NORTHCOAST RESEARCH

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Automotive Aftermarket

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Independent Automotive Repair Garage Survey: November 2015

Overview

- According to the survey responses from our network of independent garage owners, demand trends increased in November relative to the prior year's period, boosted by a favorable calendar shift. Solid traffic and ticket trends more than offset weakness in the period due to unseasonably warm weather as evidenced by the 57.2 reading in our Current Sales Index (vs. 55.8 in October and an average of 56.7).
- The Three Month Outlook Index fell 11.9 points to 64.4, which was the lowest level since October 2013 and compares to an average of 67.6. Contacts' optimism was impacted by tough comparisons that are on the horizon and the belief that the absence of harsh winter weather across the northeast, Great Lakes, and Mid-Atlantic regions will weigh on demand in the near term.
- Consumers continued to perform more preventative maintenance compared to last year's period as 32.6% of respondents indicated increased willingness to perform this type of work, which compares to 34.6% and 33.8% in October and September, respectively (vs. an average of 6.1%).
- A net 30.0% of techs noted stronger ticket trends compared to a net 41.1% and 37.1% in October and September, respectively (vs. an average of 29.8%).
- A net 9.2% of contacts noted positive traffic trends compared to 5.5% and 14.5% in October and September, respectively (vs. an average of 4.2%).

Conclusion

While 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 AAP, AZO, MNRO, and ORLY as we feel the market has fairly priced shares in the healthy operating environment. We are maintaining our BUY rating and $18 price target on shares of Pep Boys until the dust settles in the current bidding war for the company between Bridgestone and Icahn Enterprises.

Symbol:	Price	Target Price	Rating	EPS ($) Cur Qtr	EPS ($) Cur Year	EPS ($) Out Year	Mkt. Cap (M)
AAP	$147.83	NA	N	$1.22e	$7.84e	$9.33e	$10,826.6
AZO	$744.82	NA	N	$7.19e	$40.84e	$46.00e	$22,499.8
MNRO	$64.36	NA	N	$0.56e	$2.15e	$2.53e	$2,058.0
ORLY	$253.75	NA	N	$2.06e	$9.17e	$10.14e	$25,029.9
PBY	$16.89	$18.00	B	$(0.16)e	$0.17e	$0.19e	$914.4

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

Important: Please read disclosures and disclaimers on pages 12 - 14 of the report.

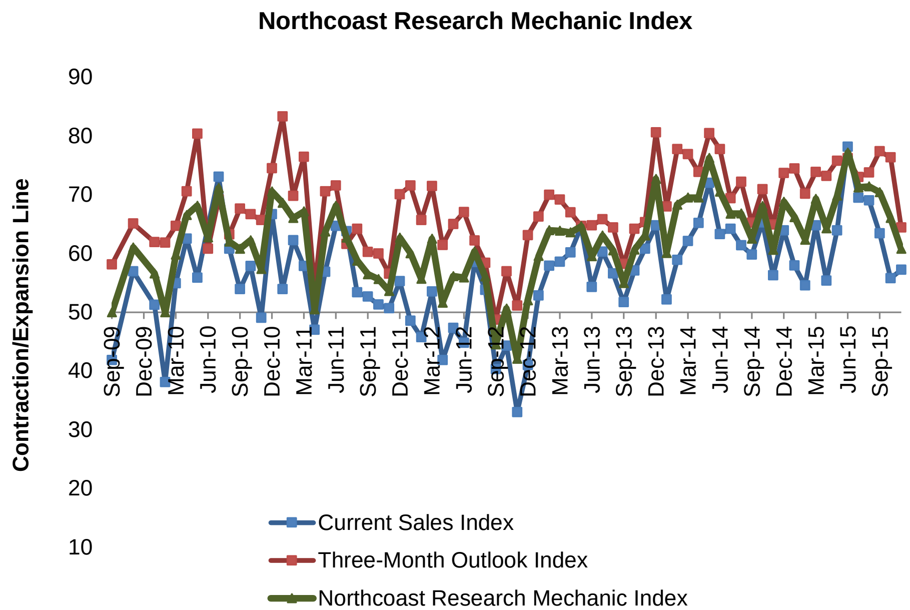
Independent Automotive Repair Garage Survey

