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New Rec: Pep Boys	(PB: \$9.68)	September 26, 2010
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Position: Buy

Target: \$13.25

\$ooo	Q110a	Q210a	Q310e	Q410e	2010E	2011E	2012E
Rev (\$mil)	510.0	504.9	484.0	472.0	1,971	2,052	2,131
EPSS	0.23	0.18	0.07	0.02	0.51	0.60	0.78
Y/Y	44%	20%	50%	300%	44%	18%	29%
PE	n/a	n/a	n/a	n/a	18.8	15.9	12.4
PSR	n/a	n/a	n/a	n/a	0.4	0.4	0.3
Cons.	n/a	n/a	n/a	n/a	0.51	0.58	0.75
FCF *	n/a	n/a	n/a	n/a	1.05	1.20	1.48

* assumes annual maintenance capex of \$42M

Shares Out: 52.8M

Market Cap: \$515M

FYE: Jan

Concept:

1. Defensive business trading at 8x 2011 FCF (before expansion capex) and 1.1x TBV
2. New management is implementing a successful turnaround – 6 consecutive quarters
3. Rollout of low-cost, high-return service stores should add meaningfully to earnings
4. Undervalued real estate should provide financial flexibility and downside protection.

5. Balance sheet has improved markedly – should result in higher multiple

Summary: Pep Boys (PBK) is a leading provider of automotive parts and services to both retail and commercial customers through 600 stores in 35 states. Following years of poor results, the company appears to be in the early stages of a sustainable turnaround, led by a new management team that has reinvigorated the company and that has delivered six consecutive quarters of improved profitability. PBK has been a serial underperformer, a result of poor management and two legacy disadvantages: its existing superstores, which average 20k SF with 11 service bays, are too large. In addition, PBK's store footprint is spread too thin in most regions. As a result, its EBIT margin is far below those of major competitors.

PBK is addressing its market density issue by rolling out smaller service & tire centers (STCs) to fill in the gaps between its existing supercenters in key markets. This should enable it to gain market share in the highly-fragmented localized automotive service business, and to leverage its existing distribution, inventory and advertising. The STCs, which are focused on service, are much less costly to open than the traditional superstore format and, produce a much higher profit margin and ROIC. PBK has opened 33 stores since mid 2009, and plans to open another 28 and 80 locations in 2010 and 2011, respectively. It is financing the new stores entirely with internal cash flow. We think PBK could also accelerate its plans by completing a meaningful accretive acquisition of existing service locations.

As the store expansion and turnaround progress, PBK's sales should grow and its margins increase, at a minimum, to a level that would justify the purchase of PBK shares at the current valuation. The EBIT margin has increased from 0.4% in 2007 to 3.3% for the latest 12 month period. We forecast a continued increase in EBIT margin to 3.7% in 2011 and 4.2% in 2012, even including an estimated 25bp drag from new store expansion that masks underlying profitability. PBK management has set a longer-term target of 5%-7% margins. For comparison, service competitors Midas and Monro have EBIT margins in the 9%-11% range, while the four largest auto parts providers have an average margin of 12%. Our recommendation is predicated on the continued success of the turnaround strategy.

PBK is generating solid free cash flow. Actual FCF was \$0.88 in 2009. Using a conservative estimate of \$42M for core maintenance capex (which excludes new store openings), we estimate FCF to be \$1.05, \$1.20 and \$1.48 in 2010, 2011 and 2012 respectively. In addition to the new store expansion, PBK is also investing in existing store profitability, employee productivity, and customer satisfaction. Stores have been outfitted with the latest high-tech diagnostic and service equipment. Shrink has been reduced by nearly 50% in two years. Excess store support staff has been reduced, and low-margin, non-core inventory is being

eliminated. Management is also attacking gross margin “leaks,” such as excessive discounting, customer claims, and worker safety, and it has shifted its marketing focus to the service business with an everyday low price strategy. It recently introduced a web based appointment scheduling system as well as a rewards card that already has 9M members. PBYS aims to create more repeat customers and to convert retail parts customers to service. For example, a typical store has 10x the number of daily retail customers as service customers, and PBYS is working to convert more retail patrons to service. If it could convert just 1% of retail customers, the result would be a 10% increase in service customers. Year to date, the service customer count has increased by nearly 6%.

PBY’s balance sheet has improved markedly due to well timed sale-leasebacks of stores in 2007 and 2008. Management also repurchased debt at a large discount during the financial crisis, and cash flow has increased. As a result, net debt has declined from \$381M in 2007 to \$214M in the latest quarter, while net debt to trailing EBITDA has declined from nearly 5x to 1.6x over the same period. PBYS has \$93M in cash and no borrowings under its lines of credit. Moreover, none of the debt matures until 2013. We also think there is potential upside to FCF from an improvement in trade payables for inventory. PBYS’s ratio of payables to inventory of 45% is well below the average of its main competitors. If PBYS can achieve investment grade status, it could unlock substantial capital that is tied up in inventory. We have not incorporated any such improvement into our forecasts.

There appears to be considerable unrealized value in PBYS’s real estate. The company owns 231 superstores, 4 distribution facilities and its headquarters in Philadelphia. The underlying land, much of whose ownership dates back several decades, is carried at its original cost of \$204M. PBYS also holds very favorable ground leases on an additional 170 properties. As we discuss in the report, we think there could be at least \$100M of after-tax unrealized value in PBYS’s owned real estate. Adding this back to equity would result in an adjusted TBV of \$10.70. At the very minimum, we think the real estate increases PBYS’s financial flexibility and provides additional downside protection to PBYS shares.

