Advance Auto Parts, Inc.

Secular Tailwinds Still Building; Raising Price Target to $42

Overweight

AAP, AAP US

Price: $37.00

▲ **Price Target: $42.00**
Previous: $39.00

Higher comp and margin drives EPS well above the Street. AAP reported adjusted 4Q08 operating EPS of $0.51 vs. $0.35 LY, our Street-high $0.42 estimate, and consensus of $0.37. Total sales rose 13.7% to $1.19B, with same-store sales of 3.0%, which handily beat our 0.2%E. By segment, DIFM comps rose 13.7%, while DIY comps declined 1.1% (both ahead of expectations). Gross margin expanded 140 bps YOY to 48.5% due to decreased inventory shrink, more effective pricing, and higher sales from AI. Operating expenses de-levered 50 bps to 41.5% vs. 40.9%E. In total, EBIT improved 100 bps to 7.1% vs. 6.1% LY.

- **Weather helped but was not the driver.** Both AAP and ORLY generated comps above consensus forecasts and substantial earnings beats. As we indicated in our 1/22 note "Just Gettin' Started," both AAP and ORLY had high exposure to the most extreme weather states in December with 34% and 23% of stores, respectively. We estimate that at most 100 bps of comp were driven by weather. Thus, even without that benefit, comps would have exceeded our forecasts.
- **Secular tailwinds continue to strengthen.** We continue to believe that the secular tailwind of an aging vehicle fleet remains strong and is, in fact, building. As indicated in the same note, average vehicle age is rising a projected 40 bps from 2007 to 2010. The last time that we experienced such an increase, retail sales at auto parts stores surged 400 bps over the same four-year period.
- **Miles driven shows sequential improvement; easy compares ahead.** In our view, vehicle age is the primary driver of demand, while miles driven acts as a governor/accelerator from the baseline trend. As reported on Thursday, miles driven showed significant sequential improvement in December with this metric down only 1.6% YOY, better than the 5.4% decline in November and the best showing since April 2008. Importantly, December represents the first "easy comp" where miles driven were down on a YOY basis in the prior year. Compares continue to ease as we head toward the summer.
- **Increasing Dec 2009 Price Target to $42 from $39.**

Hardlines Retail

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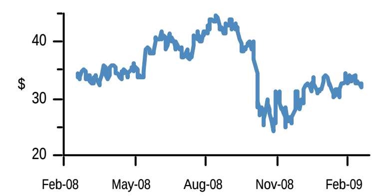
J.P. Morgan Securities Inc.

Price Performance



	YTD	1m	3m	12m
Abs	-3.0%	2.9%	22.9%	-3.1%

Advance Auto Parts, Inc. (AAP;AAP US)

	2008A	2009E *(Old)*	2009E *(New)*	2010E *(Old)*	2010E *(New)*
EPS (Operating) ($)					
Q1 (Mar)	0.86	0.87	0.88		
Q2 (Jun)	0.79	0.76	0.77		
Q3 (Sep)	0.59	0.71	0.69		
Q4 (Dec)	0.51	0.44	0.46		
FY	2.75	2.78	2.80	3.10	3.11
P/E (Operating) FY	13.5	13.3	13.2	11.9	11.9

Source: J.P. Morgan

Company Data	
Price ($)	37.00
Date Of Price	19 Feb 09
52-week Range ($)	45.48 - 24.03
Mkt Cap ($ mn)	3,515.00
Fiscal Year End	Dec
Shares O/S (mn)	95
Price Target ($)	42.00
Price Target End Date	31 Dec 09

See page 7 for analyst certification and important disclosures.