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–November Snapshot



Source: Northcoast Research

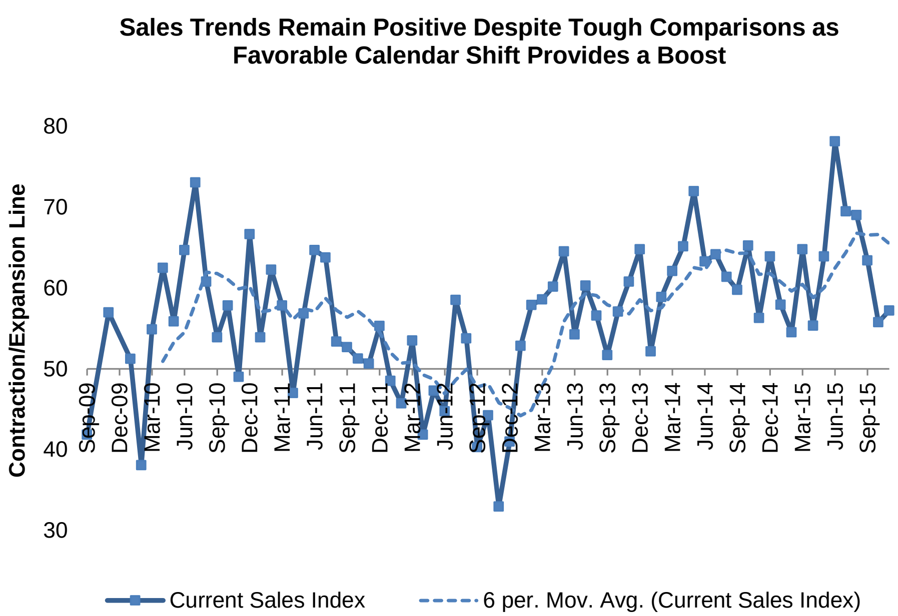
According to the survey responses collected from almost 300 independent garage owners, demand trends in the DIFM channel increased in November relative to the prior year's period; however, this performance included a benefit from a favorable calendar shift. The sales gains were driven by stronger ticket and traffic trends, and by car owners continuing to be more proactive regarding the maintenance of their vehicles. These positives more than offset the drag from unseasonably warm weather across the Great Lakes, northeast, and Mid-Atlantic regions of the country, and resulted in solid sales growth in the period. This is evidenced by the fact that the Current Sales Index clocked in at 57.2. This performance compares to 55.8 in October and an average reading of 56.7 since the inception of the survey.

Not surprisingly, respondents noted that low fuel costs are still having a clear positive impact on demand trends in the DIFM channel. Needless to say, vendors indicated that this factor is still having a bigger impact in the DIY channel given the increased exposure to lower-income customers. More importantly, many contacts speculate that the ongoing relief at the pumps will continue to aid discretionary repairs and maintenance spending trends in the coming months, as the low prices should translate into increased driving trends and more disposable income in consumers' wallets, which should make it easier to fund this work.

Notwithstanding the positive results in November, we were concerned by the fact that the Current Sales Index closed in the lowest quartile of the readings recorded over the past year despite a benefit from a favorable calendar shift, and that the Three Month Outlook Index dropped to 11.9 points to 64.4, which was the lowest level since October 2013. These signs of weakness underneath the surface are troubling given the lofty valuations in the space. At this point, we believe the less optimistic outlook can be attributed to difficult comparisons, a moderation in the failure rates related to the harsh weather experienced in January and February 2015 (natural to see this tailwind decay), and the absence of a noticeable cold spell across the Great Lakes, northeast, and Mid-Atlantic regions of the country in either October or November, rather than fundamental weakness among shoppers.

Sales Trends Remained Solid in November, Aided by a Calendar Shift

Our recent channel work suggests that demand trends across the automotive aftermarket remained positive in November, as high failure rates related to previously deferred maintenance and an aging car parc continued to provide a nice tailwind to traffic and ticket trends. The underlying performance was boosted by a favorable calendar shift. The positive results are clearly visible in the fact that the Current Sales Index (CSI) finished the period at 57.2, which was 1.4 points higher than in the previous month, and slightly higher than the long-term average of 56.7. Notwithstanding the positive results in November, we are concerned by the fact that the index has fallen sequentially in four of the past five months as tough comparisons and the absence of a winter-weather related demand catalyst have weighed on the performance.