PBYS should benefit from several long-term trends. The fleet of U.S. automobiles continues to age, as annual new car sales have plummeted from 16.5M to 11.5M. The closing of new car dealerships should also benefit PBYS’s service business. In addition, an aging demographic, combined with the increasing complexity of vehicles should result in increased demand for automotive service. PBYS’s long term objective is to increase its share of the highly fragmented and highly localized auto aftermarket service business, which is estimated to be \$165B, nearly 4x the size of the automotive aftermarket DIY market.

We recognize PBY's inherent structural disadvantages and realize that an operational turnaround will be a lengthy and difficult process. However, we think there is solid evidence that the current management is orchestrating a sustainable turnaround. If investors are willing to look through the early ramp up of the new STCs, PBY shares are inexpensive, trading at 8x our estimated 2011 FCF, 4.8X EBITDA, 0.4x revenue, and 88% of our adjusted TBV. The low valuation, combined with the improved balance sheet and unrealized real estate value, should provide investors with considerable downside protection as PBY's turnaround progresses.

At \$9.68, the risk reward profile seems attractive. There are numerous ways in which PBY investors could win: continued progress of the turnaround should lead to both higher earnings and a higher multiple. In fact, PBY needs only to achieve a 0.4% annual comp sales increase combined with continued cost discipline and a moderately successful rollout of the STC footprint in order to meet our estimates for 2011 and 2012. An accretive acquisition could also meaningfully improve results; the domestic economy could improve more rapidly than we expect; PBY could generate substantial cash (and reduce debt or repurchase shares) by increasing trade payables; and lastly, PBY could unlock value in its real estate either through a sale/leaseback or a sale of the company.

As we detail in the report, we have used a valuation matrix to establish an initial one-year target price of \$13.25 for PBY shares. Based on our 2011 estimates, our target price implies an EV/EBITDA multiple of 6x; a P/FCF multiple of 10.9x; and a P/TBV of 1.4x. These multiples are all considerably below the average of PBY's service and parts competitors. Our price target implies potential upside of 38% in the near term.

Background:

Founded in 1921, PBY is the only national chain offering automotive service, parts, tires and accessories. PBY currently operates 554 Supercenters in 35 states and Puerto Rico, which serve both "do-it-for-me" (DIFM – includes service labor, installed parts and tires) and "do-it-yourself" (DIY – retail and commercial) customers. The company owns 231 locations and leases the rest. These Supercenters average 20,000 SF and have, on average, 11 service bays. PBY sells a vast array of automotive merchandise (25,000 skus) which it purchases directly from multiple manufacturers. 19 of its Supercenters have been converted into "Superhubs" that carry a greater level of inventory and thus increase the inventory efficiency of stores in a given market. These 19 locations support 271 Superstores. PBY also has 9 retail only locations. PBY's service technicians provide a wide array of maintenance services including tune ups, oil changes, alignments, brakes, HVAC, fuel systems, tires and engine performance services, to name a few. PBY

also operates 33 Service & Tire Centers (STCs), which it began to open in 2009. These centers average 5k-6k sf with 5-7 service bays, and stock a smaller assortment of high-velocity merchandise.

Total revenue was \$1.9B in FY 2009 (January 2010), of which tires accounted for 16.4% and service labor accounted for 19.7%. Parts and accessories accounted for the remaining 63.8% of sales (split between retail sales and parts installed during service). In 2009, 31% of merchandise revenue consisted of private label products. The company is headquartered in Philadelphia, PA.

Discussion:

1. PBX appears to be in the early stages of a sustainable operational turnaround. After many years of negative earnings and several failed turnaround attempts, a new management team that arrived in 2007-2008 has achieved considerable success in improving the entire operation of the company. Top management includes several executives from both AutoZone and Sears Automotive. Importantly, we think this management understands the structural disadvantages of the existing footprint as well as the operational weaknesses that were a vestige of prior management.

The first issue is that, in most locations, the 20,000 sf superstore format (with 10-12 service bays) is too large, by perhaps 5,000 sf, based on average traffic in a typical PBX store. The excess space results in suboptimal absorption of occupancy costs and a low return on invested capital. It also forces PBX to carry a larger than necessary amount of non-core slower moving inventory. The company's second issue is its low store density. While stores are fairly concentrated in several key markets, many of the 554 superstores are scattered too thinly across its 35 state footprint, resulting in poor economies of scale in inventory management, advertising, and general market coverage. As a result, PBX's margins are far below those of its main competitors. For example, Monro Muffler/Brake operates 785 stores in a contiguous 19-state region, with an average store size of roughly 5,500 sf. As a result, Monro is able to generate an EBIT margin of 10.8% compared to PBX's latest TTM margin of 3.3%.

To address these issues, management has formulated the following strategic objectives: implement a new store growth plan to increase density and profitability within key markets; maximize use of excess store space without attempting a risky move outside its core area of expertise; build the Pep Boys brand with a focus on service and customer loyalty; and continue to attack costs and inefficiencies across the enterprise.

