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## Credit Summary: Advance Auto Parts, Inc. (BBB, Stable)

### Advance's Rating is Supported by an Improving Competitive Position

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#### Morningstar Credit Ratings, LLC

2 October 2018

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#### Credit Rating Rationale

Morningstar Credit Ratings, LLC maintains a BBB corporate credit rating and a stable outlook on Advance Auto Parts, reflecting the company's leading market position in auto-parts retailing offset by ongoing expenses related to supply chain investments and leverage that remains above its long-term targets.

Advance's moderate Business Risk score reflects its leading position in the \$135 billion-plus auto-parts retailing market, which is supported by nearly 5,200 stores and branches. Auto-parts retailing remains highly fragmented, yet Advance and other large chains possess brand awareness, inventory breadth and availability, geographic coverage, and cost advantages that smaller firms find difficult to replicate. As such, we expect that Advance will continue to gain market share. The company generates nearly 60% of revenue from the faster-growing commercial segment, with the balance of revenue from the do-it-yourself market. Given the extensive in-store services that are often required by customers, we believe the DIY market may be difficult for online-only retailers to penetrate. On the commercial side, high parts availability, professional training programs, and brand reputation will limit online inroads, as well. The auto-parts retailing industry continues to benefit from the growing number and average age of vehicles, an increasing number of miles driven, and low unemployment. Advance has been assigned a narrow economic moat rating by Morningstar's Equity Research Group.

Advance's recent results have begun to reflect management's five-year transformation plan that was instituted in 2017 and is designed to increase in-store parts availability, reduce inventory over time, and lower overall costs. Following various acquisitions, Advance operates multiple supply chains that still maintain duplicative inventory. Advance continues to focus on technology and other initiatives to improve productivity at its 54 distribution centers in North America. Once completed, management expects the strategic plan will result in average annual mid-single-digit comparable-store sales growth and a 500-basis-point-plus improvement in operating margins. While the company's Solvency Score have been negatively affected by inventory and supply chain initiatives, recent operating results have begun to reflect a recovery in revenue, operating margins, and return on invested capital.

Advance reported adjusted debt leverage of 2.9 times at the end of the second quarter of fiscal 2018, above its 2.5 times long-term target (management capitalizes operating leases at 6 times rent). Morningstar calculates total adjusted debt of \$5.3 billion, including \$1.0 billion of senior unsecured notes and \$4.3 billion related to operating lease commitments, along with an adjusted leverage ratio of debt/EBITDAR of 3.7 times (8 times rent). Liquidity includes \$902 million of cash and equivalents at the

end of the second quarter, which is the highest cash balance the company has had in the past several years. In addition, Advance maintains a \$1 billion unsecured revolving credit facility with nearly \$900 million of borrowing availability based on its leverage ratio. After the second quarter, management also increased its full-year free cash flow estimate by 25% to \$500 million. While historically shareholder distributions have been limited to cash dividends, management indicated that share repurchases could range between \$100 million and \$200 million for the remainder of the year. Nevertheless, management intends to use remaining free cash flow to return to targeted leverage ratios, consistent with an articulated financial policy to maintain a credit profile that is supportive of an investment-grade rating. The company's moderate Cash Flow Cushion reflects good free cash flow approximating 7% of sales, moderate shareholder distributions, and a modest five-year maturity schedule that includes \$300 million due in 2020 and \$300 million due in 2022.

The stable outlook reflects Morningstar's expectation that in 2018 operating profitability will stabilize, including demonstrated improvement exiting the year, while strong free cash flow generation will lead to progress in returning leverage toward management's 2.5 times target. The rating could be lowered if management can't execute on its inventory and supply chain initiatives, limiting profitability, leverage, and Solvency Score improvements. While a rating upgrade is unlikely over the next several years, extraordinary success exemplified with strong and consistent same-store sales growth coupled with significantly higher margins and lower targeted adjusted debt leverage could result in an upgrade over time.

