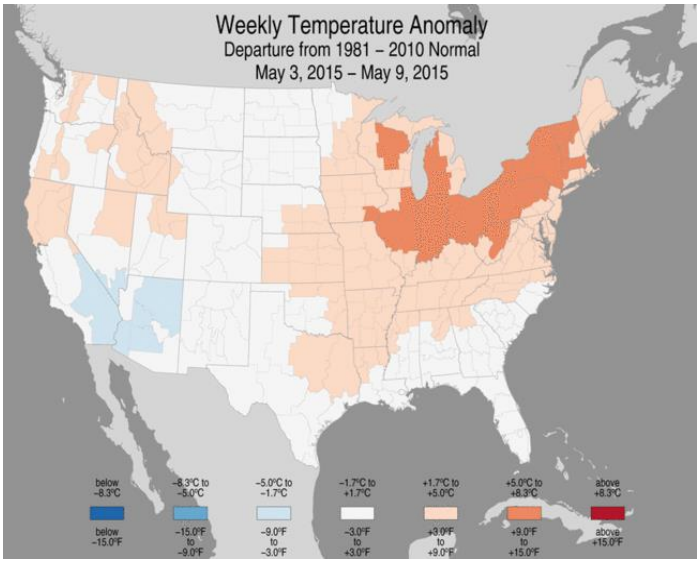
Source: U.S. Department of Commerce

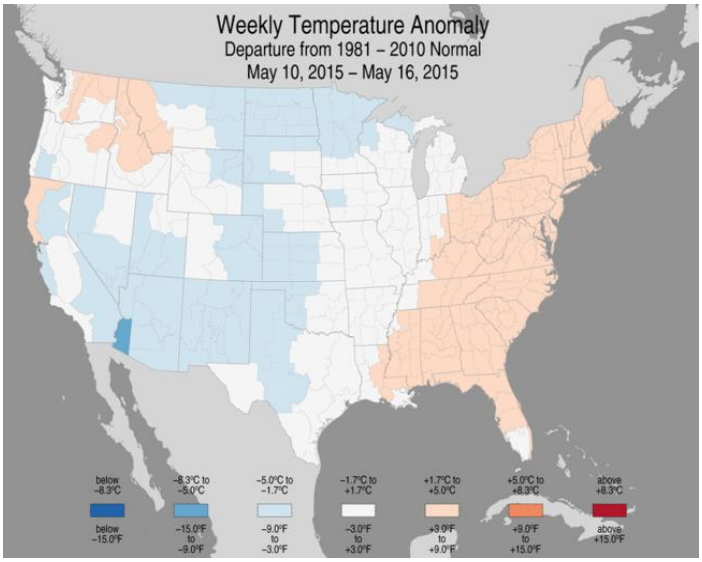


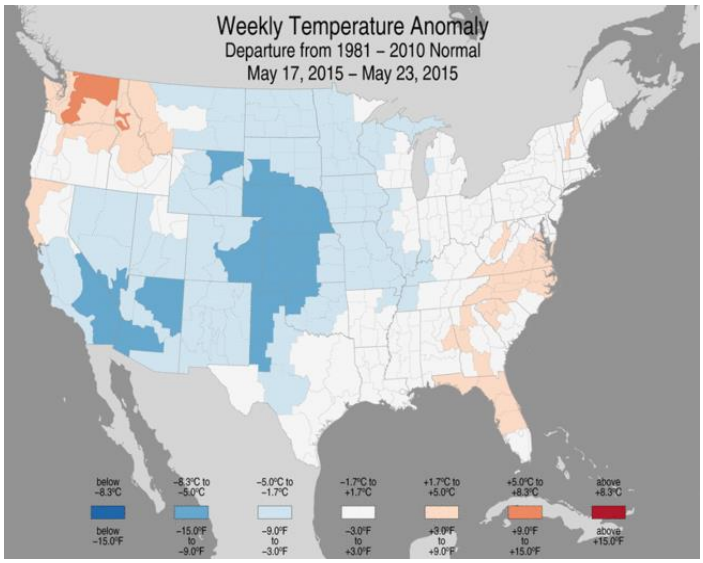
Source: U.S. Department of Commerce

The following maps illustrate the weekly temperature trends during May 2015 relative to the long-term averages:







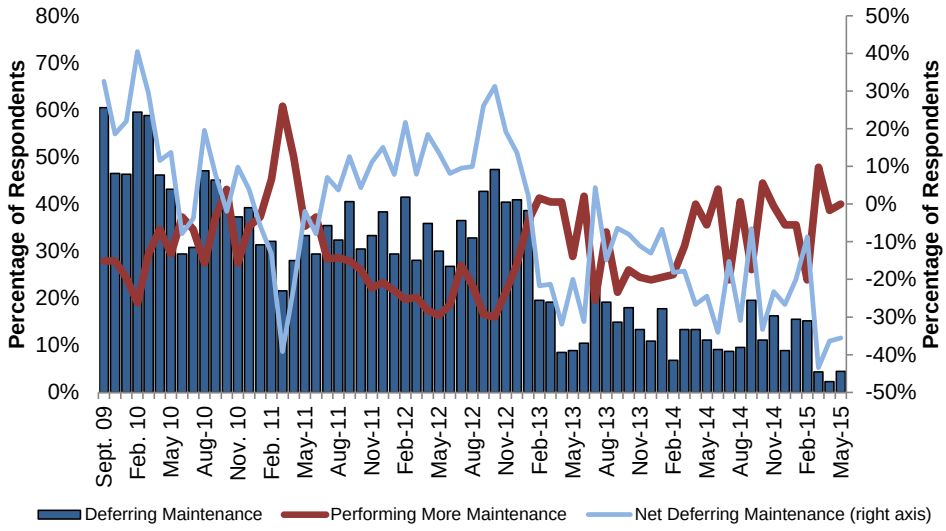


Source: U.S. Department of Commerce

Solid Routine Maintenance Trends Provide a Tailwind to Aggregate Demand in May

Our work suggests that car owners continued to perform more preventative work and nonessential repairs in May, which clearly aided demand trends in the period. Indeed, a net 35.6% of the respondents indicated that their customer base was performing more routine maintenance than they normally do. In fact, the barometer of the collective attitude towards routine maintenance and nonessential repairs finished May at the fourth highest reading that we have recorded since the inception of our study (most favorable reading occurred in March 2015). Additionally, this performance compares to the long-term average reading for this metric of 3.5% of respondents noting an increased amount of preventative maintenance. Operators indicated that trends benefited somewhat from improved weather conditions and a general feeling of increased economic prosperity among a portion of customers (i.e. lower-income households), in large part due to the declining price of gasoline, resolved uncertainty regarding income tax obligations, improving labor markets, and to a lesser extent, less anxiety over healthcare costs.

Routine Maintenance Continues to Provide Tailwind



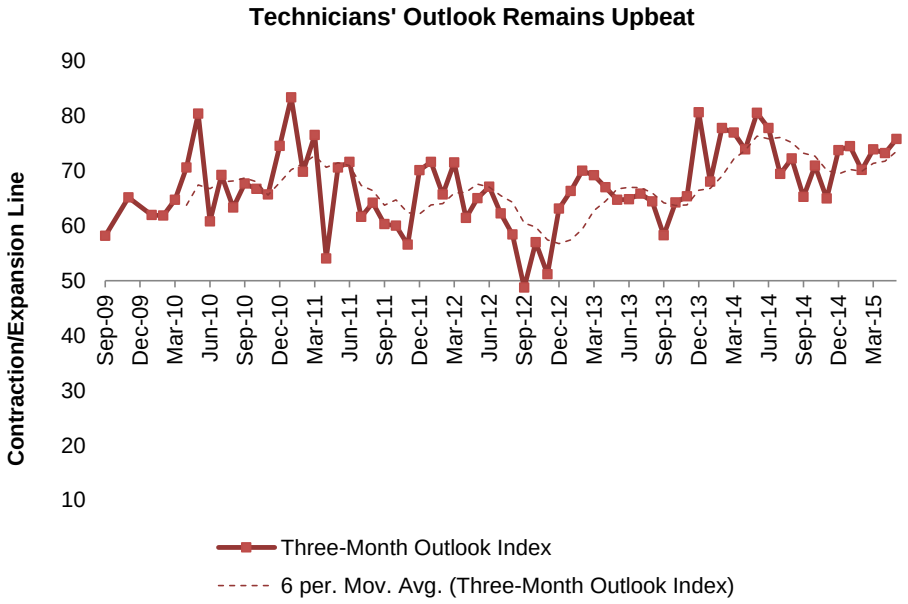
Source: Northcoast Research

While we still have some minor concerns over the health of demand trends in the automotive aftermarket in the intermediate term as a result of macro headwinds (increase in healthcare expenses for average family, some consumers are still not on solid financial footing despite ongoing economic expansion, etc.) and the changing demographics of the car parc (mix of vehicle headwind extends into 2017, albeit at a much reduced rate relative to 2012 and 2013), there is no doubt that the recent string of positive data regarding preventative maintenance is encouraging. In fact, now that routine maintenance trends have been a tailwind to demand for 22 consecutive periods (and 27 of the past 28 months), there is little doubt that the strength is a function of a fundamental change in consumer attitudes toward repair work, and the ability to fund it, rather than merely the impact of short lived weather-related (seasonal) impacts.