Today, PBY is focused solely on a core automotive strategy built around the extensive breadth and depth of its automotive parts and accessories inventory. The previous management attempted to fill excess store space with non-core merchandise (power tools, sports vehicles, etc.), a strategy that ultimately backfired, forcing PBY to take considerable markdowns to clear unwanted inventory. In contrast, current management realizes there is no quick fix, and has been gradually converting excess space in a rational manner, and only where necessary. For instance, it has been reformatting existing stores into what are referred to as “superhubs.” These are strategically selected locations that carry a greater level and assortment of inventory to support other stores in the general area. As of the latest quarter, there were 19 such hubs supporting 271 stores (14 stores/hub), and we expect another 5 locations to be retrofitted by year end. These hubs typically carry 40,000 SKUs (including a limited amount of slow moving items) as opposed to 23,000 at the standard superstore. With improved inventory availability within a given market, sales should increase. Margins should also improve by reducing the need to purchase outside product to cover out of stock positions.

PBY has also expanded its commercial operations, which are now located in 453 of its 554 superstore locations and account for roughly 11% of total sales. This business provides essential parts, equipment, tires and services for the small independent service operators, and further leverages PBY’s inventory and overhead. In the latest quarter, commercial comp store sales increased 9.8%. To a much lesser extent, PBY has also been remodeling select locations to accommodate specialty “speed shops.” These are designed to attract auto enthusiasts (muscle cars, specialty imports, sport trucks). PBY should have 10 of these operating by year end.

2. One of the key parts of our thesis is PBY’s new store strategy. In an effort to increase market density, PBY has developed a plan to open smaller service & tire centers (STCs) in its key existing markets. These locations, which offer full automotive service, should average 5k-6k SF with 4-8 service bays, and stock only high velocity inventory. Moreover, they will be located within 15 minutes of an existing superstore, which holds a full assortment of inventory. We like the small-format auto service business, and we think there is ample room for both market growth and market share gains. We think the STCs should be well positioned to capture revenue from scheduled maintenance, oil changes, inspections, tires and general repairs and maintenance.

PBY anticipates having 3-5 STCs supported by a single superstore, with multiple advantages. First, this “hub and spoke” strategy should enable PBY to capture market share by having more locations closer to the customers’ homes and workplaces. Given the highly fragmented and localized nature of the service

business, we do not expect meaningful cannibalization of existing superstores, since the typical customer is unwilling to drive far for routine service and maintenance. In fact, in our discussions with store managers, we learned that existing superstores might actually experience an increase in sales after an STC opens within its territory. The STC format should also enable PBY to leverage its advertising (especially its national cable ads and direct marketing) to increase local market sales. Furthermore, PBY should be able to leverage its inventory by utilizing the supercenters to serve as a warehouse, of sorts, for the smaller STCs, which can operate on a much smaller assortment of product (~3,000 SKUs).

PBY estimates that it can open a location for slightly under \$400,000. Its strategy is to lease existing locations (there is a large amount of empty capacity), and install the necessary equipment and inventory. The leases typically average 5 years, with multiple options to extend an additional 20 years. After more than a year of experience (and 33 STCs opened), PBY estimates a typical location will mature in 3 years, with annual sales reaching \$1M and EBITDA of at least \$150,000. This provides a much better (more than double) overall return profile than PBY's large existing superstores. In Table 1, we highlight our projected store rollout. In our model, we estimate that PBY will open 68 STCs in 2011 compared to management's goal of 80 new stores. Without a meaningful acquisition, we are somewhat skeptical that the company will identify and open 80 locations in one year.

Table 1: new store rollout

	2009	2010e	2011e	2012e
New Service & Tires	24	28	68	42
New Superstores	0	7	5	3
Total new stores opened	24	35	73	45
Ending new stores	24	59	132	177
Existing Superstores	552	552	552	552
Existing retail-only stores	10	9	9	9
Total ending stores	586	620	693	738
Additional sq. footage	144,000	262,500	475,500	292,500
Existing sq. footage	11,686,000	11,686,000	11,686,000	11,686,000
Total sq. footage	11,830,000	12,092,500	12,568,000	12,860,500
y/y % chg	0.5%	2.2%	3.9%	2.3%

In 2009, PBLY acquired a 10 store chain of STCs in Florida. Management is currently looking for additional targets in its larger existing markets. If PBLY is able to find a larger (25+ stores) chain in the right location, it could be highly accretive to future earnings, and could enable PBLY to reach its target of 80 new locations in 2011.

To a much lesser extent, PBLY has been opening smaller prototype superstores in select markets. These stores offer the same parts coverage of a traditional superstore but with less service space, and average roughly 13,500 SF with 6-7 service bays. These newly built stores have a modern, customer friendly design and are also expected to serve as hubs for newly opened STCs. PBLY has opened 4 locations to date with a target of 7 by year end.

As the new store rollout progresses, PBLY's overall sales and profits should increase. As the stores mature, it should result in higher EBIT margins and a higher return on capital. However, it is important for investors to understand that in the early stages of the expansion, the new store rollout should have a drag on reported margins. This results from the fact that, while sales of a new store ramp up over the first three years, PBLY bears the full costs of the occupancy, depreciation, and labor expenses. Moreover, the initial capex related to new stores will have a dampening effect on reported free cash flow. We think investors should look through the margin drag and growth related capex in order to more accurately assess PBLY's true earnings and FCF potential.