### **Strengths**

- ▶ Favorable industry growth dynamics should generate low-single-digit growth rates, including increasing number of vehicles, increasing average age, increasing number of miles driven, lower unemployment.
- ▶ Larger, more efficient chains have significant opportunity to continue to increase market share.
- ▶ Considerable opportunity to substantially increase margins toward peer levels.

### **Weaknesses/Risks**

- ▶ The integration of acquisitions and supply chain investments have depressed revenue and margins.
- ▶ A new management team will be challenged to execute on margin improvement goals and manage activist investor interests while maintaining moderate debt leverage.
- ▶ Longer-term implications for auto-parts demand and pricing include increasing new automobile purchases and improved quality, which reduces repair needs; increased complexity of cars, requiring the use of dealers; the electrification of cars; and the potential widespread adoption of self-driving cars, leading to lower vehicle sales and/or increased fleet management.



- ▶ **Cash Flow Cushion (6, Moderate):** Advance has a \$300 million debt maturity in each of 2020 and 2022, in addition to substantial annual operating lease payments of over \$500 million. Existing cash balances and strong forecast cash flow covers these obligations 171% over the next five years.
- ▶ **Solvency Score (7, Weak):** A weak solvency score reflects recent profitability pressure. In addition to ongoing restructuring actions related to the integration of General Parts, Advance has taken deliberate actions to invest in its business and improve productivity, increase pricing discipline in stores, and reduce inventory. As such, in 2017, return on invested capital declined to single digits, down from the midteens three years earlier. Morningstar forecasts returns will recover to the low teens over the next few years, improving the Solvency Score pillar.
- ▶ **Distance to Default (4, Strong):** A strong DTD score reflects a solid equity cushion as evidenced by a 13 times EBITDA multiple compared with an adjusted net debt/EBITDA ratio of 3.0 times.

### **Advance Auto Parts Inc.**

#### **Company Overview**

Advance operates 5,026 stores and 133 Worldpac distribution branches, with locations primarily in the U.S., along with others in Canada, Puerto Rico, and the U.S. Virgin Islands. In addition, the company services 1,219 independently owned Carquest branded stores. Advance acquired Carquest in the January 2014 \$2.08 billion acquisition of General Parts International, which included approximately 1,200 company-operated stores, 1,400 franchised locations, and 103 Worldpac locations. Advance continues its multiyear plan to integrate the operations of GPI with Advance. At the end of the second quarter of 2018, 352 Carquest stores had been consolidated into existing Advance Auto Parts stores and 423 stores had been converted to the Advance Auto Parts format. About 419 Carquest stores remain.

In 2015, activist investor Starboard Value, LP pointed out that Advance's operating margins were 800 to 900 basis points behind AutoZone (rating BBB+, Stable) and O'Reilly Automotive (rating: BBB+, Stable). Starboard recommended that Advance could increase margin growth by improving inventory and supply chain management that would lead to increasing product availability and service quality. To promote these initiatives, Advance replaced senior management, including its CEO and CFO. Advance hired Tom Greco as its CEO, who joins with nearly 30 years of experience at PepsiCo and Frito-Lay. Starboard is still represented on the company's board of directors.

#### **Auto-Parts Retail Industry Commentary**

Advance operates in an estimated \$135 billion market, including the \$85 billion commercial industry and the \$50 billion DIY industry.

The industry remains highly fragmented, and despite its position as the second-largest industry participant based on revenue, Advance estimates it holds only a 7% share of the market. The top four chains, including Advance, AutoZone, O'Reilly Automotive, and Genuine Parts Company (not rated), represent approximately a third of the total industry as estimated by Morningstar. We anticipate the

largest chains will be able to continue to gain market share due to competitive advantages that include strong brands, large-scale distribution, and economies of scale.