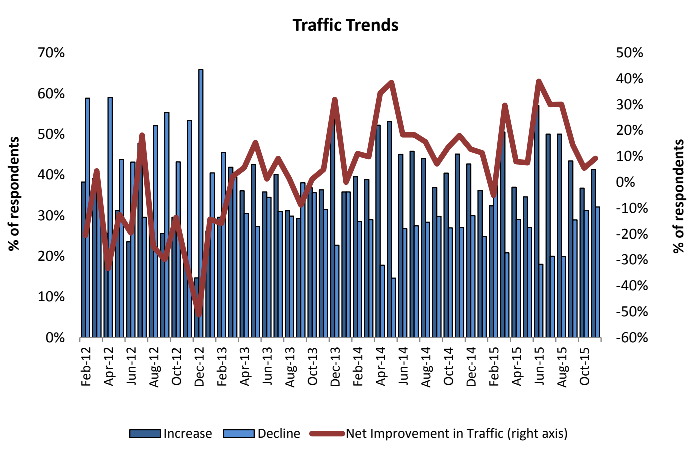


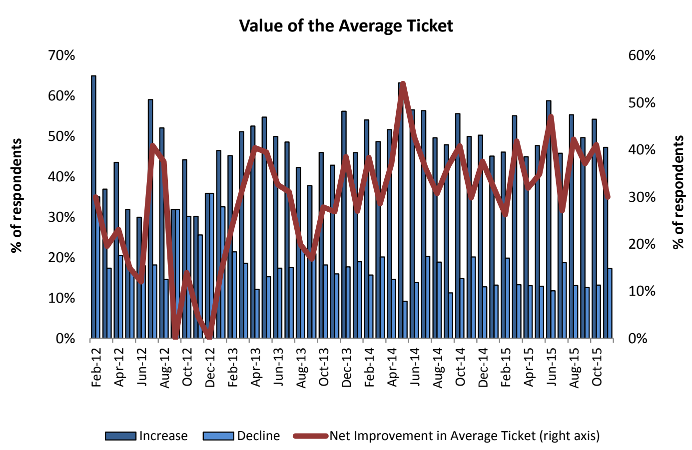
Source: Northcoast Research

Ticket and Traffic Trends Remain Positive

As noted earlier, the technicians in our sample noted that the sales gains in November were driven by increased ticket and traffic trends. In fact, a net 30.0% of the respondents noted seeing stronger ticket trends in the period. This performance compares to a net 41.1% and 37.1% of respondents reporting a similar benefit in October and September, respectively (average reading since inception is 29.8%). 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. In our opinion, both of these findings are 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 ongoing slide in oil and base metal 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 9.2% of the survey participants reported that traffic levels were stronger on a year-over-year basis in the period, which was slightly better than the reading in October (5.5%), but weaker than the performance recorded in September (14.5%). We are encouraged by the fact that this metric remained positive despite the headwinds associated with difficult comparisons and the absence of a winter-weather related demand catalyst, with traffic trends healthier than the long-term average of 4.2% of the garages reporting positive car count. However, we would be remiss not to point out that the latest performance included a benefit from a favorable calendar shift. More importantly, dealers in many cold weather markets are growing incrementally more concerned that the unseasonably warm weather trends will pressure car counts in December and 1Q16. Notwithstanding this headwind, the mechanics noted that they still expect to see 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 (i.e. big traffic drivers). 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.

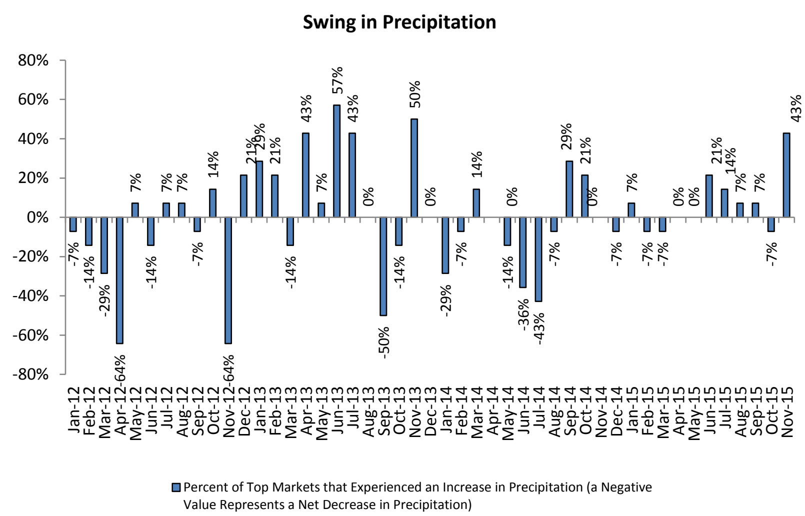




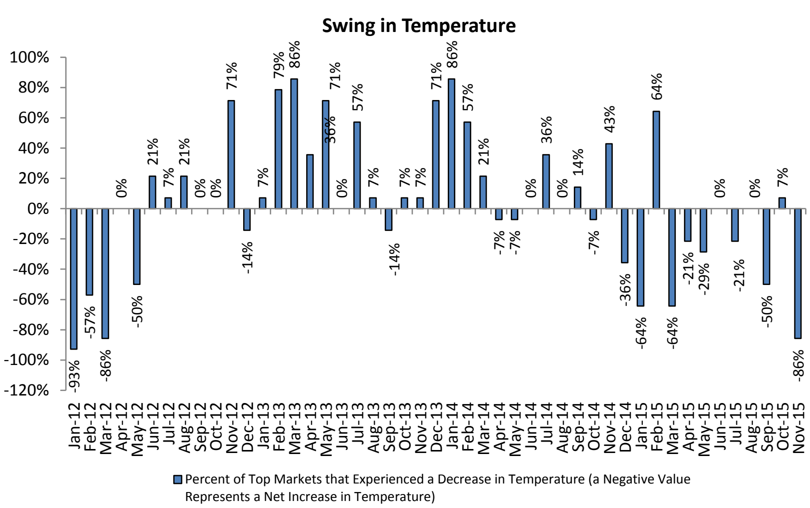
Source: Northcoast Research

Key Markets Experienced Warmer and Wetter Weather Trends this November

According to our proprietary weather screen, the key markets in our survey witnessed warmer temperatures and increased precipitation relative to the prior year. Specifically, the first chart illustrates that rainfall/snowfall levels were noticeably higher than in the prior year's period, as a net 43% of the markets witnessed increased precipitation levels. The second chart highlights the fact that temperatures were unseasonably warm, as a net 86% of the markets witnessed a higher average temperature during the month compared to the prior year. Anecdotally, technicians in key cold weather markets noted needing help from Mother Nature in December if they are going to cycle the strong results from 4Q14.