3. PBLY has been aggressively reducing costs and inefficiencies throughout the enterprise. At the end of 2007, it closed 31 unproductive stores. Since that time, it has also reduced SG&A expense by \$81M on an annual basis (from 25.2% of sales in 2008 to 22.5% of sales in the latest 12 month period). PBLY has also reduced shrink by nearly 50% over the past two years. This was accomplished by installing closed-circuit TVs in all stores, reorganizing back room areas, and implementing EAS tagging for certain items. Management has also been addressing what it refers to as "gross margin leaks." These include excessive markdowns, worker safety, customer claims, back-end inventory disposition and product returns. As a result, gross margin as a % of revenue has increased from 24.6% in 2007 to 25.8% in the latest 12 month period. We think gross margins have room to expand further. PBLY's scale enables it to purchase quality parts directly at very low prices. As its revenue begins to grow again, we think its buying volume should result in additional discounts and vendor rebates.

The gross margin and SG&A improvements have resulted in a marked improvement in the EBIT margin. As we detail in Table 2, the EBIT margin has increased from 0.4% in 2007 to 3.3% in the latest 12 months. Moreover, the more recent results include a drag of roughly 20bp-30bp from the ramp up of the new

service & tire centers (STCs) which began to roll out in mid 2009. If we adjust for this impact, it becomes evident that a 5% EBIT margin should be achievable over the next several years. We estimate a 4.2% margin in 2012. Moreover, when we compare PBK to a group of its major service and parts competitors, we see that PBK should have considerable room to improve its EBIT margin.

Table 2: EBIT as % of revenue

EBIT Margin	2007	2008	2009	2010e	2011e	2012e	TTM
PBK	0.4%	-0.7%	2.9%	3.4%	3.7%	4.2%	3.3%
Company	Midas	Monroe	AutoZone	O'Reilly	Advance	PBK	AVG
EBIT Margin	9.1%	10.8%	17.0%	12.9%	9.0%	3.3%	11.8%

PBK continues to invest in its existing stores. It has installed expensive state of the art diagnostic and service equipment, high-impact energy efficient lighting, and closed circuit TVs. Moreover, it has invested heavily in training programs and has hired ASE certified service technicians that are able to handle the increasing complexity of late model automobiles. The company also recently implemented an electronic technician scheduling program to better match its labor capacity with actual service volume. This is replacing the current manual system.

PBK has also revamped its marketing strategy. Before the new management arrived, advertising was focused on the retail business and was heavily weighted in print media. Moreover, much of the print spending was focused on driving non-automotive retail sales. Today, PBK's advertising message is focused primarily on its service business with an everyday low price strategy. Management has been rebuilding the Pep Boys brand and has consolidated ad spending into consistent national cable TV advertising complemented by local print and radio ads aimed to drive store traffic. As such, it has reduced overall marketing costs. In 2009, PBK launched a rewards program in order to create customer loyalty and repeat business. The program already has over 9M members. Lastly, PBK has invested in its internet strategy by improving its website functionality and launching programs on Twitter and Facebook. It recently initiated a test of E-Serve, which enables customers to schedule appointments and create a work order on the PBK website.

4. PBK generates solid free cash flow, which has been driven by increased margins (and profits) and improved working capital. In FY 2009, PBK generated \$0.88 per share in FCF net of \$43M in capex. Given the recent ramp up in new store openings, we think that a FCF estimate based on maintenance capex is the most appropriate way to view PBK's sustainable cash flow. Based on our discussions

with management and our breakdown of the components of capex, we estimate annual maintenance capex to be \$42M. This excludes capex for new stores as well as for one-time growth related initiatives. We detail our FCF estimates in Table 3.

Table 3: Free cash flow

\$Mil	2009	2010e	2011e	2012e
Net Income	18.7	26.4	32.0	41.3
D&A	70.5	73.7	74.0	77.0
Working capital	(6.5)	(5.5)	(3.8)	(1.5)
Other	6.5	3.3	3.7	3.6
Operating cash flow	89.3	97.9	105.9	120.5
Maintenance capex	(42.0)	(42.0)	(42.0)	(42.0)
Free cash flow	47.3	55.9	63.9	78.5
FCF/share	\$0.90	\$1.05	\$1.20	\$1.48
Reported capex	43.2	78.0	70.0	60.0

One area where we see potential for cash flow improvement is in PBY's trade payables. Currently, PBY has substantial cash tied up in inventories. Its payables/inventory ratio is 45%, far below the average of a group of comparable providers, which have ratios ranging from 53% to 95% (AutoZone). Although our forecasts do not assume a meaningful improvement in cash flow from increased payables, we note that PBY could potentially free up \$50M+ in cash over the next several years, especially if it achieves investment grade status on its debt. Inventories were \$559M in Q210.

PBY's balance sheet has improved markedly over the past several years. In four separate transactions during 2007 and 2008, PBY completed the sale leaseback of 97 owned properties for net cash proceeds of \$376M and a substantial gain. (It also purchased 29 previously-leased stores for \$117M). PBY also sold \$45M of company owned life insurance and repurchased its own debt at a substantial discount during the recent financial crisis. As a result, net debt has declined from \$516M at the end of 2006 to \$214M in the most recent quarter. Moreover, net debt/EBITDA has declined from more than 5x in 2006 to 1.6x in the latest 12 month period. PBY currently has \$92M of cash and \$0 borrowings on its credit facility. We think the company's improved financial flexibility should warrant a higher multiple if the turnaround continues.

