J.P.Morgan

North America Equity Research
20 February 2009

O'Reilly Automotive

A Long Runway Ahead; Raising Price Target to $39

Overweight

ORLY, ORLY US

Price: $32.84

▲ **Price Target: $39.00**
Previous: $36.00

Hardlines Retail

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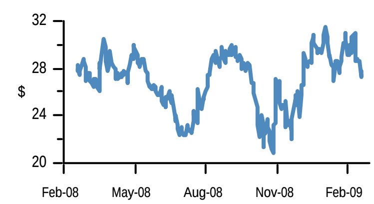
J.P. Morgan Securities Inc.

Price Performance



	YTD	1m	3m	12m
Abs	-9.8%	-2.8%	18.0%	-2.2%

A substantial beat: comps and SG&A. ORLY beat earnings expectations and reported operating EPS of $0.37 vs. our $0.31E and consensus of $0.30. Total same-store sales rose 4.0% vs. 2.1% LY and 0.7%E. Core ORLY comps increased 6.2%, while CSK comps rose 0.8% (the first positive comp since 3Q05). Gross margin expanded 150 bps YOY and SG&A de-levered 370 bps. In total, EBIT declined ~220 bps to 8.3%, but was 90 bps higher than our estimate.

- **CSK: a long runway ahead.** We believe that this quarter's results are just the beginning of a three-pronged multi-year sales ramp at CSK stores driven by improved merchandise availability (with much of the effort representing "low-hanging fruit"). First, during 4Q ORLY significantly increased inventory levels by fully stocking 79 CSK hub stores with 30K-35K additional SKUs (in addition to putting all CSK stores back on auto-replenishment). An incremental 41 hubs are expected to be completed in 1Q. Second, line-by-line inventory reviews are underway and ORLY will have impacted 80-90% of the merchandise assortment in non-affected CSK stores by Nov. Third, four DCs have already been selected and will be completed by late spring 2010. The DCs bring the supply chain up to ORLY standards through systems conversions, better product offerings, and more frequent deliveries.
- **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 Dec 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 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.**

O'Reilly Automotive (ORLY;ORLY US)

	2008A	2009E (Old)	2009A (New)	2010E
EPS (Operating) ($)				
Q1 (Mar)	0.40	0.41	0.38	
Q2 (Jun)	0.48	0.50	0.53	
Q3 (Sep)	0.40	0.61	0.61	
Q4 (Dec)	0.37	0.47	0.47	
FY	1.64	2.00	2.00	2.45
P/E (Operating) FY	20.0	16.4	16.4	13.4

Source: Company data, Reuters, J.P. Morgan estimates.

Company Data	
Price ($)	32.84
Date Of Price	19 Feb 09
52-week Range ($)	31.58 - 20.00
Mkt Cap ($ mn)	4,445.03
Fiscal Year End	Dec
Shares O/S (mn)	135
Price Target ($)	39.00
Price Target End Date	31 Dec 09

See page 7 for analyst certification and important disclosures.

A Substantial Beat: Comps and SG&A. ORLY beat earnings expectations and reported operating EPS of $0.37 vs. our $0.31E and consensus of $0.30. Note EPS excludes $5.9MM in charges to conform vacation policies and $1.7MM amortization of trade names and trademarks, both net of tax. Total sales rose 84.5% to $1.11B (including the benefit of the CSK acquisition in July 2008), with total same-store sales of 4.0% vs. 2.1% LY and 0.7%E. Core ORLY comps increased 6.2% vs. 3.0%E, while CSK same store sales increased 0.8% vs. (2.8%)E (the first positive comp since 3Q05). Gross margin expanded 150 bps YOY to 46.2% vs. 46.5%E. Operating expenses de-leveraged 370 bps to 37.9% vs. 39.3%E. In total, EBIT declined~220 bps to 8.3%, but was 90 bps higher than our 7.2% forecast.