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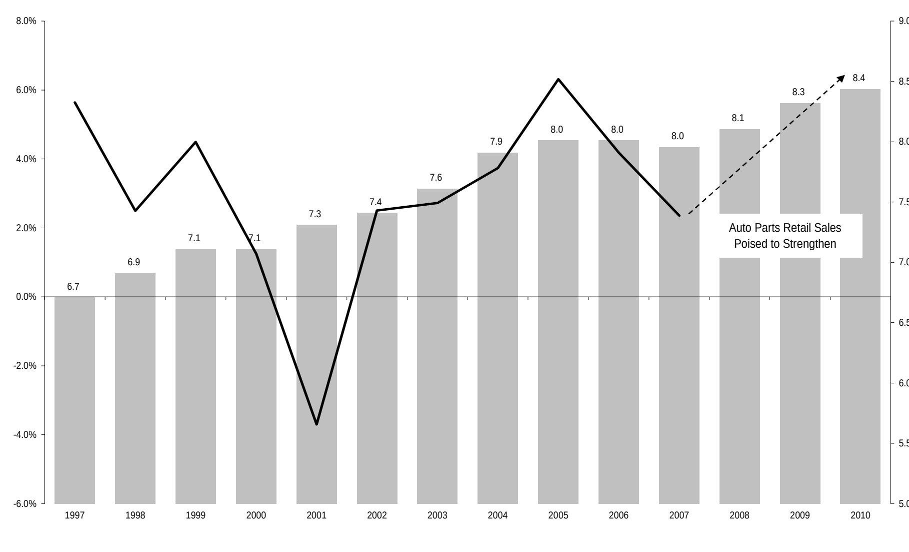
Higher Comp and Margin Drives EPS Well Above the Street. AAP reported adjusted 4Q08 EPS of $0.51 vs. $0.35 LY, our Street-high $0.42 estimate, and consensus of $0.37. Note, EPS is adjusted for a ($0.25) inventory charge and includes a 53rd-week contribution of $0.10. Total sales rose 13.7% to $1.19B, with same-store sales of 3.0%, which handily beat our 0.2%E. By segment, DIFM comps rose 13.7%, while DIY comps declined 1.1% (both ahead of expectations). Gross margin expanded 140 bps YOY to 48.5% due to decreased inventory shrink (about 50% of the change), more effective pricing, and higher sales from AI. Operating expenses de-levered 50 bps to 41.5% vs. 40.9%E. In total, EBIT improved 100 bps to 7.1% vs. 6.1% LY.

Guidance Looks Good. While AAP provided all the inputs to EPS in 2009, no precise earnings range was provided. Using the "midpoint" of its sales assumptions (i.e., a (2%) DIY comp and a +11% DIFM comp), we arrive at a 2% total comp gain. This translates into roughly $0.14 of EPS growth from the $2.65 comparable 2008 base – or roughly $2.79. This was ahead of the Street's $2.68 forecast but in-line with our estimate.

Weather Helped But Was Not the Driver. Both AAP and ORLY generated comps above consensus forecasts and substantial earnings beats. As we indicated in our 1/22 note "Just Gettin' Started," both AAP and ORLY had high exposure to the most extreme weather states in December with 34% and 23% of stores, respectively. We estimate that at most 100 bps of comp were driven by weather. Thus, even without that benefit, comps would have exceeded our forecasts.

Secular Tailwinds Continue to Strengthen. We continue to believe that the secular tailwind of an aging vehicle fleet remains strong and is, in fact, building. As indicated in the same note, average vehicle age is rising a projected 40 bps from 2007 to 2010. The last time that we experienced such an increase retail sales at auto parts stores surged 400 bps over the same four-year period.

Table 1: Average Light Vehicle Age vs. Auto Parts Retail Sales Growth



Source: J.P. Morgan estimates and US Census Bureau.

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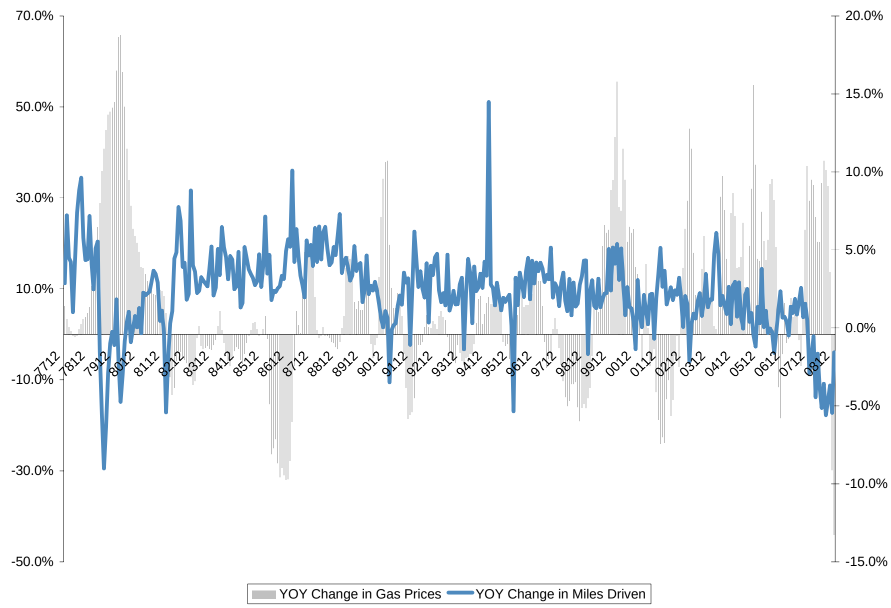
Miles Driven Shows Sequential Improvement; Easy Compares Ahead. In our view, vehicle age is the primary driver of demand, while miles driven acts as a governor/accelerator from the baseline trend. As reported on Thursday, miles driven showed significant sequential improvement in December with this metric down only 1.6% YOY, better than the 5.4% decline in November and the best showing since April 2008. Importantly, December represents the first "easy comp" where miles driven were down on a YOY basis in the prior year. Compares continue to ease as we head toward the summer.