5. There appears to be substantial hidden value in PBY's owned properties. As of the latest quarter, PBY owned 231 of its superstores including the land, building and all fixtures and equipment. It also owns 4 distribution centers and a 5-story, 300k SF corporate headquarters in Philadelphia. Lastly, PBY has an additional 170

stores under ground leases, where it owns the buildings and controls the property. These are mostly older leases that are considerably below current market value. Thus, we think it probable that there is substantial equity value in these properties.

One measure of potential unrealized value can be derived from the historical sale/leaseback transactions. During Q4 2007 and the first half of 2008, PBY sold 97 store locations (land + buildings) at an average price of \$3.9M per location, with the 2007 deal being completed at \$4.9M/store near the top of the real estate cycle. If we assume a 30% decline in value from the 2007 sale, we arrive at a potential current value of \$3.4M/store, or roughly \$785M. Adding in another \$40M for the headquarters, 4 distribution centers and ground leases implies a total value of \$825M. At 7/31/10, reported PP&E was \$694M, which would suggest roughly \$130M of unrecognized value on a pretax basis.

Looking at it from a different perspective, PBY reports a value for land of \$204M. According to management, most of this land was acquired decades ago (PBY was founded in 1921), and is most likely worth considerably more than the reported original cost. If we assume that the average land holding dates back to 1991 and that the land has appreciated by 70%, (both reasonable assumptions in our view), we arrive at a surplus of \$142M, all else being equal. This nets out to a potential appreciation (pre-tax) of \$2.70 per share in PBY's book value, which was \$8.84 in the most recent period. It is important to note that our recommendation does not depend on excess property value, nor have we attempted to derive an exact value for PBY's real estate. However, we are convinced that there is a meaningful amount of unrecognized value that, at the very least, improves the company's financial flexibility and provides genuine downside protection to shareholders. Importantly, given the improved balance sheet, PBY can be patient in unlocking its hidden real estate value.

6. We surveyed dozens of PBY superstores and several of the new service & tire centers (STCs) in Florida, Texas, California, Massachusetts, Rhode Island, Louisiana and Alabama. Most of the stores we visited were very busy in the service area. We spoke with store managers, service managers and retail employees. We focused mostly on learning about the rollout of new STCs and the effect they might have on existing stores. What we concluded is that PBY is definitely positioning the STCs for customers that do not want to fix their cars themselves. It is basically taking the service center portion of the existing superstores and replicating it with fewer bays and without the retail store area. PBY is also targeting higher income neighborhoods, preferably with an older demographic and a supercenter nearby which can increase the efficiency of the existing supply chain and also leverage the company's advertising. Moreover, the STCs will stock a very limited array of inventory, primarily the most profitable

consumables such as tires, batteries, brakes, shocks, hoses, belts and anything needed for oil changes.

One strategy PBY is using as it rolls out STCs is to undercut local competitors (by ~5%) on oil changes in order to attract new traffic. Included with the oil change is a free service diagnostic and recommendation of what the car needs with an offer to beat the competition on the service cost as well. Thus, if PBY is able to select good STC locations, the new stores can draw from the vast parts inventory and mechanical expertise within the nearby superstores. This should provide a considerable competitive advantage. We also learned that many of the superstores located near a new STC are experiencing meaningful sales increases. One manager told us, “the spokes act as a bridge to get us closer to customers.” This manager expected 2 new STCs to open within his “supply area” within the next year, and he was quite certain that his tire and parts demand would rise significantly as a result. Another store manager echoed these comments and also added that occasional referrals for more complicated service work (transmissions etc) were also expected. Finally, nearly every manager with whom we spoke thought that the value of awareness of PBY’s low priced offerings through a smaller STC closer to middle income suburban markets should result in PBY taking market share from smaller competitors (that don’t have the hub store support).

Importantly, with the substantial fixed costs of the existing infrastructure, we would expect margins to increase along with any sales increase. It is also important to note that our model does not include any such incremental revenue (or margin increase) at the existing superstores.

7. The automotive service industry (do-it-for-me, or DIFM) is a large, highly-fragmented market, estimated to be worth \$165B in the U.S. This is roughly 4x the size of the domestic DIY auto parts business. The service market can be broken down into three groups: New car dealerships; small independent garages and service stations; and regional/national service chains including PBY, Monro, Midas, Meineke, Sears, Jiffy Lube, Goodyear and AAMCO. The business is extremely local, with customers often not willing to drive more than 10-15 minutes for service. It is also highly fragmented, with the top 5 service chains holding less than 8% of the market.

There are a number of favorable trends that support the long-term growth of the service business. First, the domestic automobile fleet continues to age as people keep their cars longer and buy more used cars. The average age of today’s fleet is estimated to be 10.2 years and is expected to reach 12 years by 2013. Car owners are choosing to invest in maintaining older vehicles instead of buying new cars, and an older car typically requires more maintenance and service. In addition, the

actual number of vehicles on the road continues to increase. According to the APAA Factbook, the number of cars and light trucks in service increased 24% over the past decade to an estimated 249M vehicles. Over the same period, the number of service outlets and service bays has declined, and it continues to decline. Although total miles driven declined in 2009 (the first such occurrence since 1980), this is partially offset by the increasing age of the average vehicle on the road. In other words, a car with 100,000 miles that drives 10,000 miles per year might be a better target customer than a 20,000 mile car that drives 14,000 miles per year.