Over the next several years, Advance expects 2%-3% annual overall industry growth, 3%-4% commercial annual growth, and 1%-2% DIY growth. The industry is currently experiencing several favorable industry dynamics, including a significant increase in the number of vehicles in operation over the past several years, an average vehicle age that exceeds 11 years, an expectation that miles driven will continue to increase based on historical trends, low unemployment rates, and moderate fuel prices. In addition, the industry exhibits certain countercyclical traits, as evidenced during the last recession in 2008. During this period, leading auto-parts retailers performed well, as customers deferred new vehicle purchases, which increased the average age of vehicles on the road. As such, sales benefited from higher routine maintenance and repairs, which was only somewhat offset by a slower pace of spending on elective maintenance on used vehicles.

Auto-parts retailers are negatively affected by improved quality of new vehicles, which increases the time before regular maintenance or parts failure and the increasing complexity of new cars, which can lead to greater use of dealers that purchase parts directly from manufacturers. Longer-term concerns include the increasing penetration of electric cars, which have fewer moving parts and a lower frequency of repairs, and the potential industry disruption from self-driving vehicles, which could lead to a reduction in new vehicle sales.

### **Advance Auto Parts Financial Projections**

Advance is in the second full year of a five-year strategic plan that includes a goal for ongoing comparable-store sales growth in the midsingle digits and operating margins in the midteens. Following 2018 second-quarter results, management increased revenue and the low end of margin guidance. For the full year, Advance forecasts revenue of \$9.4 billion at the midpoint and operating margins of 7.65%, which includes same-store sales expectations of flat to up 1.5%. Over the next five years, we forecast revenue growth in the low-single-digit range, largely reflecting positive comparable-store sales, along with operating margin improvement as the transformation plan is executed. We forecast Advance can reduce adjusted debt leverage to its target of 2.5 times (6 times multiple for operating leases) in 2020.

## Advance Auto Parts Financial Summary With Forecast

### Exhibit 2

All values (except per share amounts in: USD Millions)	Forecast							
	2015	2016	2017	2018	2019	2020	2021	2022
<b>Income Statement</b>								
Revenue	9,737	9,568	9,374	9,400	9,644	10,046	10,451	10,873
Gross Profit	4,423	4,256	4,085	4,120	4,285	4,534	4,779	4,994
Operating Income	995	901	686	721	812	952	1,126	1,209
Adjusted EBITDA	1,222	1,119	896	966	1,061	1,221	1,415	1,520
Net Income	472	458	476	361	486	622	785	847
<b>Balance Sheet</b>								
Cash + Investments	91	135	547	761	917	961	1,017	1,006
Total Debt	1,207	1,043	1,044	1,044	1,044	1,044	1,044	1,044
Total Adjusted Debt	5,503	5,363	5,316	5,297	5,332	5,434	5,536	5,636
<b>Cash Flow Statement</b>								
Cash Flow From Operations	703	523	601	795	893	1,048	1,239	1,348
Capital Expenditures	(235)	(260)	(190)	(220)	(272)	(382)	(405)	(428)
Free Cash Flow (CFO-Capex)	468	264	411	575	621	666	834	920
Free Cash Flow / Sales	4.8%	2.8%	4.4%	6.1%	6.4%	6.6%	8.0%	8.5%
<b>Growth (% YoY)</b>								
Revenue	0.4%	-1.7%	-2.0%	0.3%	2.6%	4.2%	4.0%	4.0%
Gross Profit	0.8%	-3.8%	-4.0%	0.9%	4.0%	5.8%	5.4%	4.5%
Operating Income	4.1%	-9.4%	-23.9%	5.1%	12.6%	17.2%	18.3%	7.4%
Adjusted EBITDA	0.3%	-8.5%	-19.9%	7.8%	9.8%	15.0%	16.0%	7.4%
<b>Profitability (%)</b>								
Gross Margin	45.4%	44.5%	43.6%	43.8%	44.4%	45.1%	45.7%	45.9%
Operating Margin	10.2%	9.4%	7.3%	7.7%	8.4%	9.5%	10.8%	11.1%
Adjusted EBITDA Margin	12.6%	11.7%	9.6%	10.3%	11.0%	12.2%	13.5%	14.0%
Net Margin	4.8%	4.8%	5.1%	3.8%	5.0%	6.2%	7.5%	7.8%
Adjusted ROIC	10.9%	10.1%	6.1%	8.7%	9.6%	10.8%	12.2%	12.9%
<b>Coverage / Cash Flow</b>								
Adjusted EBITDA / Interest Expense	18.7	18.7	15.2	15.4	15.6	18.0	20.9	22.4
(Adj. EBITDA-CapEx) / Int. Exp.	15.1	14.3	12.0	11.9	11.6	12.4	14.9	16.1
Adj. EBITDAR / (Int. Exp. + 1/3 Rents)	7.2	6.9	6.0	6.2	6.5	7.1	7.8	8.1
Dividends / FCF	4%	7%	4%	3%	3%	4%	3%	3%
Share repurchase (issuance) / FCF	0%	5%	1%	52%	64%	83%	84%	92%
<b>Leverage</b>								
Total Debt / Adj. EBITDA	1.0	0.9	1.2	1.1	1.0	0.9	0.7	0.7
Net Debt / Adj. EBITDA	0.9	0.8	0.6	0.3	0.1	0.1	0.0	0.0
Total Adj. Debt / Adj. EBITDAR	3.1	3.2	3.7	3.5	3.3	3.1	2.8	2.7
EV / Adj. EBITDA	10.0	12.0	8.8	-	-	-	-	-
Debt / Capital	33%	26%	23%	23%	23%	23%	22%	23%
FCF / Total Debt	39%	25%	39%	55%	59%	64%	80%	88%

