Initiation of Coverage

Ticker	Company	Rating	Price Target	2013	2014	2015	2016	Analyst
CRL	Charles River Laboratories International, Inc.	HOLD	NA	$2.93	$3.16E	$3.48E	--	Donald Hooker, CFA, John Gagliardi, CFA
CVD	Covance Inc.	BUY	$120.00	$3.23	$3.89E	$4.56E	--	Donald Hooker, CFA, John Gagliardi, CFA
Q	Quintiles Transnational Holdings Inc.	HOLD	NA	$2.10	$2.39E	$2.64E	--	Donald Hooker, CFA, John Gagliardi, CFA

FOR FURTHER INFORMATION, PLEASE CONTACT ANDREW DEANGELIS AT 216.689.3649

HEALTHCARE: CVD: Initiation of Coverage with a BUY Rating — Hooker, CFA **4**

COVERAGE INITIATION: We initiate coverage of CVD with a BUY rating ($120PT). CVD's differentiated capabilities (i.e., diversity across the services spectrum, clear leadership in central laboratory, and global footprint) position it to gain share from smaller CROs and benefit from a stronger spending env't for drug discovery and development. Add'lly, CVD possesses the best capitalized balance sheet within the space, supporting capital redeployment via tuck-in M&A and share repurchases.

- EST: New '14-15E of $3.89 (FC $3.85) and $4.56 (FC $4.48).
- Valuation: ~10.7x EV/EBITDA on our '15 est. vs. CRO peers at ~11x; our PT implies a ~12.6x multiple.
- Ratings: 12/9/1. Short Interest (2/28): 6.5d, 4.5%.

HEALTHCARE: CRL: Initiation of Coverage — Hooker, CFA **6**

COVERAGE INITIATION: We initiate coverage of CRL with a HOLD rating. We believe CRL's growth profile is likely to be inhibited by softness in its core research models franchise, where downsizing by global biopharma participants continues to weigh on volumes and, in our view, only partially returns to the Company in the form of greater pre-clinical services outsourcing over time. We believe CRL's premium valuation reflects an optimistic view with respect to improving fundamentals across the Company's early-stage exposure.

- EST: New '14-15E of $3.16 (FC $3.08) and $3.48 (FC $3.36).
- Valuation: ~11.4x EV/EBITDA on '15 est. vs. CRO peers at ~11x.
- Ratings: 7/13/1. Short Interest (2/28): 1.2d, 1.2%.

HEALTHCARE: Q: Initiation of Coverage — Hooker, CFA **8**

COVERAGE INITIATION: We initiate coverage of Q with a HOLD rating. We expect Q's CRO to outgrow most of its peer group, though see this growth being weighted toward the back-half of '14, given the wind-down of a major consulting program during '13. Additionally, while we believe Q's commercial services offerings are strategic in their importance and could yield compelling performance over time, we anticipate some dilution to the Company's overall growth profile over the near term, as the business evolves and reconciles channel conflicts with its biopharma customers. Q's balance sheet is the most highly-leveraged in the CRO space, placing a relative limitation on capital redeployment, i.e., tuck-in M&A and share repurchases.

- EST: New adj. '14-15E of $2.39 (FC $2.42) and $2.64 (FC $2.74).
- Valuation: ~11.3x EV/EBITDA on '15 est. vs. CRO peers at ~11x.
- Ratings: 11/5/1. Short Interest (2/28): 4.6d, 4.5%.

INDUSTRIAL: Monthly Tire Dealer, Wholesaler and Supplier Channel Check – February — Hoselton, CFA **10**

INDUSTRY UPDATE: We remain bullish on MNRO following our Feb. monthly tire channel checks as results indicate consumer tire sell-out & service sales have remained positive. We reiterate our BUY rating ($62 PT). For the manufacturers, we remain HOLD rated on CTB & GT as the consumer replacement shipment (sell-in) outlook remains mixed w/ positive momentum in consumer retail tire sales overshadowed by strong import shipments and high inventory levels.