While we expect the rising tide will benefit all participants, we continue to think the firms that are executing the best will deliver the strongest results in the near-term, which in recent quarters has been O'Reilly and Genuine Parts (i.e. NAPA), as we believe the outperformance is a function of a superior strategy, including the decision to invest heavily in distribution assets over the years; however, any outperformance will likely be muted by difficult year-over-year comparisons in the coming quarters.

Operators Confident in Fundamentals Despite Tough Comparisons

The collective outlook for near-term sales trends among the garage owners in our sample increased slightly in May to 75.8 from 73.2 in April, which is not surprising in light of the previously mentioned acceleration in the rate of sales growth in the period. This resilient optimism despite facing tough comparisons this summer, is evidenced by the fact that the Three Month Outlook finished well above the long term average of 67.3. Needless to say, we believe that sentiment was positively impacted by a strong start to June, lower gasoline prices, healthy attitudes among consumers toward routine maintenance, and ongoing solid traffic trends despite tough comparisons.



Source: Northcoast Research

Despite making a few cautionary statements regarding their upbeat outlook in light of the tough comparisons on the horizon, technicians continue to believe that sales trends will benefit from drivers maintaining their cars longer, as opposed to buying new vehicles (i.e. the age of the car parc continues to age). Additionally, the effects of the most recent harsh winter should provide a boost to demand trends throughout summer. That said, contacts commented that it is unlikely that we will see the failure rates for hard parts accelerate in the coming months relative to the prior year given the tough comparisons (i.e. this is the most commonly cited caveat to the bullish outlook). In general, garage owners are fairly upbeat regarding business conditions for the foreseeable future due to healthy traffic trends and solid routine maintenance behavior in recent months, and the sharp drop in gasoline prices relative to the prior year.

A Quick Look at Same-Store Estimates

The table below highlights our same-store sales estimates for Advance Auto parts, AutoZone, O'Reilly Automotive and Monro Muffler:

Comparable-Store Sales Trends

	Jul-14	Oct-14	Dec-14	Apr-15	Jul-15E	Oct-15E	Dec-15E	Apr-16E
Advance Auto Parts (AAP)	2.6%	1.5%	1.1%	0.7%				
Northcoast Research Estimates					1.0%	1.7%	1.9%	2.5%
Consensus					1.0%	1.7%	1.9%	2.1%
	May-14	Aug-14	Nov-15	Feb-15	May-15	Aug-15E	Nov-16E	Feb-16E
AutoZone (AZO)	4.0%	2.1%	4.5%	3.6%	2.3%			
Northcoast Research Estimates						3.2%	2.3%	2.2%
Consensus						3.2%	2.5%	2.7%
	Jun-14	Sept-14	Dec-14	Mar-15	Jun-15E	Sept-15E	Dec-15E	Mar-16E
Monro Muffler Brake (MNRO)	1.0%	(2.0%)	(1.8%)	(2.6%)				
Northcoast Research Estimates					0.0%	2.5%	2.5%	2.5%
Consensus					0.0%	1.8%	1.6%	1.8%
	Jun-14	Sept-14	Dec-15	Mar-15	Jun-15E	Sept-15E	Dec-16E	Mar-16E
O'Reilly (ORLY)	5.1%	6.2%	6.3%	7.2%				
Northcoast Research Estimates					5.0%	4.5%	4.5%	3.5%
Consensus					5.1%	4.5%	4.3%	3.9%

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 are spending less at Advance Auto Parts due to recent price discounts expiring resulting in our costs going up. At the end of the day, I was just cherry picking the special deals that were coming my way." (Pennsylvania)
- "I have seen a significant increase in routine maintenance as my customers across the board have more money to spend, but remain very wary of trading in their vehicle for a new one." (Ohio)
- "Business has been solid, and I am hopeful the trend continues. However, I saw really great numbers last summer, and I guess I would be pleased if I could only match those revenue levels." (New York)
- "I've started buying more from Advance Auto Parts/CARQUEST (at the expense of AutoZone) because their service and delivery speed are improving." (Illinois)
- "Although pricing is staying relatively stable, there has been a noticeable increase in the use of non-price promotions such as rebates and incentives from our parts suppliers. O'Reilly is definitely having an impact down here." (Florida)
- "I used to buy exclusively from NAPA, but now I am buying half of my parts from NAPA and half from O'Reilly Auto Parts." (Tennessee)
- "Car dealerships are continuing their push for my business at their commercial parts desks." (Michigan)