Source: Company Reports, Morningstar Credit Ratings, LLC

### Capital Structure, Liquidity Analysis, and Capital Allocation Policy

Advance's adjusted debt leverage was 2.9 times at the end of the second quarter, yet it continues to trend toward management's 2.5 times long-term target (management capitalizes operating leases at 6 times rent). Morningstar's leverage calculation includes total adjusted debt of \$5.3 billion, including \$1.0 billion of senior unsecured notes and \$4.3 billion related to operating lease commitments, which equates to an adjusted debt/EBITDAR ratio of 3.7 times (8 times rent). The company's senior unsecured notes are included in the capital structure below.

Cash balances increased to \$902 million at the end of the second quarter, which is the highest cash balance the company has had over the past several years. Morningstar forecasts Advance will maintain cash balances near current levels. Advance maintains a \$1 billion unsecured revolving credit facility with nearly \$900 million of borrowing availability. The credit facility contains a leveraged ratio covenant, which limits adjusted debt (including 5 times rent) to EBITDAR to 3.50 times. The revolver expires in January 2023.

Advance prioritizes its cash flow to first reinvest in its business with an efficient use of capital as measured by ROIC, second to maintain an investment-grade rating with a 2.5 leverage target (6 times rent), and last to return cash to shareholders. After the second quarter, management increased its full-year free cash flow estimate to \$500 million. While historically, shareholder distributions have been limited to cash dividends, management indicated that share repurchases could range between \$100 million and \$200 million for the remainder of the year.

The company's moderate Cash Flow Cushion reflects good free cash flow approximating 7% of sales, moderate shareholder distributions, and a modest five-year maturity schedule that includes \$300 million due in 2020 and \$300 million due in 2022. While the company's Solvency Score has been negatively affected by the company's inventory and supply chain initiatives, recent operating results have begun to reflect a recovery in revenue, operating margins, and return on invested capital.