- Sales trends remained positive in Feb. w/ dealers reporting a 0.8% y/y increase in consumer tire sales (sell-out, vs. 2.8% in Jan.) and a 7.4% y/y increase in overall service sales (vs. 6.0% in Jan.). As such we are confident MNRO should achieve its +1% same-store rev. guidance for F4Q14 (March qtr. end). We are currently modeling +1.5% and note every 100 bps of upside is ~$0.01 accretive. We continue to believe MNRO should benefit from severe weather, which should be a catalyst for solid demand.
- Despite positive momentum in consumer retail tire sales, the outlook for consumer replacement shipments (sell-in) remains mixed due to strong import shipments and high inventory levels as half of our contacts indicated inventory levels as “Too High”. We note strength in imports is particularly a negative for CTB as the Co. continues to face stiff competition in the private label / lower priced tire category.

- On the pricing front, our survey indicates that YTD pricing for consumer tires has been favorable though on the comm'l side it appears pricing has become sequentially less favorable. Add'ly, manufacturers have benefited YTD as a result of lower raw material costs. We are beginning to see evidence this benefit may start to wane, driven primarily by higher synthetic rubber (increased 25% since calendar 4Q13).
- EST: CTB '14E- from $2.35 to $2.16 (FC $2.33). '15E initiated at $2.33 (FC $2.24, 1 est.).

INDUSTRY UPDATE: We remain highly selective w/in our Teen Retailer coverage, given our view that the space continues to be severely challenged by changing fashion trends and alternate spending preferences requiring rationalization of selling sqft; we prefer BUY-rated ANF ($44PT) and WTSL ($5.50PT).

- Our bias for ANF and WTSL stems from their relative positioning, where ANF has already reduced its store count and should benefit from the strength of its brand profile/strategy and WTSL has thoughtfully aligned its model w/ its fast fashion roots and has meaningful balance sheet support (i.e., cash, NOLs).
- Laterally, we anticipate a measured approach to store count reductions in the teen space, largely providing asset owners (i.e., retail REITs) with sufficient maneuverability to avoid material fundamental impact; we believe HOLD-rated TCO and BUY-rated MAC ($69PT) are best-positioned from a fundamental perspective, while HOLD-rated CBL and BUY-rated GRT ($13PT) could see more of an impact, given their less desirable locations. We believe the primary influence on the REITs as space rationalization plays out will be sentiment-related.
- Selling sqft. across the teen retail space (on an adj. basis) has increased ~49% since '05 (compared to total retail sqft. +<10%); on an annualized basis, the implied ~5% growth rate well outpaces the annualized increase in the teen population of +0.4%. We note that prior to the downturn traditional teen retailers were more aggressive expanding their store bases while, following the recession, fast fashion retailers have led store growth.

HEALTHCARE: Covance Inc. (CVD) — Donald Hooker, CFA (917) 368-2378 donald.hooker@key.com, John Gagliardi, CFA (917) 368-2372 john.gagliardi@key.com

BUY, Price Target: $120.00

2014: $3.89, 2015: $4.56

We are initiating coverage of Covance Inc. (CVD-NYSE) with a BUY rating and a price target of $120 per share, or ~12.6x our 2015 EBITDA estimate of $507 million (consensus: $482 million).

For more detailed discussion and analysis, refer to our full investment report "Initiation of Coverage of Biopharmaceutical Services" (dated March 19, 2014).

Rating	BUY	2015E	$4.56	Next Quarter	March
Price	$103.71	2015 P/E	22.7x	Next Quarter E	$0.89
12-Mo. Price Target	$120.00	2014E	$3.89	FC Mean Quarter	$0.90
Market Cap	$5,932.2	2014 P/E	26.7x	FC Mean 2015E	$4.48
Trading Volume	459	2013A	$3.23	FC Mean 2014E	$3.85
Revenues(mm)	$2,595.1	Book Value/Share	$27.36	Yield	0.0%

Covance is the most diversified contract research organization (CRO) with market leadership in early and late stage biopharmaceutical development and with a broad geographic footprint (over 50% of revenues generated outside of the United States). 1) For investors, this translates to a more visible growth profile and more consistent share price performance. 2) Also, we think **Covance's breadth of services and geographies allows it to pursue strategic partnerships** with biopharmaceutical sponsors in a more uniquely integrated manner than can other CROs.

Additionally, we believe that **Covance has a competitive advantage in late-stage clinical development (*Phases II to IV*) due to its dominant market share in central laboratory (~40%).** Covance's central laboratories produce proprietary data on investigator patient enrollment patterns. The Company is able to query this data to optimize clinical trial site selection by identifying investigators with the best track records of enrollments. We think this improves Covance's ability to cost-effectively design late-stage projects, and will result in market share gains over time, particularly against smaller CROs that lack a central laboratory and/or informatics capabilities.