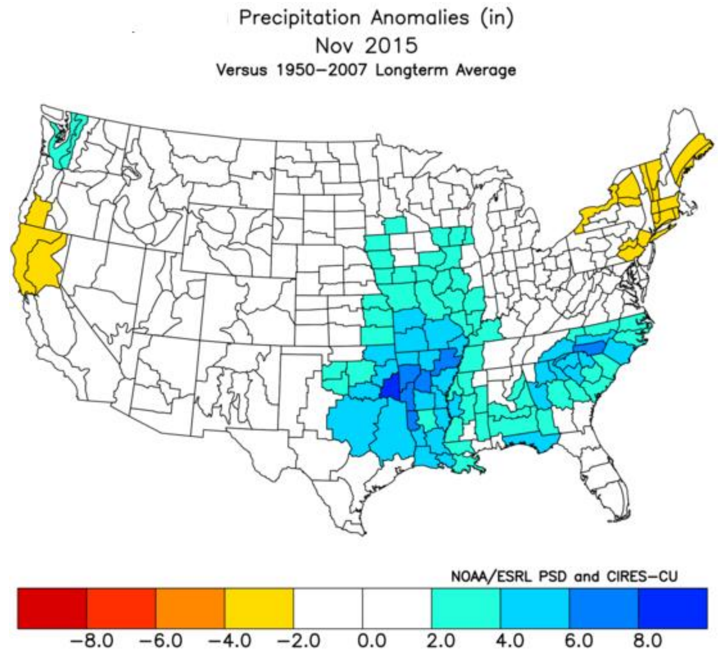


Source: U.S. Department of Commerce

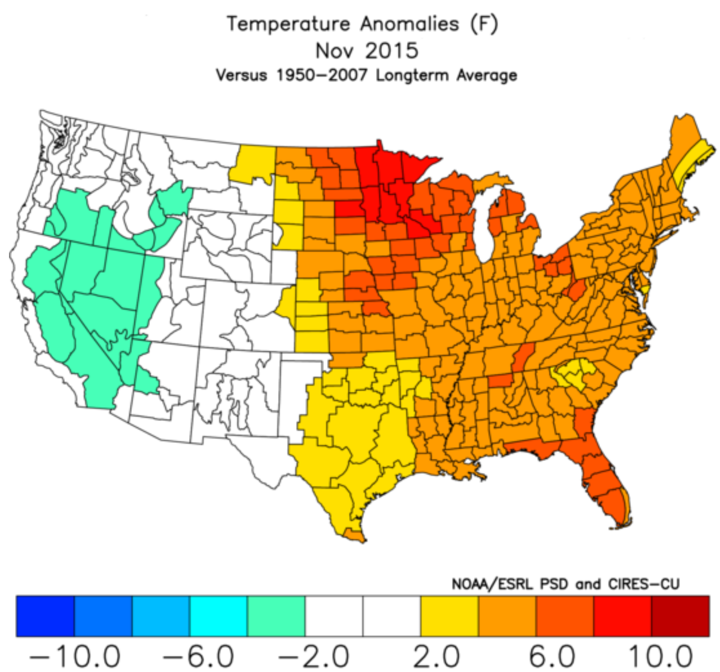


Source: U.S. Department of Commerce

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

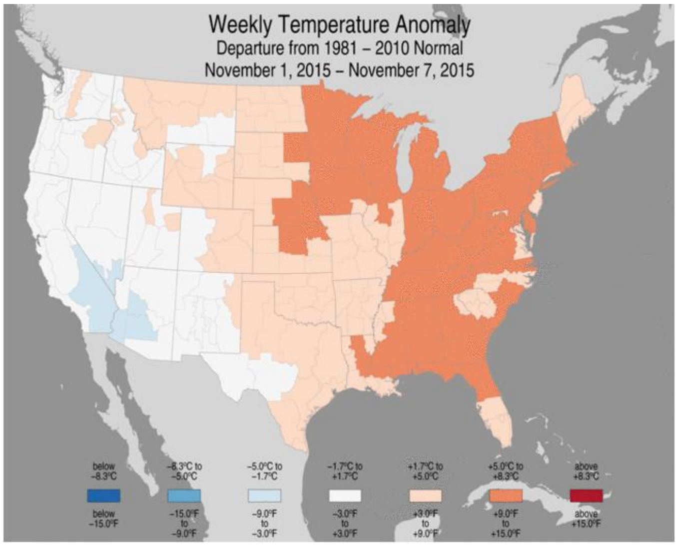


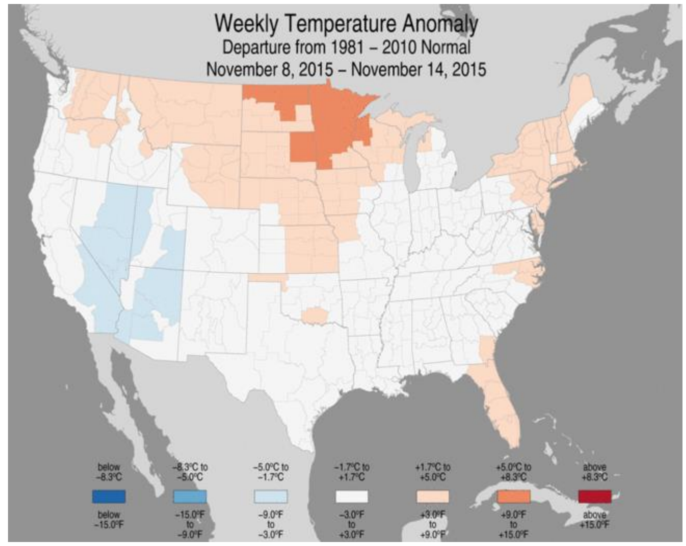
Source: U.S. Department of Commerce

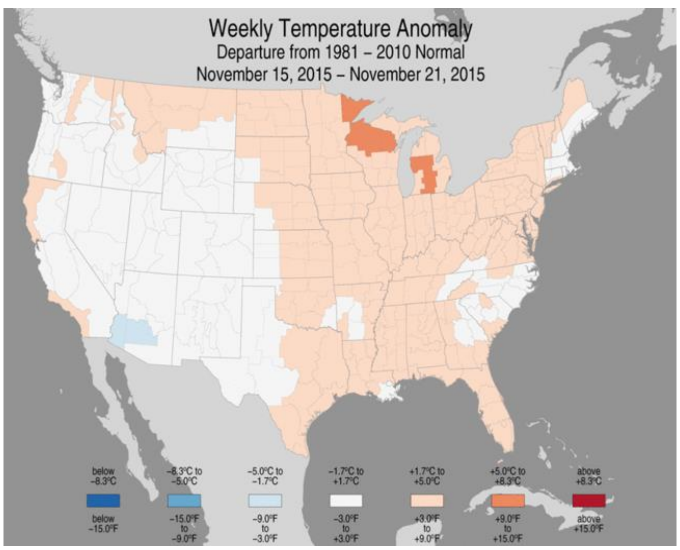


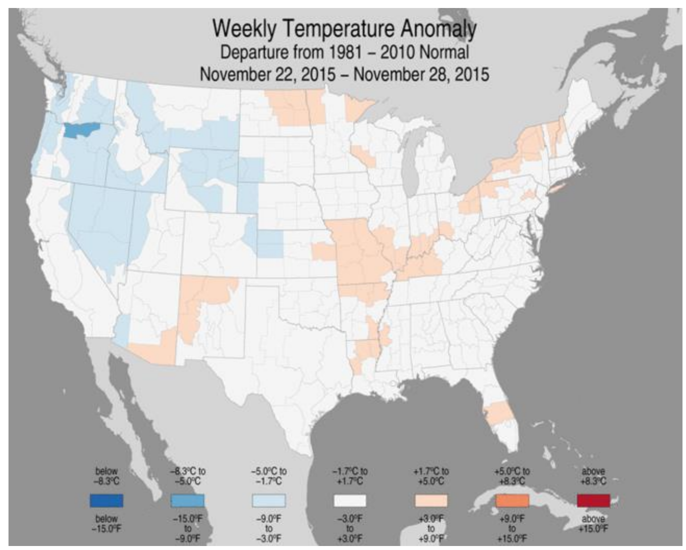
Source: U.S. Department of Commerce

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





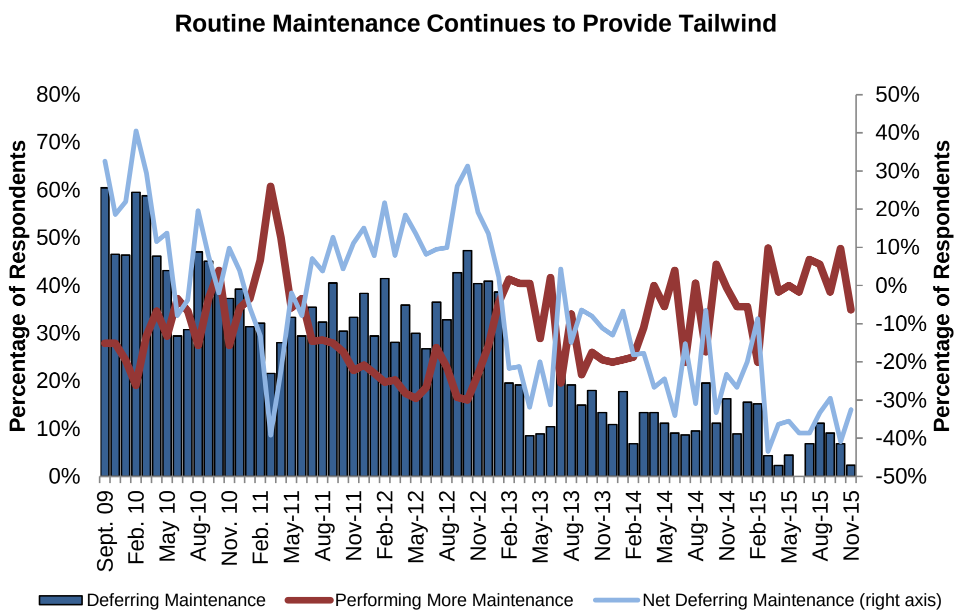




Source: U.S. Department of Commerce

Solid Routine Maintenance Trends Continued to Provide a Tailwind to Aggregate Demand in November

Our work suggests that car owners continued to perform more preventative work and nonessential repairs in November relative to historical norms, which clearly aided demand trends in the period. Indeed, a net 32.6% of the respondents indicated that their customer base performed more routine maintenance in November than they normally do. Needless to say, this performance was much stronger than the long-term average reading for this metric (6.1%). Not