#### Exhibit 3 Capital Structure

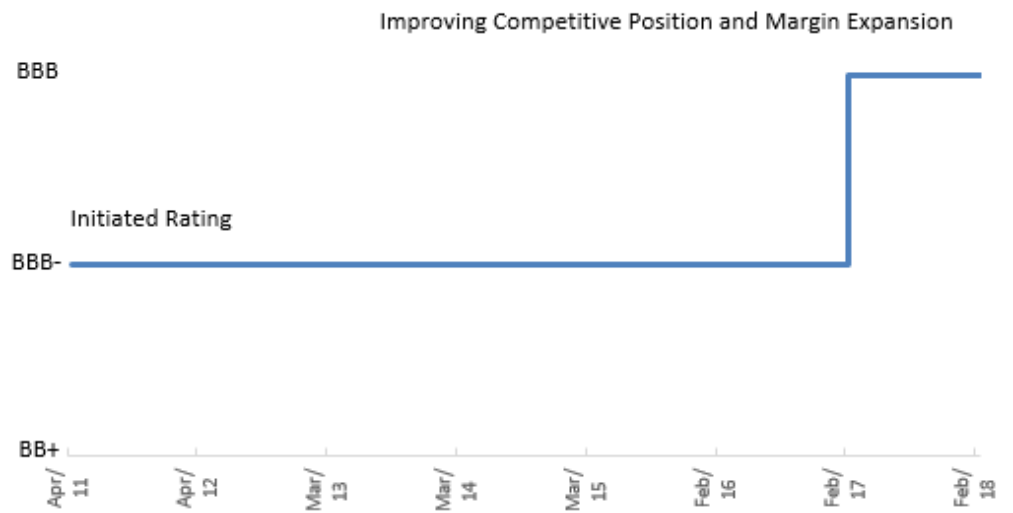
Advance Auto Parts Capital Structure at July 14, 2018 (\$ In millions)			
Type	Maturity	Amount	Leverage
5.75% Senior Unsecured Notes	2020	\$299	
4.50% Senior Unsecured Notes	2022	\$299	
4.50% Senior Unsecured Notes	2023	\$447	
Total Gross Debt		\$1,045	1.1x
Capitalized Operating Leases (8x rent)		\$4,256	
Total Adjusted Debt		\$5,301	3.7x
Cash		\$902	
Net Adjusted Debt		\$4,399	3.0x
EBITDA (July 2018 - twelve months)		\$921	
EBITDAR (July 2018 - twelve months)		\$1,449	

Source: Company Filings, Morningstar Credit Ratings, LLC

### Credit Rating History

- ▶ Morningstar, Inc. initiated non-NRSRO coverage of Advance Auto in 2011 with a BBB- rating.
- ▶ Morningstar Credit Ratings, LLC upgraded Advance Auto's rating one notch to BBB in February 2017. The rating upgrade was based on Advance's improved competitive position, expected margin expansion, and adherence to a moderate capital structure.