For these reasons, **we expect Covance to outgrow the broader CRO space with a revenue growth rate of ~8% in 2015** (e.g., vs. Quintiles of ~8% and Charles River Laboratories of ~3%). We believe that our growth outlook is well founded on a year-end backlog of $6.9 billion, consisting primarily of central laboratory and late-stage development projects. Also, Covance is benefiting from a **pick-up in toxicology activity by biotechnology firms, which has been sustained into 2014**. Over time, we anticipate demand for toxicology testing will continue to build as larger pharmaceutical firms look to replenish their early-stage pipelines.

Covance should also perform comparatively well with respect to EBITDA growth (we estimate +13% in 2015) and EPS growth (+17%). We model profitability to benefit from the completion of a corporate-wide information technology initiative that streamlined duplicative software systems and data centers. By our calculations, this will result in ~$15 million of EBITDA tailwind (~$0.17/share) in 2014 and 2015 as well as gains in employee productivity and improvements in data integrity. Also, we expect that revenue growth in high fixed cost, early development services (e.g., toxicology) will generate very accretive (~30%) incremental profit margins.

Finally, we view Covance's balance sheet as a source of strategic optionality. Covance ended 2013 with one of the most well-capitalized balance sheets in the CRO space, including $479 million of cash (no debt) and almost $500 million of bank revolving credit availability. Historically, Covance has been an organic growth story, but management does occasionally pursue tuck-in acquisitions of complementary capabilities or technologies. Management appears to be particularly interested in informatics, and the Company had been aggressively hiring data scientists in late 2013.

VALUATION

Our target valuation for Covance current trading price implies a ~12.6x multiple of our 2015 EBITDA estimate of $507 million (consensus: $482 million). This is a premium to the CRO peer group average (~11.0x), but we believe this appropriately reflects Covance's superior revenue and earnings growth profile and balance sheet. Also, we think that Covance's diversified services and geographic offerings provide advantages for the Company with regards to securing long-term, strategic relationships with major biopharmaceutical developers. Covance currently trades at ~11.2x consensus 2014 EBITDA.

RISKS

Risks that could impede the stock from achieving our price target include: Covance operates in a highly competitive industry against other CROs and providers that often have similar services. Also, the Company's ability to generate revenue and earnings growth is contingent on trends in global biopharmaceutical R&D spending and the propensity of biopharmaceutical firms to outsource drug R&D and commercialization activities to third parties.

HEALTHCARE: Charles River Laboratories International, Inc. (CRL) — Donald Hooker, CFA (917) 368-2378 donald.hooker@key.com, John Gagliardi, CFA (917) 368-2372 john.gagliardi@key.com

HOLD, Price Target: NA from

2014: $3.16, 2015: $3.48

We are initiating coverage of Charles River Laboratories International, Inc. (CRL-NYSE) with a HOLD rating with the stock trading at ~11.4x our 2015 EBITDA estimate of ~$317 million (consensus: $311 million).

For more detailed discussion and analysis, refer to our full investment report "Initiation of Coverage of Biopharmaceutical Services" (dated March 19, 2014).

Rating	HOLD	2015E	$3.48	Next Quarter	March
Price	$61.85	2015 P/E	17.8x	Next Quarter E	$0.73
12-Mo. Price Target	NA	2014E	$3.16	FC Mean Quarter	$0.74
Market Cap	$2,975.0	2014 P/E	19.6x	FC Mean 2015E	$3.36
Trading Volume	587	2013A	$2.93	FC Mean 2014E	$3.08
Revenues(mm)	$1,165.5	Book Value/Share	$13.32	Yield	0.0%

Charles River is the dominant supplier of research models (e.g., rats and mice) and is a leading early-stage contract research organization (CRO) focused on drug discovery, toxicology and related services. We view Charles River as the leader in most of its businesses, including research models (~50% market share), toxicology (~20%), drug discovery (~20%), and endotoxin and microbial detection (~20%). Charles River's breadth of early-stage services has positioned the Company well as a go-to strategic outsourced platform for biopharmaceutical developers.

