MORGAN-DEMPSEY
CAPITAL MANAGEMENT, LLC

Advance Auto Parts: Initiate Position 1.50% **March 2023**

With roughly $11 billion in 2022 revenue, Advance Auto Parts (NYSE: AAP) is one of four large, publicly-traded retailers that specialize in the automotive aftermarket—maintenance supplies, replacement parts, and discretionary enhancements for light vehicles. According to Advance's definition, which includes smaller specialty retailers, big-box stores, auto dealerships, and other channels, the automotive aftermarket represents a fragmented $150+ billion annual market in the United States. Advance operates under the Advance, CarQuest, Autopart International and Worldpac trade names. Approximately 60% of Advance's sales are made to repair professionals (the "do-it-for-me" or "DIFM" market) with the balance representing individual, "do-it-yourself" ("DIY") customers. In addition to its 4,770 owned stores at Dec. 31, 2022, Advance distributed products to 1,331 independently-owned CarQuest locations.

Dividend Suitability

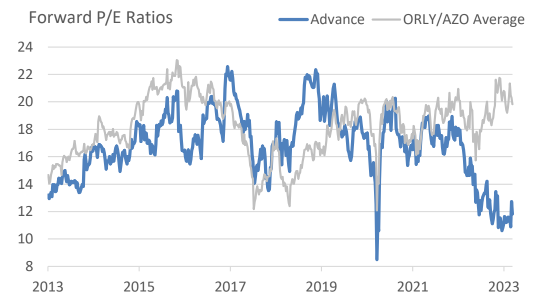
- The current annualized dividend rate of $6.00/share equates to a yield of approximately 4.5%.
- Advance paid a nominal ($0.06/share) quarterly cash dividend from 2006 through 2019; the stock's yield during this period was less than 1%. But with large increases in each of the last three years, Advance chose to distinguish itself on Wall Street with attractive dividends rather than the heavy share buybacks of its chief rivals.
- Advance's dividend represents an annual outlay of $356 million. We regard this as being well funded given that the company has generated positive free cash flow every year since 2000, and its four-year average free cash flow from 2018 to 2021 was $685 million.
    - Free cash flow in 2022—$298 million—was dented by capital spending elevated by a major expansion of its retail footprint in California and a strategic investment in inventory to improve deliveries.
    - While some additional inventory investments will be made in 2023, free cash flow for the upcoming year is targeted to exceed $400 million.
- Advance's balance sheet is solid with net debt of $1.1 billion excluding leases, or slightly above 1.0x 2022 EBITDA (Earnings Before Interest, Taxes Depreciation & Amortization). The company's credit is investment grade (BBB-/Baa2 by S&P and Moody's, respectively).

Transformational/Evolutionary Catalyst

- More than its chief rivals AutoZone, O'Reilly Automotive, and Genuine Parts (NAPA), Advance's legacy is that of a classic Wall Street "roll-up" where managers that built the business through large acquisitions did not follow up with the hard but necessary work of operational integration.
- That began to change in 2016, when current CEO Tom Greco (formerly head of Frito-Lay North America) was hired in the face of pressure from activist investors, who complained about how much lower Advance's operating margins were compared to AutoZone and O'Reilly. Greco's tenure has been devoted to the performance of long-overdue integration tasks—but given the complexity and time-consuming nature of these tasks, as well as the hard-to-manage volatility related to the pandemic and subsequent inflation, investors have largely given up on Advance's potential for improvement.
- However, our research concludes that the hard, structural work of internal integration—consolidation of distribution centers, updated IT systems, management changes and so forth—is mostly done, and only now are the long-awaited fruits ready to be harvested through consistent operational execution.

    - Advance signaled this late stage in its transformation by recently rebasing its own financial targets to GAAP accounting compared to a long-running "adjusted" framework that excluded integration and restructuring costs, even though that move has caused the stock a short-term decline.
- Four to six percentage points of the gap between Advance's targeted 8% operating margin for 2023 and AutoZone & O'Reilly's ~20% reflects structural differences (renting vs. owning real estate, DIFM vs. higher-margin DIY mix, the impact of the independent CarQuest business). Most of the rest are fixable inefficiencies.
    - We think the company should trend toward 1 percentage point of operating margin improvement each year after 2023 until it reaches ~14%.
    - Meanwhile, because AutoZone and O'Reilly are much more exposed to higher-margin DIY sales that are growing *slower* than the DIFM market (thanks to cars becoming ever-more complex and therefore difficult for owners to repair on their own), AutoZone and O'Reilly's margins have likely peaked.

Valuation



- Historically Advance has traded at similar valuation ratios to AutoZone and O'Reilly (forward P/E according to Bloomberg data is shown at left), but starting in early 2022 a significant divergence took place.
    - It looks to us as though Wall Street has given up on Advance's improvement potential at just the wrong time.
- We note the valuation on an absolute basis is also attractive, with a forward P/E of 11.8 being very low by Advance's own history.
- Furthermore, a normalized free cash flow yield of near 9% gives us a "heads we win, tails we don't lose" risk/reward profile. If in the next several years Advance closes half the operating-margin gap with its peers and half the valuation gap, the stock could triple in value (plus hefty dividends along the way). But even if Advance is unable to improve profit margins or its market valuation in the years to come, its free cash flow combined with low single digit organic growth still frames a double-digit annualized total return profile.

Pros/Positives

- The automotive aftermarket is economically resilient during recessions, especially compared to new vehicle sales. Some DIY sales are discretionary, but most maintenance and repair expenditures are essential purchases.
- Even if Advance's key performance metrics pale in comparison to "great" results from AutoZone and O'Reilly, Advance is still a good business with strong returns on tangible capital and impressive cash flow.
- Though AutoZone and O'Reilly have lately shown a willingness to sacrifice gross margin to grow their DIFM revenues, Advance believes part availability, delivery time, and quality are professional customers' top concerns (price being a distant fourth), so price competition should be a limited threat to Advance.
- We believe the reset to GAAP financial targets, though painful up front, will improve management's credibility.

Risks/Negatives

- CEO Tom Greco recently announced an intention to retire before the end of 2023, and the board is leading a search process that includes both internal and external candidates; this introduces risk of changing strategies.
- Though AutoZone and O'Reilly should realize only limited returns to their willingness to compete on price—and their high valuation multiples are at risk if they go too far—Advance will struggle to improve profit margins if it continues to lose DIFM market share as it did in 2022.
- Electrification represents a long-term threat in that electric vehicles have fewer parts and are less complex than their ICE (internal combustion engine) counterparts.

Current & Historical Valuations

Valuation Matric	Current	5-Year High	5-Year Low	Average	Vs. Industry
Price to Earnings (P/E)	14.4	31.9	10.4	22.6	.7
Forward PE	10.7	23.3	8.1	16.6	.5
Price to Expected Growth (PEG)	1.6	3.9	.7	1.5	.5
Price to Book Value	2.6	4.8	1.4	3.3	.4
Price to Sales (P/S)	.6	1.5	.5	1.1	.9
Dividend Yield	5.1	5.1	.1	.9	4.3

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