surprisingly, operators indicated that demand benefited from healthy trends in miles driven and a general feeling of increased economic prosperity among customers, especially lower-income households, in large part due to the declining price of gasoline, improving labor markets, and to a lesser extent, sticker shock when examining the cost of purchasing a new vehicle.

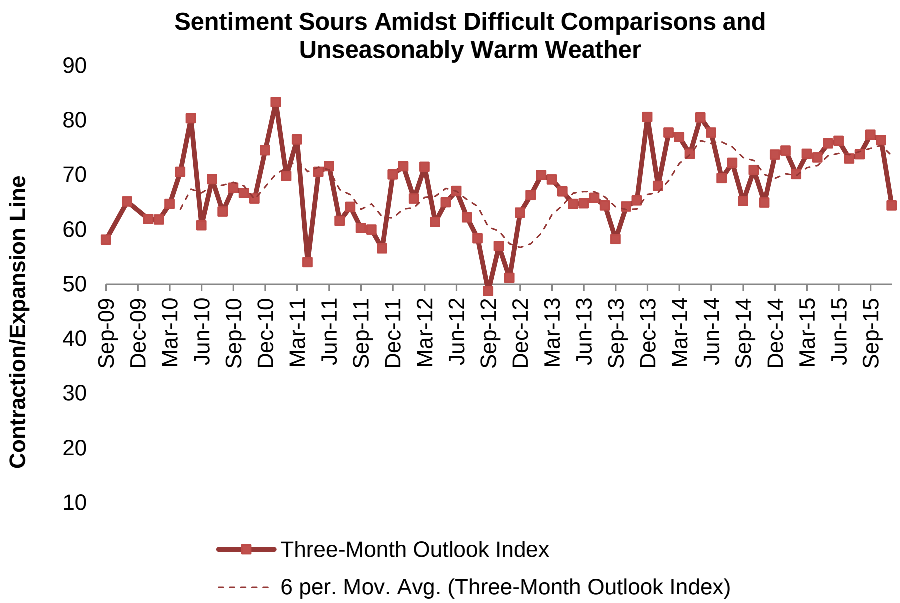


Source: Northcoast Research

In light of the fact that routine maintenance trends have been a tailwind to demand for 28 consecutive periods (and 33 of the past 34 months), we remain increasingly confident that the underlying strength in the market 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. Notwithstanding the moderation in growth rates in recent months, and the difficult comparisons on the horizon, we expect the rising tide will benefit all participants; however, we continue to think the firms that are executing the best will deliver the strongest results for the foreseeable future, which in recent quarters has been O'Reilly and Genuine Parts (i.e. NAPA), as we believe the outperformance is partially a function of a superior strategy, including the decision to invest heavily in distribution assets over the years.

Optimism Wanes

The collective optimism among the garage owners in our sample regarding near-term sales trends slid fairly sharply in November despite the positive sales trends in the period. Specifically, the Three Month Outlook Index fell 11.9 points to 64.4, which was the lowest level since October 2013. As a frame of reference, the long-term average for this index is 67.6, so it is clear that the mechanics that we speak with are far from upbeat. Needless to say, we believe sentiment was negatively impacted by the difficult comparisons in the coming months, and the unseasonably warm weather in many cold weather markets in November and early December, especially the Great Lakes, northeast, and Mid-Atlantic regions of the country. In short, dealers in many cold weather markets are growing more anxious that demand in weather sensitive categories in the coming months will fall short of last year's strong performance in light of the absence thus far of the cold and harsh weather trends needed to accelerate failure rates.