Our investment thesis on Charles River reflects some caution on the small research model business (about a third of revenues). Volumes of research models have declined at a mid single-digit rate in 2012 and 2013 (our estimate) as a result of a downsizing of in-house preclinical laboratory capacity at biopharmaceutical firms. In our view, only a portion of this lost revenue finds its way back to Charles River over time via increased preclinical outsourcing. Also, since model sales carry high incremental margins, we think it will be challenging for Charles River to grow earnings in a sustainable manner unless its small models business can stabilize and grow.

Looking ahead, we model Charles River generating low single-digit revenue growth in 2014 and 2015, assuming the Company can partially mitigate the weakness in model volumes with market share gains from a financially struggling private competitor and with growth opportunities in China, where we suspect the competition is less sophisticated. Also, our models assume a modest recovery in preclinical study activity. Preclinical capacity has been significantly cut industry-wide over the past several years, and funding for early-stage research has improved, in our view. This results in a much more favorable supply-demand dynamic for Charles River.

We model **endotoxin and microbial detection (EMD) to provide a modest kicker (~100 basis points per year) to near-term consolidated revenue growth.** EMD represents ~10% of consolidated revenues, and is on a double-digit growth trajectory. We anticipate ~12% organic revenue growth in 2014 and ~10% in 2015, driven by product launches (the Endosafe Multi-Cartridge and Nexus systems) and an increasing regulatory focus on the contamination of injectable drugs and medical devices. Also, management has added new microbial testing facilities in France, Korea and India, which should drive more cross-selling of the recent Accugenix acquisition.

In the mid/long term, we also think Charles River's discovery research services (~$241 million in annual revenues, pro forma for the pending Galapagos acquisitions) could be a source of double-digit growth. However, the outsourcing market for discovery services is still undeveloped and fragmented, with ~90% of discovery-related activities still being performed in-house by biopharmaceutical firms. As such, growth may be lumpy and inconsistent in the near term.

VALUATION

Charles River's current trading price implies a ~11.4x multiple of our 2015 EBITDA estimate of $317 million (consensus: $311 million). This is a modest premium to its CRO peer group average (~11.0x), reflecting optimism for improving fundamentals for both preclinical outsourcing and endotoxin and microbial detection. In the near term we will be watching for progress with the integration of the Galapagos acquisitions (announced March 13). We assume these acquisitions will close in April.

RISKS

Charles River operates in a highly competitive industry against other CROs and providers that offer similar services. Also, the Company's ability to generate revenue and earnings growth is contingent on trends in global biopharmaceutical R&D spending and the propensity of biopharmaceutical firms to outsource R&D and sales activities to third parties.

HEALTHCARE: Quintiles Transnational Holdings Inc. (Q) — Donald Hooker, CFA (917) 368-2378

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HOLD, Price Target: NA from

2014: $2.39, 2015: $2.64

We are initiating coverage of Quintiles Transnational Holdings Inc. (Q-NYSE) with a HOLD rating with the stock trading at ~11.3x our 2015 EBITDA estimate of ~$727 million (consensus $741 million).

For more detailed discussion and analysis, refer to our full investment report "Initiation of Coverage of Biopharmaceutical Services" (dated March 19, 2014).

Rating	HOLD	2015E	$2.64	Next Quarter	March
Price	$52.96	2015 P/E	20.1x	Next Quarter E	$0.58
12-Mo. Price Target	NA	2014E	$2.39	FC Mean Quarter	$0.55
Market Cap	$7,043.7	2014 P/E	22.2x	FC Mean 2015E	$2.74
Trading Volume	765	2013A	$2.10	FC Mean 2014E	$2.42
Revenues(mm)	$5,100.0	Book Value/Share	$(5.65)	Yield	0.0%

We view Quintiles as unique in the biopharmaceutical services space due to its sheer size and scale with net services revenues of ~$3.8 billion and a staff of ~28,000. By our models, Quintiles is the leader in late-stage (Phases II-IV) clinical trials (~15% market share), the largest contact sales organization (CSO; ~20%), and the second largest central laboratory (~15%). Also, we consider Quintiles a pioneer among its peer group with respect to the use of informatics (data). Together, Quintiles's breadth of late-stage and data capabilities position it well to win strategic partnerships with the global biopharmaceutical industry.