Dealer consolidation is also benefiting automotive service providers by reducing competition. Following the financial crisis of 2008, the Big 3 auto companies shuttered thousands of dealerships in response to plummeting sales. New vehicle sales in the U.S. have declined from an average of 16.7M annual units from 1998-2007 to a current annual run rate of roughly 11.5M. This means more people are driving older cars, a good trend for PB.Y. A weak economy has also caused more customers to avoid expensive dealer service, which we estimate to be nearly twice as expensive, on average, as PB.Y. Car dealers are also typically not conveniently located near homes or workplaces.

At the opposite end of the spectrum, small independent service providers (the largest segment of the market) continue to lose market share either by selling out, converting to convenience stores or closing down. To begin with, the independents are at a cost disadvantage in scale, buying power, and logistics. Moreover, they are often unable or unwilling to afford the expensive diagnostic tools, computer equipment and inspection equipment required to service many of the newer more complex model vehicles.

Lastly, the aging U.S. demographic is also a tailwind for automotive service. As people age, they are less likely to service their own vehicles, and are looking for quick cheap service. Moreover, baby boomers increasingly have 3 or more cars per household, with children often driving a hand me down or other used vehicle that will require regular maintenance and service. The increasing complexity of cars also results in more car owners needing professional service and fewer people repairing their own vehicles.

8. There are a number of risks to an investment in PB.Y. The biggest risks, in our view, are macro driven. First, while the auto aftermarket business has recession resistant characteristics, PB.Y would nevertheless be negatively impacted if the economy were to “double-dip,” since consumers would attempt to delay servicing their vehicles and would most likely cut back on retail parts, tire and accessories purchases. In addition, PB.Y’s business has a negative correlation to retail gasoline prices. In the past, every time gas prices have experienced a dramatic increase,

consumers, on average, have reduced the number of miles driven. This results in less wear and tear on automobiles and thus less required service. The average price of retail gasoline has roughly doubled from the 2000-2004 average prices, and has increased at a cagr of 5% over the past 20 years, well above the rate of consumer price inflation.

There is also a risk that management's strategy of opening smaller service and tire centers could prove less profitable than expected or that it will not be able to find a sufficient number of attractive locations. While we think it is an intelligent and viable strategy, the rollout is at an early stage. Increased competition could also pressure pricing in both retail parts and service.

Lastly, we note that tires are the largest single product category for PBX, at roughly 16% of revenue. PBX sells mostly lower end Cooper and private label tires. Tires are a big ticket purchase and thus are more sensitive to the economy. Tire sales are also very competitive and generate lower margins for PBX vs. its other merchandise. However, tires also serve as a lead in to other higher-margin merchandise and service business (alignments, etc.) and they drive store traffic.

9. Recent results

In the most recent quarter, ended July 30 (Q210), revenue increased by 3.3% to \$504.9M on a 1.8% total same store sales increase. Service center revenue (service labor + installed parts) increased 2.9% to \$236M, on flat same store sales. This was negatively impacted by weaker tire sales. Retail & commercial sales increased 3.6% (+2.5% on a same store basis) to \$268.8M. This included a 9.8% same store increase in commercial sales. Retail customer counts were flat y/y, while service customer counts increased 5.6%, due partly to new service stores and also due to the increased effectiveness of the company's advertising. In Q210, PBX opened 3 new superhubs, 5 new STCs and 1 new prototype supercenter.

Gross margin increased to 26.6% in Q210 vs. 26.2% y/y. This includes a drag from new store openings, which we estimate at 20bp. SG&A increased 3.3% to \$113M. As a % of sales, SG&A was flat y/y at 22.4%. EBIT increased 15% y/y to \$21.4M. The EBIT margin was 4.2% vs. 3.8% in the prior year. We note that Q1 and Q2 are both seasonally strong periods for PBX. Net interest expense and other income was flat y/y at \$6M. After applying a normalized tax rate of 38.5% and dividing by average shares of 52.8M, EPS was \$0.18 in Q210, +20% y/y.

For the first half of FY 2010, free cash flow was \$51M, or \$0.96 per share. This compares with \$35M or \$0.67 in the first half of 2009. At 7/31/10, cash was \$92.4M; debt was \$307M. Net debt of \$214.6M compared to \$288M at 7/31/09.

Net debt/EBITDA was 1.6x on a TTM basis. Inventory was \$559M, up 1.9% y/y. Book value was \$8.84 per share.

10. Financial assumptions

For FY 2011 (ended Jan. 31, 2012), our assumptions are as follows: Total revenue increases 4.0% to \$2.05B. Merchandise sales should increase by 2.9% to \$1.63B, while service-only revenue increases by 8.0% to \$419M. These increases are driven by the 2011 rollout of 68 new STCs and 5 new superstores in addition to the 28 STCs and 7 superstores opened in 2010. We estimate initial year sales of \$700k for the average STC and \$1.5M for the new small-prototype superstores. We estimate total comparable store sales to increase by 0.8% y/y in 2011.