Table 2: Gas Prices vs. Miles Driven



Source: DLXHaver.

Investment Thesis and Valuation

Please see our 1/22 note on AAP in which we upgraded to Overweight.

We maintain our Overweight rating on Advance for the following reasons: (1) increasing secular tailwinds including lower gas prices and an increase in the average age of vehicles on the road, and near-term weather benefits; (2) greater emphasis on expense control, as well as better cost absorption due to improved top-line trends; and (3) turnaround progress.

Valuation Matrix

	2008	2009E	2010E
EPS	$2.75	$2.80	$3.11
PE	13.5x	13.2x	11.9x
Relative PE	1.20x	1.06x	1.23x
Hist Avg PE		16.1x	13.7x
Historic Low PE		11.7x	9.5x
Hist Avg Relative PE		1.00x	0.90x
EBITDA	$599.0	$608.7	$639.2
EV/EBITDA	6.6x	6.5x	6.2x
Hist Avg		8.0x	7.0x
Dec 2009 Price Target		$42.00	
PE		15.0x	13.5x
EV/EBITDA		7.2x	6.9x
Upside/Downside			14%

Source: Factset and J.P. Morgan estimates.

Increasing Dec 2009 Price Target to $42 from $39

The stock is trading at 11.9x our 2010 EPS forecast and 6.2x EV/EBITDA. This compares to its five-year average of 13.7x P/E and 7.0x EV/EBITDA.

Our December 2009 price target of $42 is based on 13.5x P/E and 6.9x EV/EBITDA using our 2010 estimates, which is in-line with the historical FY2 averages noted above. Given the relative strength of the sector vs. other aspects of retail and the market, we believe that this represents a fair valuation (in spite of most companies not trading in-line with their respective averages). This target represents 14% upside from current levels.

Earnings Review

- AAP reported 4Q08 adjusted EPS of $0.51 vs. $0.35 last year, above our estimate of $0.42 and the Street's $0.37.
- Total revenues increased 13.7% (5.3% ex. 53rd week) to $1.19B vs. $1.05B last year and our estimate of a 10.3% increase. Same-store sales rose 3.0%, vs. our 0.2%E. By segment, DIFM comps rose 13.7% vs. 10.0%E, while DIY comps declined (1.1%) vs. (3.5%)E.
- Overall, nearly 50% of stores had positive DIY comps.
- The consolidated gross margin increased 150 bps to 48.6% of sales vs. 47.1% last year and above our estimate of 47.3% driven by decreased inventory shrink, more effective pricing, and higher sales from Autopart International which generated a higher gross profit rate.
- The total operating expense ratio increased 50 bps to 41.5% of sales vs. 41.0% a year ago and our estimate of 40.9% driven by increased incentive comp, higher investments in strategic initiatives, and legal settlement costs. These were

partially offset by lower medical expense and leverage from the 53rd week (77 bps).

- The gross margin expansion and higher operating expense ratio yielded a 100 bp increase in the total company operating margin ratio to 7.1% of sales and above our estimate of 6.4%.
- Interest expense was $7.5MM vs. $8.2MM last year primarily driven by lower interest rates. The company's current borrowing costs are ~4%.