**Exhibit 4** Advance Auto Parts Credit Rating History



Source: Morningstar Credit Ratings, LLC



**Exhibit 5** Peer Comparison

	<u>O'Reilly</u>	<u>Advance Auto</u>	
	<u>Auto</u>	<u>AutoZone</u>	<u>Parts</u>
Ticker	ORLY	AZO	AAP
<b>MCR Credit Rating</b>	<b>BBB+</b>	<b>BBB+</b>	<b>BBB</b>
<b>MCR Rating Outlook</b>	<b>Stable</b>	<b>Stable</b>	<b>Stable</b>
Economic Moat	narrow	narrow	narrow
<b>Pillars:</b>			
Business Risk	5	5	5
Cash Flow Cushion	5	6	6
Solvency Score	5	5	7
Distance to Default	5	5	4
Rawdata Score	100	98	121
<b>Business Risk Detail:</b>			
Size	8	8	8
Moat	5	5	5
Uncertainty	7.5	7.5	5
Concentration	3	3	3
Management Score	3	3	3
Depend on Cap Mkt	3	2	4
Cyclicalilty	3	3	3
LTM (\$ in mm)	<u>6/30/18</u>	<u>5/5/18</u>	<u>7/14/18</u>
Revenue	\$9,270	\$11,174	\$9,421
EBITDA	\$2,018	\$2,269	\$921
EBITDA Margin	21.8%	20.3%	9.8%
EBITDAR	\$2,324	\$2,589	\$1,449
EBITDAR Margin	25.1%	23.2%	15.4%
ROIC (2018 E)	22.7%	27.1%	8.7%
Cash & Investments	\$37	\$218	\$902
Bank Availability	\$1,075	\$2,000	\$897
Total Liquidity	\$1,112	\$2,218	\$1,799
Net Debt	\$3,217	\$4,737	\$143
Total Debt	\$3,254	\$4,955	\$1,045
Adjusted Debt	\$5,638	\$7,387	\$5,301
Cash from Operations	\$1,568	\$1,819	\$777
CAPX	(\$462)	(\$523)	(\$129)
Free Cash Flow	\$1,106	\$1,296	\$648
Share Repurchase	(\$1,797)	(\$1,154)	(\$9)
Dividends	\$0	\$0	(\$17)
Retained FCF	(\$691)	\$142	\$622
Adj. EBITDAR/(Int.+ 1/3 Rent)	10.9x	9.3x	6.2x
Net Debt / EBITDA	1.6x	2.1x	0.2x
Debt / EBITDA	1.6x	2.2x	1.1x
Adj. Net Debt / EBITDAR	2.4x	2.8x	3.0x
Adj. Debt / EBITDAR	2.4x	2.9x	3.7x
Market Cap	\$27,800	\$20,100	\$12,400
Enterprise Value	\$31,017	\$24,837	\$12,543
EV / EBITDA	15.4x	10.9x	13.6x
FCF / Sales	12%	12%	7%
FCF / Adjusted Debt	20%	18%	12%
Store count	5,019	6,029	5,183
Same store sales (2017)	1.4%	0.5%	-2.0%
DIY %	58%	82%	43%
Commercial %	42%	18%	57%

Source: Morningstar Credit Ratings, LLC

## Appendix

### Company Moat and Trend

The following description comes directly from Morningstar's Equity Research Group.

*"We have assigned Advance a narrow economic moat rating due to its brand intangible assets and the cost advantages afforded by its national presence. The firm's returns on adjusted capital support our contention. Advance consistently generated returns on invested capital above our 9% weighted average cost of capital estimate until 2017, when turnaround-related investments resulted in a 6% mark. We expect recovery to begin in 2018, with Advance building to a 12% mark by fiscal 2022.*

*"Advance participates in an industry where differentiated service levels can lead to the formation of strong brands. Demand is price-inelastic, with part availability, convenience, and in-store services (in the DIY segment) carrying significant weight. As these consumer benefits are costly to deliver, larger retailers are at an advantage as they can spread service costs (as well as inventory holding expenses) over a large sales base. Brands are especially significant on the commercial side of the industry, where clients tend to be retailer-loyal, preferring to stay with trusted partners as any cost differentials can largely be passed on to vehicle operators. High levels of part availability further enhance retailers' reputations with commercial buyers (and are difficult to replicate for regional players with less extensive infrastructure). Commercial customers depend on quickly sourcing necessary components in order to turn over service bays, making reliable part availability a key point of customer engagement. Advance augments its relationships through its technician and shop owner training programs and technology solutions, which we believe deepen the firm's engagement with professional clients and strengthen its brand equity.*

*"From a DIY standpoint, the increasing complexity of automotive parts and the infrequency of repairs lead consumers to depend on in-store sales staff for knowledge and advice to find the right product and understand how to complete the installation. The company has deepened this level of engagement by offering tool loans, oil and battery recycling, how-to videos, and simple diagnostics at its stores, gratis. As replacement of a failed part is often critical to the operability of the vehicle, consumers favor trusted retailers that are likely to have the part needed on hand (or can obtain it quickly), aiding larger chains like Advance. For DIY customers that often work on and maintain their own cars, Advance's high level of part availability (relative to subscale rivals)*