CSK: A Long Runway Ahead. We believe that this quarter's results are just the beginning of a three pronged multi-year sales ramp at CSK stores driven by improved merchandise availability (with much of the effort representing "low-hanging fruit"). First, during 4Q ORLY significantly increased inventory levels and distribution capabilities by fully stocking 79 CSK hub stores with 30K-35K additional SKUs (in addition to putting all CSK stores back on auto-replenishment). An additional 41 hubs are expected to be completed in 1Q providing inventory throughout the non-converted store base. Second, line-by-line inventory reviews are underway and ORLY will have impacted 80-90% of the merchandise assortment in non-affected CSK stores by November of this year (when the West Coast DC rollout begins). Third, four DCs have already been selected and will be completed by late spring 2010. The DCs are the final step and bring the supply chain up to ORLY standards through store systems conversions, better product offerings, and more frequent deliveries.

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.

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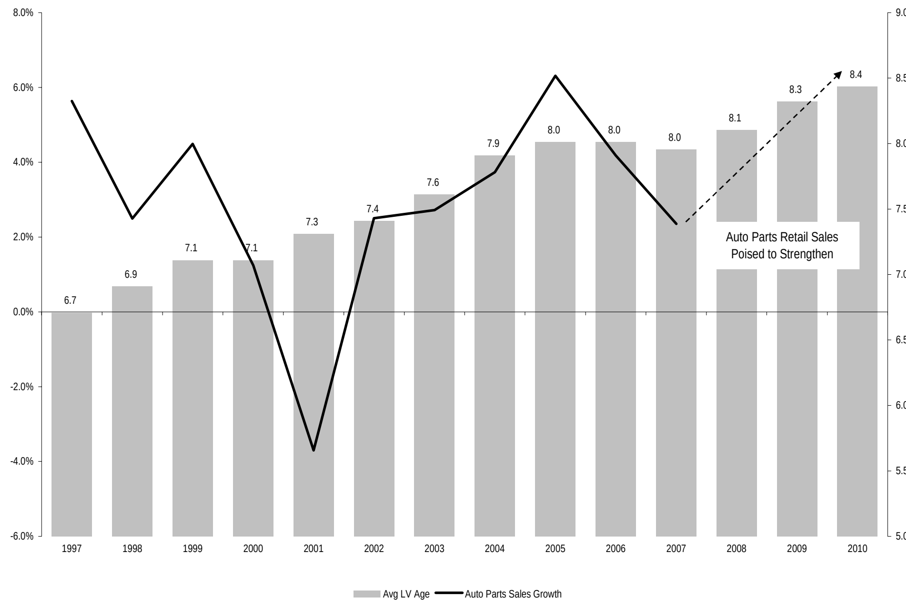
Table 1: Average Light Vehicle Age vs. Auto Parts Retail Sales Growth



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

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.

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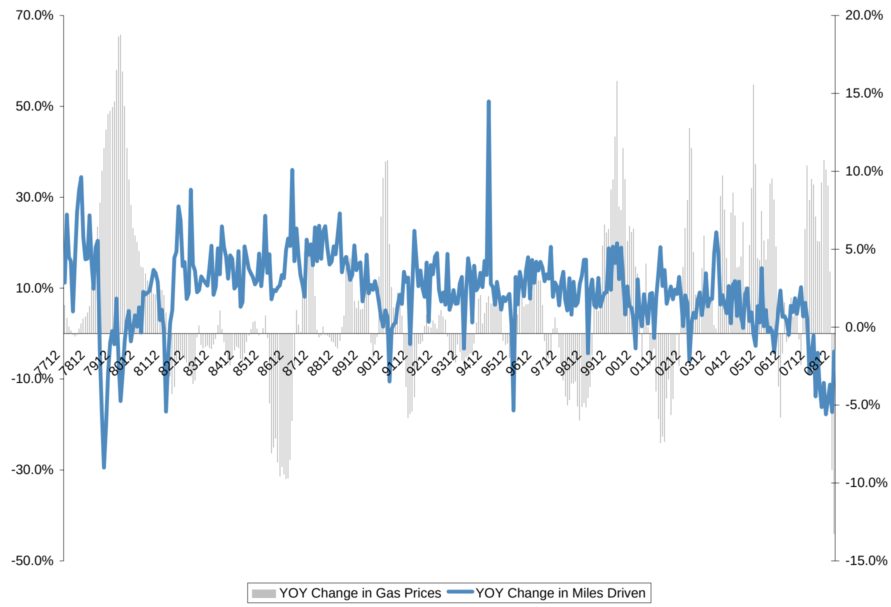
Table 2: Gas Prices vs. Miles Driven



Source: DLXHaver.