Balance sheet & other items

- Cash and cash equivalents increased 155% to $37.4MM vs. $14.7MM LY, while debt to capital fell to 30%% vs. 33% last year.
- Total inventory rose 6.1% during 4Q08 to $1,623MM vs. $1,530MM on a year-over-year basis, compared to a total top-line increase of 13.7%. LTM inventory turns slightly fell to 1.68x vs. 1.69x last year.
- Capital expenditures totaled approximately $48.0MM in 4Q08 vs. $64.1MM last year.
- During 4Q08, the company opened 26 new AAP stores, closed 10, and relocated two stores to end with 3,368 total stores vs. 3,261 last year.
- The company is assessing the potential divestiture of incremental 40-55 unprofitable stores in 2009.
- For 2009, the company plans to open 105 new stores (including 75 AAP and 30 AI stores).
- The top 10% of stores are delivering over $340 per square foot, while the bottom stores are delivering less than $100 per square foot.
- For 2009, capex is expected in the range of $180MM-$200MM.

Risks to Our Rating

Key downside risks:

- **Turnaround initiatives are less successful than anticipated.** If Advance is unable to narrow the sales per square foot gap with industry leader, AutoZone, then our rating may prove to be too aggressive.
- **Further deterioration in the macro environment.** If the economy worsens significantly from here, consumer spending may continue to weaken. This would make Advance's turnaround more challenging.
- **Certain initiatives may heighten operational risks.** Pieces of the company's turnaround plans are lengthy and complex, such as supply chain changes, systems implementations, and cultural changes. These initiatives may interfere with normal operating results in the short term.

Advance Auto Parts, Inc.: Summary of Financials

Income Statement - Annual	FY08A	FY09E	FY10E
Revenues	5,142	5,204	5,339
COGS	2,642	2,663	2,720
Gross Profit	2,501	2,542	2,618
SG&A	2,048	2,081	2,132
Operating Income	452	461	486
EBITDA	599	609	639
Interest, Net	34	31	29
Pretax Income	-	-	-
Taxes	156	161	171
Tax Rate	-	-	-
Net income - operating	-	-	-
Diluted Shares Outstanding	95	96	92
Operating EPS	2.75	2.80	3.11

Income Statement - Quarterly	1Q09E	2Q09E	3Q09E	4Q09E
Revenues	1,577	1,259	1,241	1,128
COGS	802	640	638	582
Gross Profit	774	619	603	545
SG&A	628	495	490	468
Operating Income	146	125	113	77
EBITDA	191	159	148	111
Interest, Net	11	7	6	7
Pretax Income	-	-	-	-
Taxes	50	44	40	27
Tax Rate	-	-	-	-
Net income - operating	-	-	-	-
Diluted Shares Outstanding	95	96	96	97
Operating EPS	0.88	0.77	0.69	0.46

Balance Sheet and Cash Flow Data	FY08A	FY09E	FY10E
Cash and Equivalents	37	68	51
Inventories	1,623	1,641	1,699
Current Assets	1,758	1,802	1,844
PP&E	1,071	1,113	1,150
Total Assets	2,964	3,048	3,125
Short-term Debt	-	-	-
Current Liabilities	-	-	-
Long-term Debt	-	-	-
Total Liabilities	1,889	1,937	2,003
Shareholders' Equity	1,075	1,111	1,123
Net Income (including charges)	238	268	285
D&A	147	148	153
Other adjustments	-	-	-
Changes in Working Capital	48	35	7
Cash flow from Operations	479	452	446
Capex	(185)	(190)	(190)
Free Cash Flow	294	262	256
Free Cash Flow/Share	3.09	2.75	2.70
Dividends	-	-	-
Dividend Yield	-	-	-

Ratio Analysis and Valuation	FY08A	FY09E	FY10E
Sales growth	6.8%	1.2%	2.6%
Same store sales	1.5%	2.5%	2.6%
EBITDA Growth	5.0%	1.6%	5.0%
EBIT Growth	6.8%	1.8%	5.5%
EPS growth - operating	18.4%	2.0%	11.0%
Gross Margin	48.6%	48.8%	49.0%
EBIT Margin	6.8%	1.8%	5.5%
EBITDA Margin	11.6%	11.7%	12.0%
Inventory growth	6.1%	1.1%	3.5%
AP/inventory	48.8%	51.1%	52.6%
Debt/EBITDA	0.8	0.8	0.8
Debt/Capital (book)	30.7%	30.4%	30.2%
Return on invested capital (ROIC)	12.7%	-	-
Enterprise value / revenues	0.8	0.8	0.7
Enterprise value / EBITDA	6.6	6.5	6.2
Free Cash Flow Yield	9.0%	8.0%	7.8%
P/E	13.5	13.2	11.9