However, the Quintiles investment story may take some time to fully play out. We assume Quintiles generating consolidated net new business (net bookings) growth of ~7% in 2014 and 2015, which is modestly below that of some of its trading comparables. Quintiles's own CRO should comfortably grow at the high end of its peer group (over ~8% in 2015), particularly with the Company's leadership in the rapidly growing Asia-Pacific region. However, we expect this growth may be diluted by the slower growing integrated health services (e.g., the CSO). These businesses are highly strategic; however, it may take some time for them to fully evolve and become consistently accretive to consolidated growth.

We expect a slow but steady acceleration of growth at Quintiles's CSO, driven by a growing number of approved drugs and mandated health insurance in the United States. Quintiles should be well positioned here because we believe many biopharmaceutical firms have downsized their in-house sales staff and the use of CSOs remains low (we estimate 15%). Finally, we think CSO may grow in strategic importance over time. With the rise of value-based reimbursement, drug developers may want to better understand the commercial potential of a prospective drug by getting feedback from opinion leaders earlier in the development process (i.e., in Phase II).

Quintiles is the most forward-looking CRO with its use of data, which could translate to a competitive advantage and unique growth opportunities over time. Quintiles's software reduces the time and costs of drug research by means of more adaptive clinical trials, risk-based monitoring and predictive modeling. Notably, Quintiles also provides data services to providers and payers to help them analyze the economics and comparative effectiveness of different therapies. This business creates unique revenue channels outside the traditional biopharmaceutical space. However, it may take time to evolve and overcome channel conflicts with biopharmaceutical customers.

Quintiles has one of the most indebted balance sheets in the CRO space with ~$1.4 billion of net debt at year-end 2013 (~2.2x EBITDA). However, with ample backlog (~$9.8 billion) and strong free cash flow generation, we see little reason for concern here.

VALUATION

Quintiles's current trading price implies a ~11.3x multiple of our 2015 EBITDA estimate of $727 million (consensus: $741 million). This is a modest premium to the CRO peer group average (~11.0x), which may reflect an attractive long-term value proposition. In the near term we are watching for improving performance at Quintiles's non-CRO businesses. As a final note, Quintiles completed its IPO in May 2013, so there is not a significant trading history (less than a year) for the stock.

RISKS

Quintiles operates in a highly competitive industry against other CROs and providers that offer similar services. Also, the Company's ability to generate revenue and earnings growth is contingent on trends in global biopharmaceutical R&D spending and the propensity of biopharmaceutical firms to outsource R&D and sales activities to third parties.

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Bullish Monro Muffler Brake, Inc. (MNRO-NASDAQ) Outlook Intact; Downside to Cooper Tire & Rubber Company (CTB-NYSE) Still Likely; The Goodyear Tire & Rubber Company (GT-NASDAQ) Trending in Line. Following our February monthly channel check of tire dealers, tire wholesalers and tire raw material suppliers, we remain bullish on **BUY**-rated MNRO, and we remain **HOLD**-rated on CTB and GT based on our beliefs that: 1) MNRO's same-store growth guidance in fiscal 4Q14 of ~1% continues to look achievable as consumer tire sell-out and service sales this quarter have remained positive, with our survey respondents reporting a ~2% year-over-year increase in consumer retail tire sales and a ~7% increase in service sales year-to-date; 2) for CTB and GT, the consumer replacement shipment (sell-in) outlook continues to be mixed as positive momentum in consumer retail tire sales (sell-out) is overshadowed by strong import shipments as well as half of our survey participants reporting inventory levels as "Too High" year-to-date; 3) the pricing outlook is somewhat mixed with consumer pricing from the manufacturer being characterized as "Normal" by ~70% of survey respondents while only ~40% of the respondents indicated commercial pricing is "Normal" year-to-date; and 4) raw material prices appear to be in the early stages of increasing, with a 25% increase in synthetic rubber offsetting an 11% decline in natural rubber pricing in 1Q14 relative to 4Q13.