*and consumer loyalty program (Speed Perks) help keep consumers in the fold. Advance's strong DIY brand and trusted salesforce also enable it to drive significant traction for its proprietary brands (approximately 40% of sales).*

*"The retail customer's need for assistance in purchasing the right component should forestall significant disruption of Advance's hard part sales by nontraditional, digital retailers (like Amazon) for the foreseeable future. Despite Amazon's recent efforts to sign distribution agreements with manufacturers, we anticipate that incumbent retailers will be able to defend their privileged market standing because of their in-store services and ability to offer several categories of needed components on demand. Hard parts are increasingly complex and can vary significantly depending on the model year and selected options on any vehicle. The purchase and installation of such products can be daunting, and the support provided by trained in-store sales staff is difficult to replicate through do-it-yourself videos and online assistants. Advance's tool loan offerings add additional value, as part installations sometimes require a specialized instrument that is better borrowed from Advance than purchased for a single-use application. Aside from the lack of personalized service, customers looking to replace a failed critical component often need the part immediately in order to regain reliable use of a car or truck in commuting or business. Few digital retailers are able to combine depth of inventory with speed of delivery. Advance already uses digital online ordering tools with its professional clients, and we believe the company's extensive and fairly flexible inventory makes disruption less of a concern in the commercial segment. We also expect that a large-scale move by manufacturers in favor of direct shipping is unlikely, due to the infrastructure required, end customers' price inelasticity, and the convenience associated with repair shops ordering parts made by multiple brands from one source.*

*"Advance's extensive store and distribution network forms a durable cost advantage versus smaller peers. With 5,183 stores and 54 distribution centers as of the end of 2017, the company is able to quickly shift inventory to meet customer demand while keeping reserves of slower-moving parts that can rapidly be delivered to stores if needed. This enables Advance to improve its inventory turnover despite high availability (subject to the constraints of a low-turn industry) by holding slow-moving items at distribution centers and hub stores serving many traditional locations in their vicinity. As its investments in inventory management technology and supply chain automation are spread across a broader pool of sales and stores, the firm's cost profile improves in a way that is difficult for smaller competitors to replicate.*

*"While the firm lags O'Reilly and AutoZone, Advance's scope has allowed it to mitigate its working capital burden through its 0.7 accounts payable to inventory ratio (as of 2017), as vendors agree to generous payment terms for one of the largest parts retailers. Financing inventories through this mechanism offsets the balance sheet cost of providing high availability levels for slow-moving items, enabling a standard of service that is uneconomical for smaller peers.*

*"Our moat trend rating for Advance is positive.*

*"While the industry's move toward greater part availability levels carries some expense, we believe it deepens Advance's competitive advantages by creating added brand differentiation versus smaller regional peers while capitalizing on an infrastructure that only the largest retailers have in place. Availability is a critical metric for commercial clients in particular, and Advance's scale enables it to provide a wider variety of items relatively quickly (relative to subscale peers, though it lags other national chains), allowing the firm's clients to clear service bays efficiently. As the industry is highly fragmented, differentiation from local and regional incumbents offers a significant share growth opportunity and a chance to leverage inventory investments over a larger sales base, enhancing returns over time. Advance's efforts to close duplicative distribution centers are unlikely to alter our favorable view of its standing; rather, we expect the ensuing efficiency to marginally bolster its ability to provide a high level of part availability.*

*"From a DIY standpoint, retailer-customer relationships are based on trust and service levels amid a relatively price-inelastic backdrop. Consequently, differentiating elements like availability, convenience, and in-store services are critical means of drawing customers away from competitors. As a result, the company's growing distribution capabilities and store network should act to reinforce Advance's brand strength at the expense of smaller competition that cannot match the level of investment that Advance can afford.*