Investment Thesis and Valuation

Raising Dec 2009 Price Target to $39 from $36

We maintain our Overweight rating on O'Reilly. Our rating is based on: (1) the company's focus on the DIFM market (at least 50% of core ORLY sales) and our view that average vehicle age is rising and demand should manifest itself at an increasing rate over the coming two years; (2) the low-hanging fruit from adding product to under-inventoried CSK locations, while improving its price positioning; (3) the expected synergies from the CSK integration; and (4) the strength of the management team. Taken together, we see the potential for relatively consistent EPS upside over the coming 10 months.

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Valuation Matrix

	2008	2009E	2010E
EPS	$1.64	$2.00	$2.45
PE	20.0x	16.4x	13.4x
Hist Avg		17.0x	16.0x
Relative PE		1.3x	1.3x
Hist Avg Relative Pe		1.2x	1.1x
EBITDA	$424.8	$635.4	$741.5
EV/EBITDA	12.1x	8.1x	6.9x
Hist Avg		9.5x	8.4x
Price Target		$39.00	
PE		19.5x	15.9x
EV/EBITDA		9.4x	8.1x
Upside/Downside			19%

Source: Factset and J.P. Morgan estimates.

Our Dec 2009 price target of $39 (representing 19% upside and increased from $36 previously) is based on ~16x P/E and ~8x EV/EBITDA using our 2010 forecasts. These multiples are in-line with its historic FY2 averages. 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). Moreover, we view the CSK acquisition as transformational. This target represents 19% upside from current levels.

Earnings Review

- ORLY reported 4Q08 EPS of $0.37 vs. $0.35 last year. This is above our estimate of $0.31 and consensus of $0.30.
- Total revenues increased 84.5% to $1.11B vs. $604.3MM last year and above our estimate for a 73.7% increase. Same-store sales rose 4.0% vs. our estimate of 0.7%.
- By segment, the core ORLY comps increased 6.2% vs. 3.0%E, while CSK same-store sales increased 0.8% vs. (2.8%)E (the first positive comp since 3Q05).
- The consolidated gross margin expanded 150 bps YOY to 46.2% vs. 46.5%E driven by the influx of higher-margin CSK sales, which are driven by a higher mix of DIY sales and market-specific conditions, partially offset by adjusting CSK prices to more competitive levels.
- Operating expenses de-levered 370 bps to 37.9% vs. 39.3%E driven by the addition of the CSK store base, which has a higher expense structure.
- The gross margin expansion and higher operating expense ratio yielded a 220 bp decline to 8.3%, but was 90 bps higher than our 7.2% forecast.
- Converted stores comp trends:
    - Four stores converted 16 weeks ago comped 14.9%.
    - Eleven stores converted 15 weeks ago comped 17.3%.
    - Nineteen stores converted 14 weeks ago comped 16.4%.
    - Twenty-seven stores converted 13 weeks ago comped 12.2%.

Balance sheet & other items

- Cash and cash equivalents decreased 34% to $31.3MM, while debt to capital increased to 24% vs. 6% last year.
- Total inventory rose 78.1% to $1.57B vs. $881.8MM on a year-over-year basis, compared to a total top-line increase of 84.5%. LTM inventory turns fell to 1.20x vs. 1.65x last year and inventory per store increased by 30.4% vs. last year.
- For 4Q, capital expenditures totaled approximately $81.5MM in 4Q08 vs. $63.0MM last year.
- During 4Q, the company opened 27 net new stores, converted 51 CSK stores to ORLY, and merged 19 CSK stores. In total, the combined store count was 3,285 (including 150 net, new core ORLY stores).
- ORLY plans to open an additionally 150 new stores in 2009.
- The company's Lubbock distribution center opened in November. Also, the work to convert the CSK Detroit DC is going well and the new systems are scheduled to go live in late April. Finally, the Greensboro, North Carolina DC is expected to open in May of 2009.

