



## ANALYST QUICK NOTES

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**AutoZone Inc. (NYSE: AZO: BUY)**

**Target Price: \$875**

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**1/30/2017**

### What are the industry dynamics?

- These stats continue to point to a fleet of vehicles that are no longer under warranty and in need of extra maintenance.
- The average age of an American car is over 11 years and there are a growing number of cars that are more than seven years old.
- If vehicles are driven approximately 12,500 miles per year, a car would have 87,500 miles after seven years.
- Miles driven increased by 3.5% in 2015, which AZO said was the largest increase in more than a decade.
  - Miles driven was up 3% through September of 2016 and our inference from other data sources is that consumers continued to put miles on their cars in the second half of the year.
- The price of unleaded gasoline is still relatively low at about \$2.30 per gallon, but it is up slightly on a year-over-year basis.
  - Low prices at the gas pump should also leave consumers with some extra discretionary income that can be spent on repairs.

### Any negatives?

- Potential deferral of maintenance from consumers considering a new car purchase.
- Better quality of new cars may mean longer intervals until intensive maintenance is needed.
- Near-term sales of auto parts are being pressured by record U.S. new-car sales, but in the longer term, growth in the overall fleet of cars should be beneficial to AZO.
- There is also considerable uncertainty regarding President Trump's goal of boosting U.S. manufacturing and what it could potentially mean to retailers that sell a high percentage of goods that are made overseas.

### **What about Amazon?**

- AMZN has reportedly inked deals with some major makers of auto parts.
- A greater presence by Amazon is an ongoing risk because the online giant has been willing to operate at very low levels of profitability.
- Biggest risk from AMZN is business from the very sophisticated DIY customer.
- Still believe the auto parts sector is relatively insulated from internet competition because of:
  - In-store service including advice and tool loans.
  - Substantial inventory.
  - Immediate availability.
  - Established delivery to commercial customers, sometimes within an hour.

### **What does the company do?**

- At the end of the fiscal first quarter of 2017, AutoZone had 5,835 stores including:
  - 5,313 AutoZone stores in the U.S.; 488 in Mexico; and eight in Brazil.
  - As industry sales have grown, the company's broad geographic presence has enabled it to gain market share.
- Over 80% of stores also have a commercial sales program:
  - Commercial credit.
  - Prompt delivery of parts and other products:
    - Local, regional and national repair garages;
    - Dealers;
    - Service stations; and
    - Public sector accounts.
    - IMC branches carry an extensive line of original equipment import replacement parts.
    - According to management, more than 50% of the sales mix is private label.
      - Margins on these private-label products are higher than on branded products because AZO is able to benefit from direct sourcing.
- AutoZone continues to convert stores into the hub format.
  - The new design provides more retail selling space and allows for a greater merchandise assortment.
  - The company currently operates about 185 hub stores and plans to operate as many as 225.
  - Converted stores typically generate higher sales than unconverted stores due to improved product assortment and availability and increased sales staff. The company operates 11 Mega Hub stores, which are even larger.

### **Earnings Drivers/Catalysts**

- We expect the company to focus on improving inventory availability to drive sales.
  - We expect this to be accomplished by having more inventory in individual stores;
  - By adding more large-format 'Hub' stores to improve the availability in broader, regional markets; and
  - By increasing replenishment to individual stores.
  - Despite the added cost of more inventories, deliveries, and warehousing, management expects the initiative to deliver significant internal rates of return.

- We expect management to add services for commercial customers to more stores and to improve recently-launched commercial programs as they mature.
  - We also expect AZO to offer a wider assortment of parts through its programs.
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