Conclusion and Investment Thesis

We were pleased to see that sales trends remained positive in the DIFM channel during May despite the headwinds associated with tough comparisons, which is a positive read-through for commercial delivery programs. Needless to say, we were encouraged that the sales gains were driven by stronger traffic and ticket trends, and by the fact that operators cited that car owners continued to be more proactive regarding the maintenance of their vehicles. Technicians continued to report seeing a benefit from an uptick in failure rates caused by an aging car parc, and believe that lower gasoline prices are providing a boost to demand trends.

Although we remain fairly positive on the underlying fundamentals within the automotive aftermarket industry, including the re-emergence of the expansion in the nation's light vehicle fleet, improving miles driven trends, and an increased willingness and ability for consumers to fund vehicle repairs, we continue to believe that demand trends could be volatile in the near-term as the industry is cycling tough comparisons. While the winter weather was milder than usual across much of the country during December, the cold snap and snow storms in late January and throughout February across the Midwest and Northeast have eliminated mechanics' concerns that the lack of winter weather would prove challenging as the industry cycles tough comparisons.

Despite a healthy backdrop we are reiterating our NEUTRAL ratings on Advance Auto Parts, AutoZone, Monro Muffler Brake, and O'Reilly Automotive as we feel the market has adequately priced in the improved demand environment. We continue to think O'Reilly and Genuine Parts (i.e. NAPA) will continue to outperform the industry, as we believe the outperformance is a function of a superior strategy, including the decision to invest heavily in distribution assets over the years.

DISCLOSURES

Research is produced by Northcoast Research Partners, LLC (Northcoast Research) 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 America Northcoast Securities, Inc. Member FINRA (www.finra.org) and SIPC (www.sipc.org).

Ratings

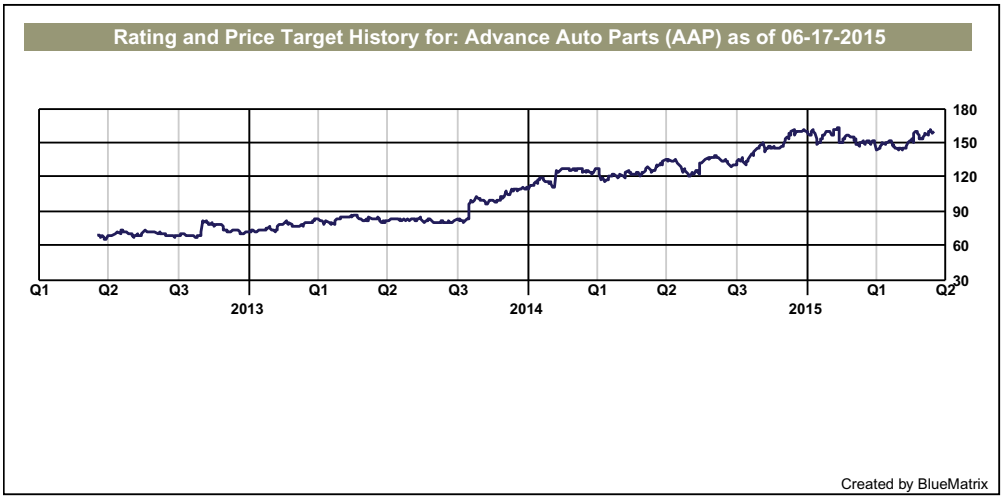
BUY – The stock is expected to outperform the S&P 500 index over a twelve-month period.

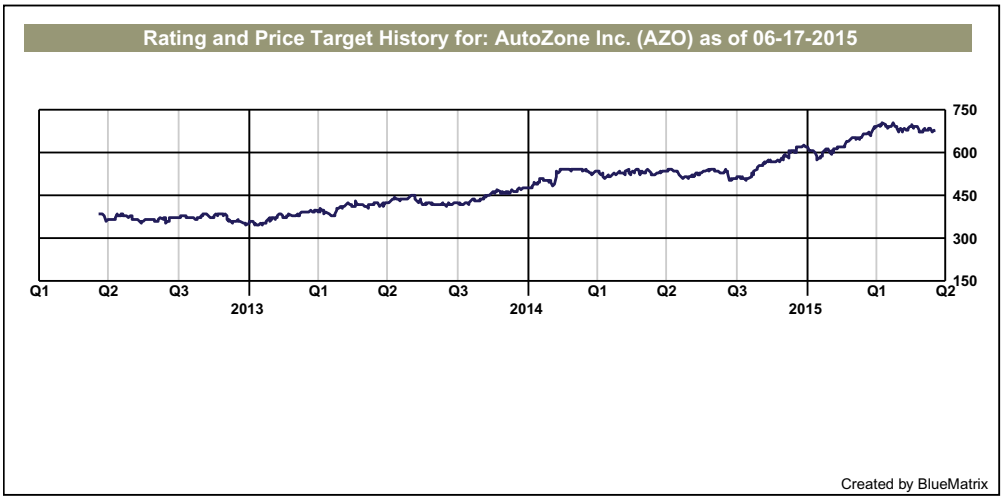
NEUTRAL – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