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data). Fiscal year ends Dec

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Other Companies Recommended in This Report (all prices in this report as of market close on 19 February 2009)
O'Reilly Automotive (ORLY/$32.84/Overweight)

Analyst Certification:
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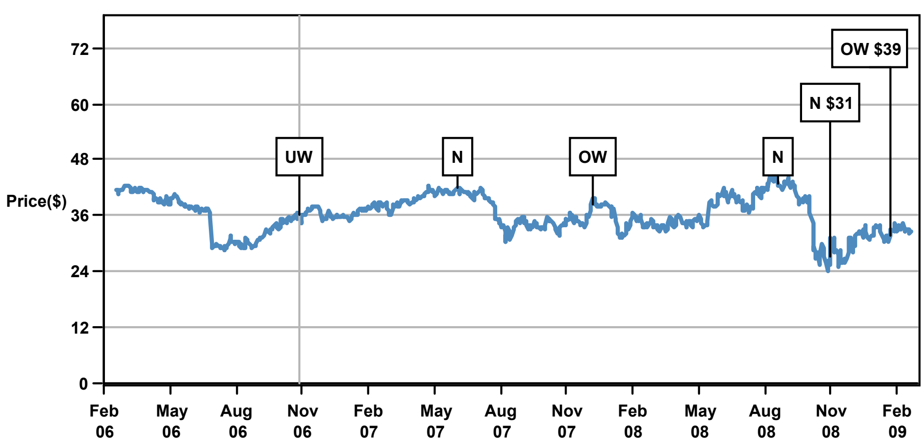
Advance Auto Parts, Inc. (AAP) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
30-Oct-06	UW	35.97	-
05-Jun-07	N	41.98	-
07-Dec-07	OW	38.51	-
20-Aug-08	N	42.96	-
31-Oct-08	N	27.07	31.00
22-Jan-09	OW	31.48	39.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Mar 16, 2004 - Oct 30, 2006. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
J.P. Morgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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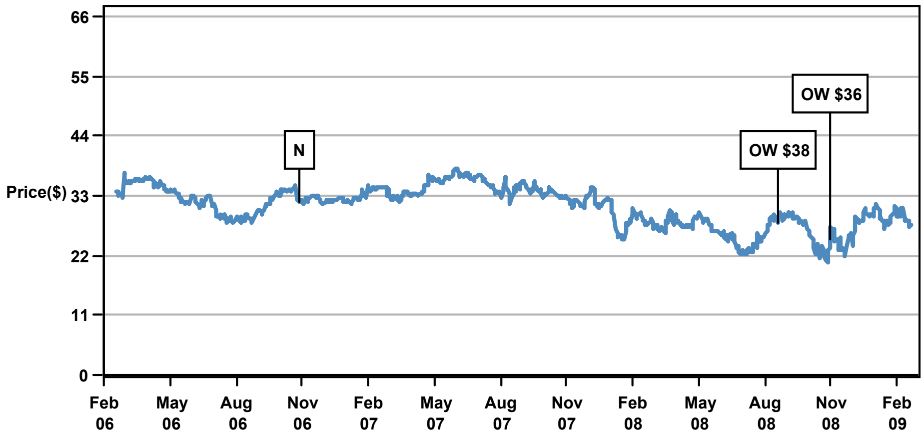
O'Reilly Automotive (ORLY) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
30-Oct-06	N	32.06	-
20-Aug-08	OW	28.08	38.00
31-Oct-08	OW	25.06	36.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Oct 30, 2006. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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	Overweight (buy)	**Neutral** (hold)	**Underweight** (sell)
JPM Global Equity Research Coverage	38%	44%	18%
IB clients*	54%	52%	43%
JPMSI Equity Research Coverage	37%	49%	14%
IB clients*	76%	71%	62%

*Percentage of investment banking clients in each rating category.
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