For 2011, we estimate a consolidated gross margin of 26.1% vs. 25.9% in 2010. Our gross margin is driven by a merchandise GM% of 30.3% (vs. 29.9% in 2010), and a service-only GM% of 9.8% vs. 9.7% in 2010. Next we estimate SG&A to be \$460M, an increase of 3.5% y/y. This increase is primarily driven by our new store estimates as well as a higher overall marketing spend. This results in EBIT of \$75M, or a 3.7% margin compared to \$66.7M or a 3.4% margin in 2010. We note that there should be a drag of 20-30bp from the ramp up of new stores, particularly on the service business. Next we subtract interest expense of \$26.5M (flat y/y) and add other rental and interest income of \$3.0M to arrive at a pretax income of \$51.5M. Subtracting tax at a 38.5% rate, we arrive at net income of \$31.7M, or \$0.60, +18% y/y. Average shares should be flat y/y. Based on expected capex of \$78M, FCF would be \$35.5M or \$0.68 in 2011. However, as we discussed in the report, this includes a substantial expenditure on new store growth. Alternatively, using a maintenance capex estimate of \$42M, we arrive at a normalized FCF of \$63.6M, or \$1.20 per share.

For FY 2012, our assumptions are as follows: Total revenue increases 3.9% to \$2.13B. Merchandise sales should increase by 2.7% to \$1.67B, while service-only revenue increases by 8.6% to \$457M. These increases are driven by the 2012 rollout of 42 new STCs and 3 new superstores in addition to the units opened in 2011. We estimate comparable store sales are flat y/y in 2012.

For 2012, we estimate a consolidated gross margin of 26.1%, roughly flat y/y. Our gross margin is driven by a merchandise GM% of 30.4% (vs. 30.2% in 2011), and a service-only GM% of 10.2% vs. 9.8% in 2011, as the drag from new stores begins to dissipate. Next we estimate SG&A to be \$467M, an increase of 1.7% y/y. This would result in EBIT of \$89M, or a 4.2% margin compared a 3.7% margin in 2011. Next we subtract interest expense of \$26.1M (flat y/y) and add other rental and interest income of \$4.2M to arrive at a pretax income of \$67.2M. Subtracting tax at a 38.5% rate, we arrive at net income of \$41.3M, or \$0.78, +30%

y/y. Average shares should be flat y/y. Based on estimated capex of \$60M, FCF would be \$61.6M or \$1.15 in 2012. Alternatively, using a maintenance capex estimate of \$42M, we arrive at a normalized FCF of \$78.5M, or \$1.48 per share. Based on these forecasts, cash at year end 2012 would be \$140M, and net debt would be \$159M, or 0.9x 2012 EBITDA. TBV at year end 2012 is estimated at \$9.90.

11. We think the risk reward equation for PBLY is attractive. The new management team appears to be having initial success with its long term turnaround strategy. Costs have been reduced across the entire enterprise. Gross margins on existing stores continue to increase. Most importantly, however, the rollout of smaller service & tire centers appears to be on track, although it is still early in the program. Over the next several years, as sales increase and the new stores mature, we expect it to have a meaningful positive affect on PBLY's overall EBIT margins. As we detailed in the report, we expect EBIT margins to increase to 3.7% in 2011 and 4.2% in 2012 (even including a 25bp drag from new stores) compared to 3.3% in the most recent 12 month period. PBLY's main service competitors have margins in the 10% range. Barring a severe downturn in the domestic economy, we think these forecasts are readily achievable if not conservative. It is also important to note that our forecasts do not assume any incremental sales at existing superstores following the opening of nearby STCs.

We recognize that PBLY has repeatedly disappointed investors in recent years, and that its structural shortcomings should prevent it from achieving margins that approach the industry average. We also realize that a turnaround will be a long and difficult process with no guarantee of success. However, we argue that there is enough evidence of a sustainable turnaround and enough potential margin upside to warrant an investment in the currently depressed shares.

PBLY shares appear to be inexpensive based on several valuation metrics. PBLY trades at 8.0x and 6.5x estimated FCF for 2011 and 2012, respectively, based on our estimated FCF using maintenance capex. The shares also are valued at 0.4x revenue, 1.1x TBV and 4.8x 2011 EBITDA. The relatively low valuation should provide investors with ample downside protection. Moreover, we think there is meaningful hidden value in PBLY's owned real estate, which could potentially add \$1-\$3 per share to the current \$8.70 TBV. This should provide an additional layer of downside protection as investors wait for the turnaround to progress. It is important to point out that PBLY operates in a highly seasonal business in which Q1 and Q2 results are typically far greater than those achieved during the Q3 and Q4 periods. Thus, PBLY shares could potentially be volatile during the seasonally weak latter half of FY 2010.

Using our 2011 forecasts, we have established an initial one-year price target of \$13.25 based on a blend of valuation metrics, as we detail in Table 4. This implies a total return of 38.5%. Longer term, we think PBX shares could trade much higher should the turnaround program drive margins above our initial estimates. Management could also add additional value through an accretive acquisition, a share buyback, sale/leaseback transaction or a sale of the entire company.