We are maintaining our earnings estimates for MNRO of $1.66 (consensus: $1.66) for 2014, $2.16 (consensus $2.15) for 2015 and $2.48 (consensus: $2.53) for 2016. In our monthly channel check published today, we lowered our 2014 CTB estimate to $2.16 (consensus: $2.33) from $2.35. We introduced a 2015 EPS estimate of $2.33 (consensus: $2.24). We are maintaining our GT estimates of $3.01 (consensus: $2.96) for 2014 and $3.65 (consensus: $3.37) for 2015

Following our February monthly channel check of tire dealers, tire wholesalers and tire raw material suppliers, we remain bullish on BUY-rated MNRO, and we remain HOLD-rated on CTB and GT based on our beliefs that:

1) MNRO's same-store growth guidance in fiscal 4Q14 of ~1% continues to look achievable as consumer tire sell-out and service sales this quarter have remained positive with our survey respondents reporting a ~2% year-over-year increase in consumer retail tire sales and a ~7% increase in service sales year-to-date as follows:

- Positive year-over-year sales growth and margin improvement continue to be reported by our dealers in February, which is a bullish read-through to MNRO.
- In February, dealer survey respondents reported a 0.8% year-over-year increase in consumer tire sales (sell-out) vs. a 2.8% year-over-year increase in January. Survey respondents also reported a 7.4% year-over-year increase in overall service sales vs. a 6.0% year-over-year increase in January. Additionally, dealers reported an 80 bps increase in service gross margin in February vs. a 120 bps improvement in January. We maintain higher than normal snowfall and abnormally cold weather in the Northeast should prove to be a catalyst for solid tire and service demand in the coming months for MNRO.
- Overall, we are modeling MNRO's 4Q14 same-store growth up 1.5%. Every 100 bps of upside to same-facility revenue growth is approximately $0.01 accretive.

2) For CTB and GT, the consumer replacement shipment (sell-in) outlook remains mixed as positive momentum in consumer retail tire sales (sell-out) is overshadowed by strong import shipments as well as half of our survey participants reporting inventory levels as "Too High" year-to-date as follows:

- The aforementioned ~2% year-over-year increase in consumer unit retail sales (sell-out) year-to-date is generally consistent with the U.S. shipment data being reported by the Rubber Manufacturer's Association (RMA), which has shown a ~3.5% increase in replacement shipments through February. The inventory situation is somewhat mixed with half of consumer contacts indicating inventory is "Too High" and the other half indicating trends are "Just Right" year-to-date. On the negative front, foreign imports continue to post strong results as evidenced by RMA's recent revision in January to +3.9% year-over-year growth in shipments from the prior negative -1.2% estimate. The positive revision was driven by better than expected import shipments into the United States, which is a negative read-through primarily to CTB as the Company continues to face stiff competition in the private label/lower priced tire category.
- As it relates to commercial tire sell-out, dealers reported a year-over-year increase of 2.3% in February vs. a decline of -0.5% in January. Dealers are beginning to restock commercial tires as shipments are up nearly 9% year-to-date vs. a low single-digit increase in sell-out growth.

3) The pricing outlook is somewhat mixed with consumer pricing from the manufacturer being characterized as "Normal" by ~70% of survey respondents while only ~40% of respondents indicated commercial pricing is "Normal" year-to-date as follows:

- Year-to-date, the percentage of respondents that indicated consumer pricing was "Normal" is averaging ~70% vs. ~40% in 4Q13. The balance of respondents indicated consumer pricing was "Aggressive" in both periods. Therefore, it appears the pricing environment remains fairly disciplined and will continue to be favorable for manufacturers.
- The percentage of respondents that indicated commercial pricing was "Normal" declined to ~40% from ~50% sequentially. The remaining respondents indicated pricing was "Aggressive." Therefore, it appears the pricing environment is becoming slightly less favorable sequentially for commercial replacement tires.

4) Raw material prices appear to be in the early stages of increasing, with a 25% increase in synthetic rubber offsetting an 11% decline in natural rubber pricing in 1Q14 relative to 4Q13 as follows:

- Tire manufacturers are mostly guiding to a favorable tailwind in 1H14 as a result of lower raw material costs. We are beginning to see evidence the benefit may start to wane going forward driven primarily by higher synthetic rubber, which has increased 25% since 4Q13.
- Natural rubber pricing (~25% of raw material cost) is averaging $1.04/lb ($2.30/kg) thus far in 1Q14, which compares to $1.17/lb ($2.57/kg) in 4Q13, representing an 11% decline sequentially and a 29% decline year-over-year. For reference, pricing averaged $1.18/lb ($2.60/kg) in 3Q13, $1.24/lb ($2.73/kg) in 2Q13, $1.46/lb ($3.21/kg) in 1Q13, $1.43/lb ($3.15/kg) in 4Q12, $1.35/lb ($2.97/kg) in 3Q12, $1.63/lb ($3.60/kg) in 2Q12 and $1.78/lb ($3.93/kg) in 1Q12. Natural rubber has averaged $1.64/lb ($3.61/kg) from 1Q10 to present.
- Synthetic rubber pricing (~25% of raw material cost) is averaging $0.70/lb in 1Q14 vs. $0.56/lb in 4Q13, representing a 25% increase sequentially and a 19% decline year-over-year. For reference, synthetic rubber pricing averaged $0.53/lb in 3Q13, $0.90/lb in 2Q13, $0.86/lb in 1Q13, $0.89/lb in 4Q12, $1.01/lb in 3Q12, $1.50/lb in 2Q12 and $1.30/lb in 1Q12. Synthetic rubber has averaged $1.11/lb from 1Q10 to present.
- Steel belt and bead wire (~13% of raw material cost) pricing is slightly lower sequentially in 1Q14 vs. 4Q13. Carbon black (~13% of raw material cost) pricing varies by market, but appears flattish. Our reinforcing fabric sources indicate pricing came under pressure in 4Q13 (down 3-5%) and we have not received an updated quote for 1Q14.

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Overcapacity is a key driver behind weakness in the teen space. While weakness observed in the teen space in 2H13 was attributable to a number of factors, we think that retailing overcapacity sets the backdrop for a multi-year period of square footage rationalization. In this joint report between KBCM's Specialty Retail/Apparel and REIT teams, we chronicle the capacity growth in teen retailing and identify areas of potential concern. We believe growth in fast fashion (particularly Forever 21) and, to a lesser extent, action sports have been the primary culprits behind the destabilized competitive teen retail environment. We remain selective within the teen space and favor Abercrombie & Fitch Co. (ANF-NYSE) and Wet Seal, Inc. (WTSL-NASDAQ) on a relative basis. In terms of the real estate, the teen retail category over the last couple of quarters has weighed on sentiment, sales productivity and, to a lesser extent (for now), the actual operating fundamentals of mall portfolios. Retailer cycles impact sentiment more than actual real estate fundamentals in the near term.

We believe that structural overcapacity is a significant factor driving the weakness in the teen space. To some extent, this answer is unsatisfying as it does not explain why the deterioration accelerated in fall 2013. We also believe that macro conditions (teen unemployment), as well as growing technology/telecommunications expenditures, weigh on teen apparel spending. Nevertheless, we think that all of these factors are against a backdrop of 49% adjusted square footage growth in teen apparel retailing since 2005. We believe this amplifies the risk that retailers will engage in a damaging pricing war.

Store closures likely, but we suspect they may be manageable for most landlords and take place over a multiyear period. Given a lack of new mall supply over the last several years, REIT landlords are seeing positive leasing trends within their portfolios. If conditions do not improve within the teen retail space, however, we suspect there could be a natural culling of portfolios that may result in store closures. Exposure to the teen retailers we analyzed within REIT portfolios ranges from the mid-single to the mid-teens as a percentage of mall store GLA. Importantly, much of the store growth experienced in the teen retail space occurred in 2006, 2007 and 2008, which may lead to a disproportionate number of expiring leases over the next few years. And those leases signed later in each retailer's life cycle may be in less ideal locations and in less productive retail centers (i.e., retailers may have stretched further out along the risk spectrum to open new stores that today would be considered non-core). Overall, however, we think the recaptured space should be manageable for most landlords–higher quality malls throughout the country should fare better and have more re-tenanting opportunities, while more moderate malls and those in secondary markets will have to work harder to backfill vacancies and/or offer rent concessions.

We go with the "best house on a bad block." If we use the Missy space as a proxy, it is our belief that the company that had arguably the best brand (Chico's FAS) had the most relative success. As such, we believe that Abercrombie & Fitch has the lowest store count (711 U.S. Abercrombie/Hollister stores vs. 1,066 American Eagle and 871 Aeropostale) and the most premium positioning. We believe that Abercrombie can use its more profitable international stores (25.0% of 2013 EBIT) to "fund" a resizing of the U.S. store base. We also view its changes to add fast fashion elements to its offering favorably. For investors with a high risk tolerance, we like Wet Seal given its nimble supply chain and balance sheet ($65.9 million cash and short-term investments and $121.4 million in NOLs as of 3Q13).

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