*"General Parts significantly shifted the company's sales mix toward professional clients, providing greater exposure to a loyal client base while acquiring a distribution network that can support faster inventory replenishment and higher levels of part availability. As Advance adds DIY sales and regains clients as the turnaround takes hold, we expect the company's brand equity to build as industry consolidation leads to clients shifting from less efficient regional players to national sellers. After repair facilities make the change to a large seller, vehicle owners' price inelasticity leaves little incentive for commercial clients to switch among national retailers (if availability is comparable), resulting in an environment that should generate growth at Advance while strengthening its brand advantage.*

*"Similarly, Advance's cost advantage should reinforce itself as the professional side of the industry consolidates. Professional clients tend to be loyal because there is little incentive to switch parts providers given vehicle operators' relative price inelasticity, unless an insurgent can provide a higher level of service. National retailers like Advance can use availability as a wedge to separate customers from their local parts retailer, a dynamic that will play out over time and result in increasing sales from a loyal client base. Growth should allow Advance to spread its fixed costs and efficiency investments over a larger sales base while enabling the firm to leverage its inventory of slow-moving items and distribution network across a greater number of stores.*

*"Although national retail chains share many of the same advantages as Advance, the industry is still fragmented, and Advance should be able to take share from smaller participants for years to come. As the industry consolidates behind large retailers, we believe their competitive positioning will improve as leaders are able to spread infrastructure and service level investments over a growing sales base, expanding their cost and brand advantages. The consolidation opportunity should also keep costly and largely futile price-based competition among the large retailers at bay (we estimate that O'Reilly, AutoZone, Advance Auto Parts, and Genuine Parts' combined market share in DIY is around 35%, with only about 25% combined share in commercial).*

*"Worldpac should add to Advance's competitive advantage as it grows, giving the company another means of addressing aftermarket parts demand for imported vehicles. The same principles of leveraging slow-turning inventory should apply as Advance adds Worldpac branches, serving to enhance the firm's cost advantage while further differentiating it from peers who are not able to access OEM foreign products as quickly, comprehensively, or efficiently."*

**Exhibit 6** Descriptors for Pillar Analysis

<b>Rating Pillars</b>					
	<b>Score Range</b>	<b>Business Risk</b>	<b>Cash Flow Cushion</b>	<b>Solvency Score</b>	<b>Distance to Default</b>
<i>Strongest</i>	1-2	Minimal	Very Strong	Very Strong	Very Strong
	3-4	Low	Strong	Strong	Strong
	5-6	Moderate	Moderate	Moderate	Moderate
	7-8	High	Weak	Weak	Weak
<i>Weakest</i>	9-10	Very High	Very Weak	Very Weak	Very Weak
<b>Business Risk Pillar Components</b>					
<b>Country Risk (10% of Business Risk Score)</b>					
<i>Weakest</i>	Very High Risk				
	High Risk				
	Moderate Risk				
<i>Strongest</i>	Low Risk				
<b>Company Risk (90% of Business Risk Score)</b>					
	<b>Size</b>	<b>Economic Moat</b>	<b>or Sustainable Competitive Advantage</b>	<b>Uncertainty</b>	
<i>Weakest</i>	Very Small	None	None	Extreme	
	Small			Very High	
	Moderate	Narrow	Moderate	High	
	Large			Medium	
<i>Strongest</i>	Very Large	Wide	Substantial	Low	
	<b>Product/Customer Concentration</b>	<b>Management</b>	<b>Dependence on Capital Markets</b>	<b>Cyclicality</b>	
<i>Weakest</i>	Highly Concentrated	Aggressive	Extremely Dependent	Highly Cyclical	
	Concentrated	Fairly Aggressive	Highly Dependent	Cyclical	
	Neutral	Neutral	Dependent	Average Cyclicality	
	Diversified	Fairly Conservative	Low Dependence	Mild Cyclicality	
<i>Strongest</i>	Highly Diversified	Conservative	Very Low Dependence	Non-Cyclical	

Source: Morningstar Credit Ratings, LLC

Economic Moat Provided by Morningstar's Equity Research Group

## Morningstar® Credit Research

### For More Information

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