Source: Northcoast Research

A Quick Look at Same-Store Estimates

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

Comparable-Store Sales Trends

	Oct-14	Dec-14	Apr-15	Jul-15	Oct-15	Dec-15E	Apr-16E	Jul-16E
Advance Auto Parts (AAP)	1.5%	1.1%	0.7%	1.0%	0.5%			
Northcoast Research Estimates						(1.0%)	1.4%	1.8%
Consensus						(0.5%)	0.8%	1.1%
	Aug-14	Nov-15	Feb-15	May-15	15-Aug	16-Nov	Feb-16E	May-16E
AutoZone (AZO)	2.1%	4.5%	3.6%	2.3%	4.5%	3.5%		
Northcoast Research Estimates							2.7%	3.2%
Consensus							2.8%	3.0%
	Sept-14	Dec-14	Mar-15	Jun-15	Sept-15	Dec-15E	Mar-16E	Jun-16E
Monro Muffler Brake (MNRO)	(2.0%)	(1.8%)	(2.6%)	(0.4%)	2.1%			
Northcoast Research Estimates						3.0%	3.3%	3.0%
Consensus						2.5%	2.8%	2.8%
	Sept-14	Dec-15	Mar-15	Jun-15	Sept-15	Dec-16E	Mar-16E	Jun-16E
O'Reilly (ORLY)	6.2%	6.3%	7.2%	7.2%	7.9%			
Northcoast Research Estimates						5.5%	3.5%	3.5%
Consensus						5.4%	4.4%	4.4%
	Oct-14	Jan-14	Apr-15	Jul-15	Oct-15E	Jan-15E	Apr-16E	Jul-16E
The Pep Boys - Manny, Moe, and Jack (PBY)	1.2%	1.3%	0.8%	0.3%	-1.8%			
Northcoast Research Estimates						-0.5%	0.9%	0.9%
Consensus						0.2%	1.1%	1.0%

Source: Company Reports, FactSet, Northcoast Research estimates

Anecdotal Comments

The following anecdotal comments were collected from the survey respondents during the month:

- "My repair business was still slightly positive in November; however, demand for tires was down big, which limited my touch points. December got off to a slow start. " (New York)
- "My NAPA sales rep has said that many stores in the area have missed sales quotas in the month of November." (Michigan)
- "More of my customers are taking road trips than in years past for the holiday season, which is causing them to have their cars prepped at my shop before they set out on their adventures." (Georgia)
- "CARQUEST's prices on hard parts are much lower than before, and as a result, I am buying more parts. That being said, the Advance that I buy from recently removed all the professionals from its commercial parts counter, which is causing me to only buy what I can find on their direct portal." (Illinois)
- "As of late, it has not been hard at all to sell preventative work. I believe this is because consumers have more money in their pockets, so they are more willing to perform preventative maintenance. However, my failure related work has moderated with the warm temps." (Ohio)

Conclusion and Investment Thesis

Sales trends remained positive in the DIFM channel during November, which is a positive read-through for commercial delivery programs. The sales gains were driven by stronger traffic and ticket trends; however, the latter benefited from a favorable calendar shift. The garages noted that car owners continued to be more proactive regarding the maintenance of their vehicles, which is helping trends in the maintenance categories. The technicians continued to report seeing a benefit from high failure rates caused by an aging car parc, and believe that low gasoline prices and modest economic growth are providing a boost to demand trends; however, we are concerned by the sharp drop in optimism regarding sales trends in the coming months. The latter was clearly driven by dealers in many cold weather markets growing more anxious that demand in weather sensitive categories in the coming months could fall short of last year's strong performance in light of the absence thus far of the cold and harsh weather trends needed to accelerate failure rates.

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 and weather patterns have been unseasonably warm in many cold weather markets, especially across the Great Lakes, northeast, and Mid-Atlantic regions of the country. In our opinion, the latter is a risk that has strengthened in recent months in light of the fact that the Current Sales Index has moderated for four of the past five months, and the mechanics optimism waned meaningfully in November due to above average temperatures. As such, 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 healthy operating environment (i.e. rich valuations). We are reiterating our BUY rating and $18.00 price target on Pep Boys as we think there is more fuel left in the tank as it relates to the takeover story. In terms of the market share story, 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 consistent execution and superior strategies, including the decision to invest heavily in distribution assets over the years.

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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