Table 4: Valuation Matrix

	PBX	Peer Group *
2011e maintenance FCF	\$1.20	
multiple	10.5	12.6
Implied valuation	\$12.64	
2011e EBITDA	149.5	
multiple	6.25	7.9
Implied valuation	\$13.62	
Adjusted Tangible BV	\$10.75	
multiple	1.25	4.0
Implied valuation	\$13.48	
Blended valuation	\$13.25	

* AZO, MNRO, ORLY, AAP, MDS

12. Financial Models

a. annual projections	2009	2010e	2011e	2012e
Merchandise sales	1,533,619	1,582,888	1,630,908	1,674,240
Service revenue	377,319	388,000	420,667	457,041
Total Revenue	1,910,938	1,970,888	2,051,575	2,131,281
Gross Profit	486,429	511,042	534,477	555,922
SG&A expense	430,261	444,040	459,000	466,800
EBIT	56,168	67,002	75,477	89,122
non-operating income	2,261	2,447	3,000	4,200
Interest expense, net	27,952	26,451	26,500	26,100
Pretax income	30,477	42,998	51,977	67,222
Income tax expense	11,734	16,554	20,011	25,880
Net income	18,743	26,444	31,966	41,341
EPS	\$0.36	\$0.51	\$0.60	\$0.78
Avg. shares - FD	52,667	53,080	53,100	53,200
FCF	0.87	0.37	0.68	1.14
Maintenance FCF	0.90	1.05	1.20	1.48
% of sales				
Gross Profit	25.5%	25.9%	26.1%	26.1%
SG&A expense	22.5%	22.5%	22.4%	21.9%
EBIT	2.9%	3.4%	3.7%	4.2%
non-operating income	0.1%	0.1%	0.1%	0.2%
Interest expense, net	1.5%	1.3%	1.3%	1.2%
Pretax income	1.6%	2.2%	2.5%	3.2%
Income tax expense	38.5%	38.5%	38.5%	38.5%
Net income	1.0%	1.3%	1.6%	1.9%
EBITDA	6.6%	7.1%	7.3%	7.8%
D&A	3.7%	3.7%	3.6%	3.6%
y/y % change				
Merchandise sales	-2.3%	3.2%	3.0%	2.7%
Service revenue	5.4%	2.8%	8.4%	8.6%
Total Revenue	-0.9%	3.1%	4.1%	3.9%
Gross Profit	3.1%	5.1%	4.6%	4.0%
SG&A expense	-11.3%	3.2%	3.4%	1.7%
EBIT	526.0%	19.3%	12.6%	18.1%
non-operating income	14.9%	8.2%	22.6%	40.0%
Interest expense, net	-4.7%	-5.4%	0.2%	-1.5%
Pretax income	175.2%	41.1%	20.9%	29.3%
Net income	175.2%	41.1%	20.9%	29.3%
EPS	174.4%	43.3%	18.0%	29.1%
Avg. shares - FD	1.0%	0.8%	0.0%	0.2%
Maintenance FCF	188.6%	17.4%	14.2%	22.7%

b. quarterly projections	Q409	Q110	Q210	Q310e	Q410e	Q111e	Q211e
Merchandise sales	364,511	409,189	406,179	388,341	381,671	418,448	416,653
Service revenue	88,385	100,844	98,676	95,659	90,329	107,636	106,690
Total Revenue	452,896	510,033	504,855	484,000	472,000	526,083	523,344
Gross Profit	108,861	137,595	134,521	124,324	114,602	141,803	140,586
SG&A expense	103,181	111,632	113,108	112,300	107,000	112,500	114,000
EBIT	5,680	25,963	21,413	12,024	7,602	29,303	26,586
non-operating income	595	584	621	621	621	680	680
Interest expense, net	6,428	6,608	6,643	6,600	6,600	6,600	6,600
Pretax income	(153)	19,939	15,391	6,045	1,623	23,383	20,666
Income tax expense	(59)	7,677	5,926	2,327	625	9,003	7,956
Net income	(94)	12,262	9,465	3,718	998	14,381	12,710
EPS	(\$0.00)	\$0.23	\$0.18	\$0.07	\$0.02	\$0.27	\$0.24
Avg. shares - FD	52,376	52,376	52,699	52,786	52,850	52,933	53,129
% of sales							
Gross Profit	24.0%	27.0%	26.6%	25.7%	24.3%	27.0%	26.9%
SG&A expense	22.8%	21.9%	22.4%	23.2%	22.7%	21.4%	21.8%
EBIT	1.3%	5.1%	4.2%	2.5%	1.6%	5.6%	5.1%
non-operating income	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Interest expense, net	1.4%	1.3%	1.3%	1.4%	1.4%	1.3%	1.3%
Pretax income	0.0%	3.9%	3.0%	1.2%	0.3%	4.4%	3.9%
Income tax expense	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%
Net income	0.0%	2.4%	1.9%	0.8%	0.2%	2.7%	2.4%
EBITDA	5.1%	8.7%	7.9%	6.3%	5.5%	9.1%	8.7%
D&A	3.8%	3.6%	3.7%	3.8%	3.9%	3.6%	3.6%

(amounts in \$000, except ratios)

Current debt	305,661
Current Equity	463,832
Current tangible BV	453,832
Current market value	504,240
Current cash	92,363

Current DSO	4
Current DIO	143

FYE December	2009	2010e	2011e
EBIT	56,168	67,002	75,477
EBITDA	126,697	140,658	149,477
Free cash flow	47,257	55,900	63,866
Surplus cash flow (NI+D&A - capex)	46,058	22,100	35,966
Capex	43,214	78,000	70,000
EV/EBITDA	5.7	5.3	4.8
EV/(EBITDA-capex)	8.6	11.9	9.0