MORGAN JOSEPH

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Company Update / Price Target Change / Estimates Change

EQUITY RESEARCH

September 10, 2008

Pep Boys - Manny, Moe & Jack

Rating: Buy

Sales/EPS Below Expectations; Sequential Profitability Improves; $12PT vs. $15

Key Metrics

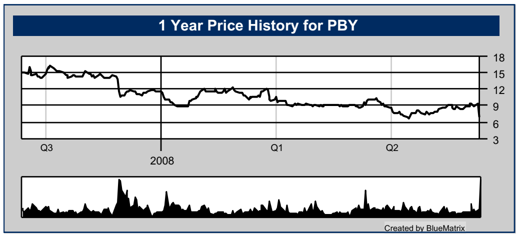
PBY - NYSE	$6.91
Pricing Date	09/09/2008
Price Target	$12.00
52-Week Range	$16.75-$6.40
Shares Outstanding (mm)	51.8
Market Capitalization ($mm)	$357.9
3-Mo Average Daily Volume	590,929
Institutional Ownership	92%
Debt/Total Capital	42.1%
ROE	NM
Book Value/Share	$9.14
Price/Book	0.8x
Dividend Yield	3.1%
LTM EBITDA Margin	4.51%

EPS($) FY: January

	2008A	Prior 2009E	Curr. 2009E	Prior 2010E	Curr. 2010E
1Q-Apr	0.06	--	0.01A	--	0.10E
2Q-Jul	0.08	0.07E	0.03A	--	0.11E
3Q-Oct	(0.01)	--	0.06E	--	0.10E
4Q-Jan	(0.25)	0.12E	0.08E	--	0.10E
FY	(0.13)	0.26E	0.17E	0.42E	0.41E
P/E	NM		40.6x		16.9x

Revenue($mm)

	2008A	Prior 2009E	Curr. 2009E	Prior 2010E	Curr. 2010E
1Q-Apr	539.6	--	498.0A	--	501.5E
2Q-Jul	552.1	522.3E	500.0A	--	510.9E
3Q-Oct	535.4	515.8E	497.4E	--	516.1E
4Q-Jan	517.6	522.8E	502.8E	--	525.5E
FY	2,144.7	2,059.0E	1,998.3E	2,109.7E	2,054.1E



Company Description: *Pep Boys – Manny, Moe & Jack (www.pepboys.com) operates as an automotive retail and service chain in the United States and Puerto Rico. PBY engages in the retail sale of automotive parts, tires, and accessories, automotive repairs and maintenance, and the installation of parts.*

Investment Highlights:

- **F2Q09 EPS of $0.03 below our estimate by $0.04.** Pep Boys reported F2Q09 EPS, ex-one time items, of $0.03, $0.04 below our estimate. Including one-time items, earnings from continuing operations were $0.11 and net earnings were $0.10.
- **Sales down 9.4% on weak comps, fewer stores and non-core sales declines.** Sales for F2Q09 were $500.0mm, down $52mm Y/Y on (7.5%) comparable store sales growth and 30 fewer locations vs. last year. Within the comp store sales decline was roughly a $13mm reduction in non-core merchandise, a category the company is exiting. Further impacting results was reduced store traffic and deferred purchases due to economic conditions. Conditions appear to have worsened toward the latter stages of the quarter; therefore, we are lowering our future sales expectations accordingly.
- **Margins down slightly; in line with our estimates.** Gross margin for the quarter of 26.1% was down Y/Y from 26.9%. Despite the lower than expected sales leverage, Pep Boys was able to generate a gross margin in line with expectations as improved pricing appeared to offset the lower sales results.
- **Sale leaseback transactions strengthen balance sheet - supports unrealized value of real estate.** Pep Boys' cash balance increased by $29.6mm to $56.2mm with total debt down $215mm Y/Y. This increase is primarily attributable to the proceeds from sale leaseback transactions totaling roughly $374mm. While do not anticipate further sale leaseback transactions, recent sales have generated deferred gains on the sale of assets of $173mm, which should be amortized as gains over time.
- **Sales down but profitability picture appears to be improving.** Despite the lower-than-expected revenues and reduced sales leverage, Pep Boys was able to generate gross profit margins in line with expectations, and above, within eight of the last nine quarters. Given an improving sales mix expected going forward, we believe current levels are sustainable, with additional upside should economic conditions improve.
- **Trading Below Book Value: Maintain Buy Rating; Reducing Target to $12 from $15.** Pep Boys' shares currently trade at a 30% discount to tangible book value. Our previous target was based upon an adjusted book value reflecting current real estate values, which we still believe equates to roughly $15 per share; however, with sale leaseback transactions currently on hold, we are adjusting our PT to $12 to reflect the current book value plus the roughly $3 per share in gains on deferred asset sales.

The Disclosure section may be found on pages 5 - 6 of this report.
The Valuation section may be found on page 5 of this report.