Risks to Our Rating

- **Further deterioration in the macro environment.** If the economy worsens significantly from here, consumer spending may continue to weaken and an extended delay of vehicle maintenance could occur, thereby impacting comp expectations. A better economy would provide an environment that would make ORLY's integration easier to execute.
- **Gas prices and consumer spending.** Any reacceleration in gas prices could cause an incremental leg down in miles driven, which is a major factor in demand determination.
- **CSK integration is lengthy and requires significant supply chain investments.** With the sheer size of the CSK integration (now 40% of revenues), different business models, and significant supply chain and systems changes, we believe that this is not an easy deal for ORLY. The lack of visibility into synergy timing coupled with a challenging macro environment heighten execution risk. Indeed, one of the reasons that there is not a big supply chain synergy opportunity is that ORLY must invest to improve inventory levels in the CSK locations not in reach of an ORLY distribution center. The company is closing the Minnesota CSK DC in June of next year. But, it needs to expand the remaining three, while building 3-4 more on the West Coast.
- **Turnarounds are not linear.** The nature of the CSK integration could cause volatility to near-term earnings results.

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Other Companies Recommended in This Report (all prices in this report as of market close on 19 February 2009)
Advance Auto Parts, Inc. (AAP/$37.00/Overweight)

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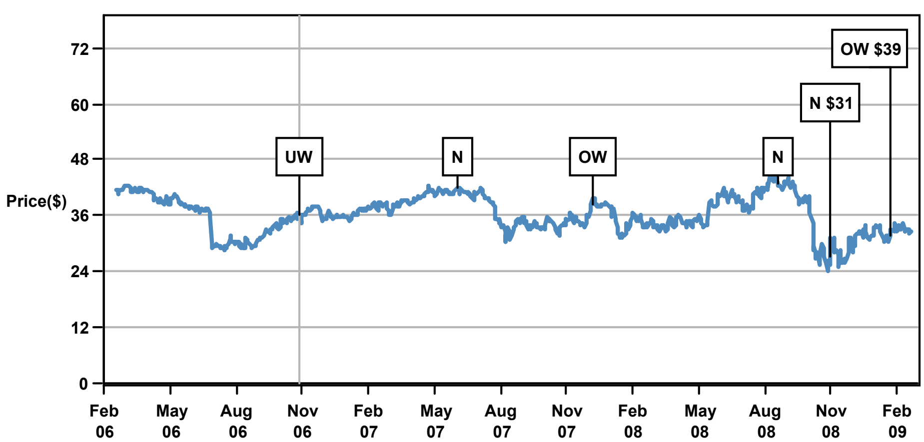
Advance Auto Parts, Inc. (AAP) Price Chart



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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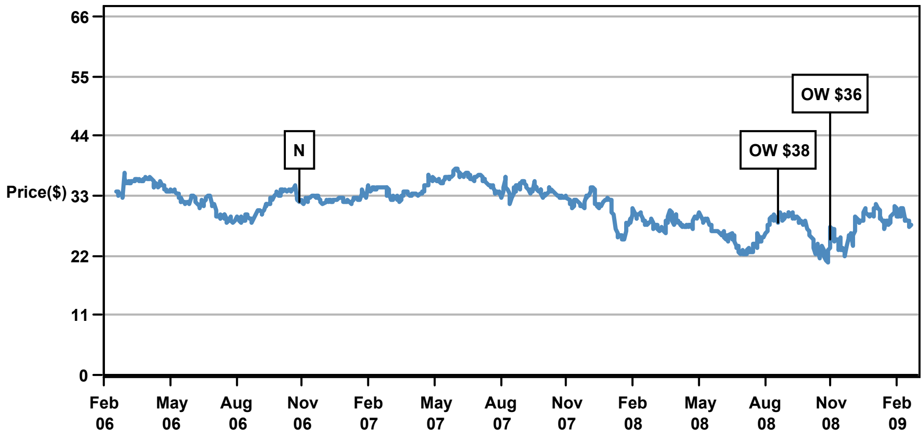
O'Reilly Automotive (ORLY) Price Chart



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)
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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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