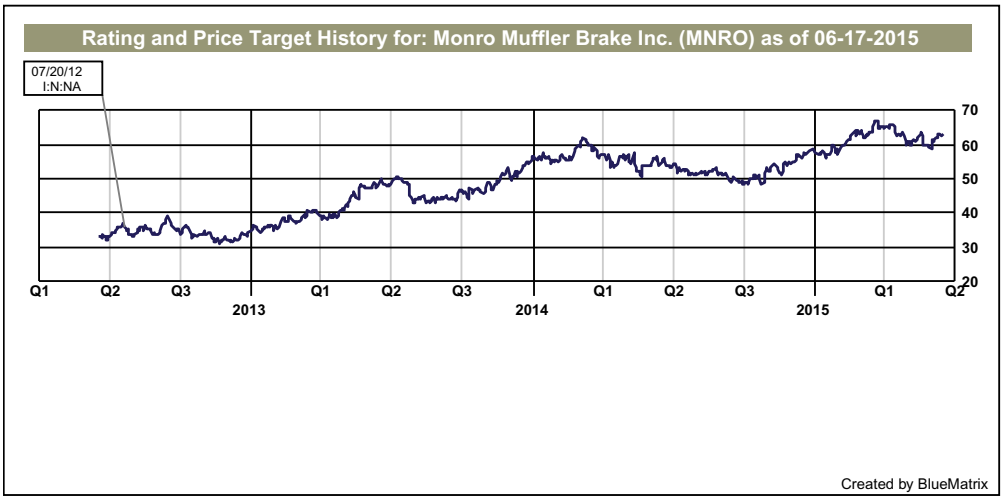
SELL – The stock is expected underperform the S&P 500 index over a twelve-month period.

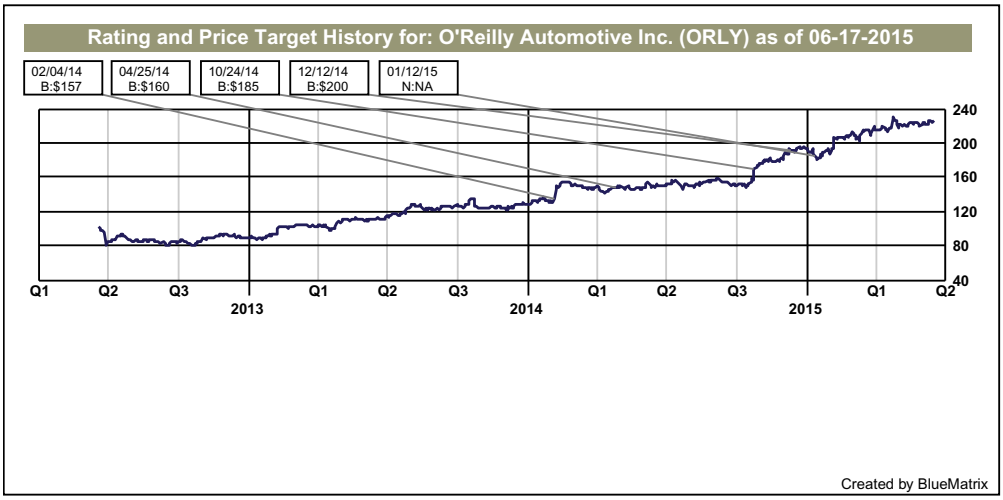
Valuation and Risks

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, depreciation, and amortization (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)	65	43.62%
NEUTRAL(N)	81	54.36%
SELL(S)	3	2.01%
Total	149	

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. Analyst compensation is based upon quality of analysis, communication skills, and stock price performance.

As a matter of policy and practice, Northcoast Research prohibits the offering of favorable research, a specific rating or a specific target price as consideration or inducement for the receipt of business or compensation. In addition, associated persons preparing research reports are prohibited from owning securites in the subject companies.

Copyright © Northcoast Research Partners, LLC