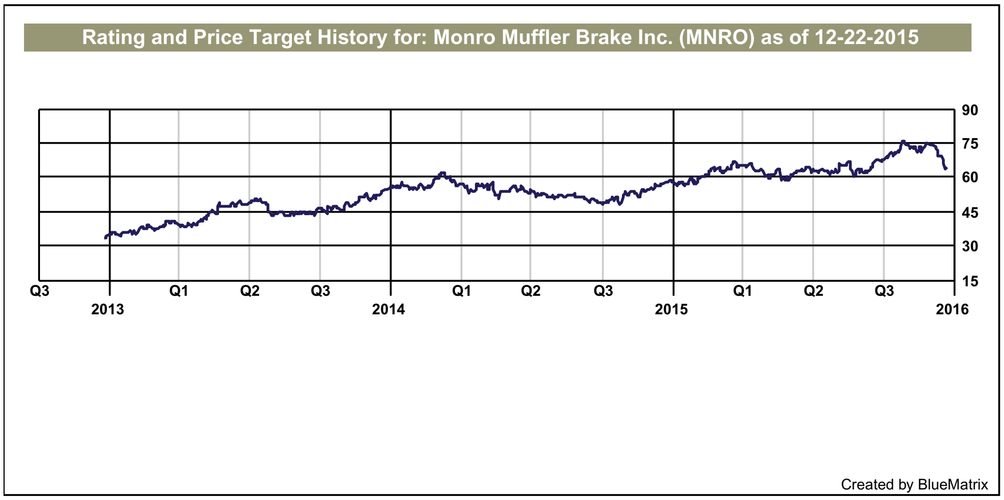
Our price target as well as our recommendation is based on a 12-month time horizon; however, we cannot guarantee an investor will achieve these results. We use a variety of methods to determine the price target of individual securities including fundamental analysis. In addition, we employ numerous valuation methodologies which include, but are not limited to, price to earnings multiples, enterprise value to earnings before interest, taxes, 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.

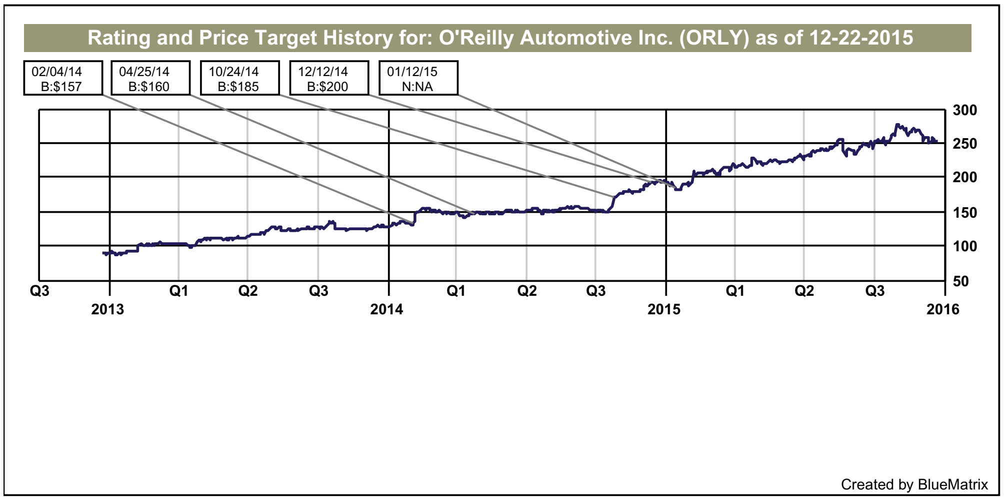
Rating and Price Target History for: Advance Auto Parts (AAP) as of 12-22-2015

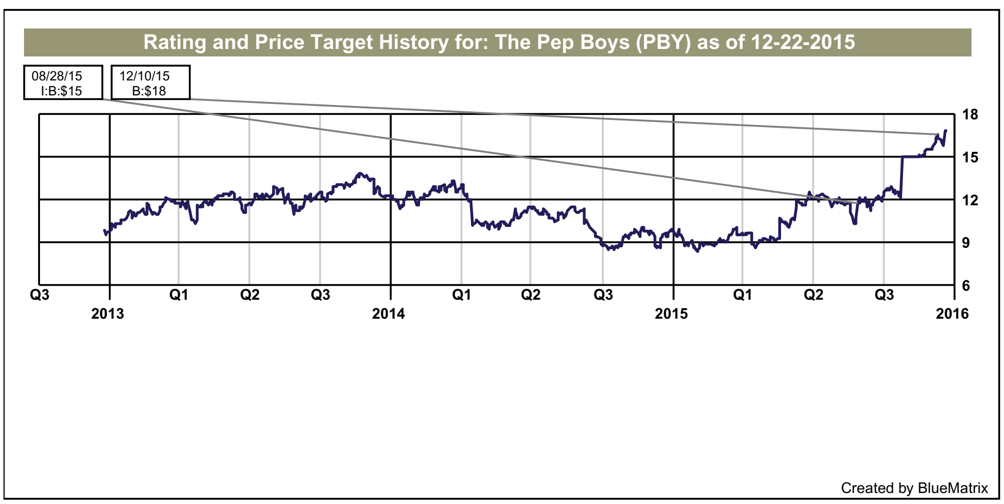
Created by BlueMatrix

Rating and Price Target History for: AutoZone Inc. (AZO) as of 12-22-2015

Created by BlueMatrix







Rating Summary

Distribution of Ratings Table

Rating	Count	Percent
BUY(B)	69	48.59%
NEUTRAL(N)	72	50.70%
SELL(S)	1	0.70%
Total	142	

Analyst Certification

I, Nick Mitchell, Seth Woolf and Sam Snyder , 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.

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