Balance sheet strengthened: Total debt down $215mm Y/Y; Adjusting price target to $12 from $15: Maintain Buy rating

Pep Boys has completed the sale leaseback of 97 stores with total proceeds to the company of roughly $370mm. The transactions allowed the company to reduce its total debt from $552mm in F2Q08 to $338mm in F2Q09 and interest expense payments from $12.3mm to $6.5mm Y/Y. The transactions generated recognized and deferred gains totaling nearly $200mm ($174mm in deferred gains recognized on the balance sheet as of 2Q09 end). These transactions and asset sale gains re-affirm our belief that the company's current per share book value of $9 is understated and does not account for the true value of owned real estate. While we continue to believe Pep Boys' true tangible book value is closer to roughly $15 per share, further sale leaseback transactions appear to have been put on hold, and thus will not immediately monetize that value. Therefore, we are lowering our price target to $12 from $15 to reflect Pep Boys' current per share tangible book value of about $9 plus roughly $3 per share, or $174mm, for deferred gains on sales of assets.

EPS of $0.03, $0.04 below our and the Street consensus expectation

Pep Boys reported fiscal year 2009 second quarter EPS of $0.03. Included in the quarter's earnings was a one-time $2.2mm tax benefit (estimated $0.04 EPS benefit) resulting from the recording of a deferred tax asset due to a June 2007 state tax law change. Additionally, a $4.1mm (estimated $0.08 EPS benefit) gain was recorded from the disposition of assets. Including this item, net earnings per share were $0.10. The $0.03 EPS result was $0.04 less than our $0.07 estimate and the consensus. The weaker-than-expected results were primarily due to decreased comparable sales coupled with fewer stores.

Troubled operating environment coupled with fewer stores and weak comparable sales shrink sales 9.4% Y/Y

Pep Boys reported fiscal 2009 second quarter sales of $500.0mm vs. $552.1 for the same period last year, a 9.4% decline. Comparable sales declined 7.5%, including an 8.0% comparable merchandise sales decrease and a 5.2% comparable service revenue decrease. Comparable store sales were weaker than our expectations due to consumers foregoing usual servicing in, as well as significant spending reductions on, accessories. It should be noted that included in the comp decline is $13.2mm less sales of items that the company is phasing out as part of its strategic transformation. Pep Boys' DIY parts category has remained relatively stable compared to other divisions, yet did decline slightly Y/Y as consumers appear to be deferring medium to heavy repair work. Other factors that appeared to negatively impact sales during the quarter included reduced national promotional activities, as well as work force and store inventory availability during product mix adjustments. The company has updated 31 categories to date with roughly 61 new category updates scheduled for the remainder of the year. The disruptions, which primarily came from physical in-store adjustments, appear to be nearly completed; therefore, future category updates should not be as disruptive. With that said, 2H sales could continue to be impacted by challenging economic conditions, fewer stores opened, and fewer non-core product sales; therefore, we are lowering our sales expectations in FY09 and FY10 by roughly $60mm, each.

Gross Margins remain in line despite weak sales: Improving margins appear sustainable

Gross margins declined 0.8% Y/Y to 26.1% in 2Q09. For 1H09, gross margin was 25.9%, down 0.6% Y/Y. While down Y/Y, Pep Boys was able to generate quarterly gross margins above that of the previous three quarters and better than eight of the past nine sequential quarters. Negatively impacting results was reduced sales leverage, clearance items sold at cost, higher rental costs, and fewer higher margined medium and heavy repair work. Offsetting these challenges appeared to be improved pricing and a focus upon core profitability rather than driving less profitable top line growth. Product margins before occupancy costs remained flat Y/Y and could improve as core merchandise assortments are updated and lower non-core merchandise sales are eliminated. Operating costs, while up 60 basis points as a percentage of sales, declined in dollars by roughly $9mm and appear to be at relatively sustainable levels, in terms of dollars, as the company continues to identify opportunities for cost reductions. The lower-than-expected sales are disappointing, and the Street's reaction understood, yet longer-term, we remain encouraged by the improved gross margins and reduced operating costs.

We are increasing our gross margin expectations in FY09 and FY10 to 26.1% and 26.6%, respectively. Our higher gross margin expectations offset reduced sales projections in FY10, yet the anticipated reduced leverage negatively impacts FY09E EPS. Accordingly, we are reducing our FY09 EPS estimate to $0.17 from $0.26. Upside to our expectations could materialize with improved revenue growth and potentially expanding commercial sales. The company added four commercial operations in the second quarter and expects to add 15 more in 2H09.

Despite yesterday's trading activity, Pep Boys, in our opinion, is not going out of business. In fact, its balance sheet is in good shape, representing one of the company's lowest quarterly debt to capitalization rates (41.4%) seen over the past ten years, no significant debt maturities until 2013, an untapped credit facility with roughly $230mm in borrowing capacity, and an unstated, in our opinion, tangible book value of roughly $9 per share. Despite the 97 property sale leaseback transactions, the company still owns roughly 250 stores and four distribution centers. Its interest expense payments have been cut in half and operating costs are well below historical norms. The company has been dealing with a challenging economic environment, which has magnified the impact of recent store closings, the exiting of non-core merchandise, and an ongoing merchandising shift to top-line results. We do expect these adjustments to be beneficial to longer-term profitability and believe the sequentially improved gross margins indicate early progress as well. While recent reaction to the turnaround has been discouraging, we continue to believe the stock is well undervalued and maintain our Buy rating.

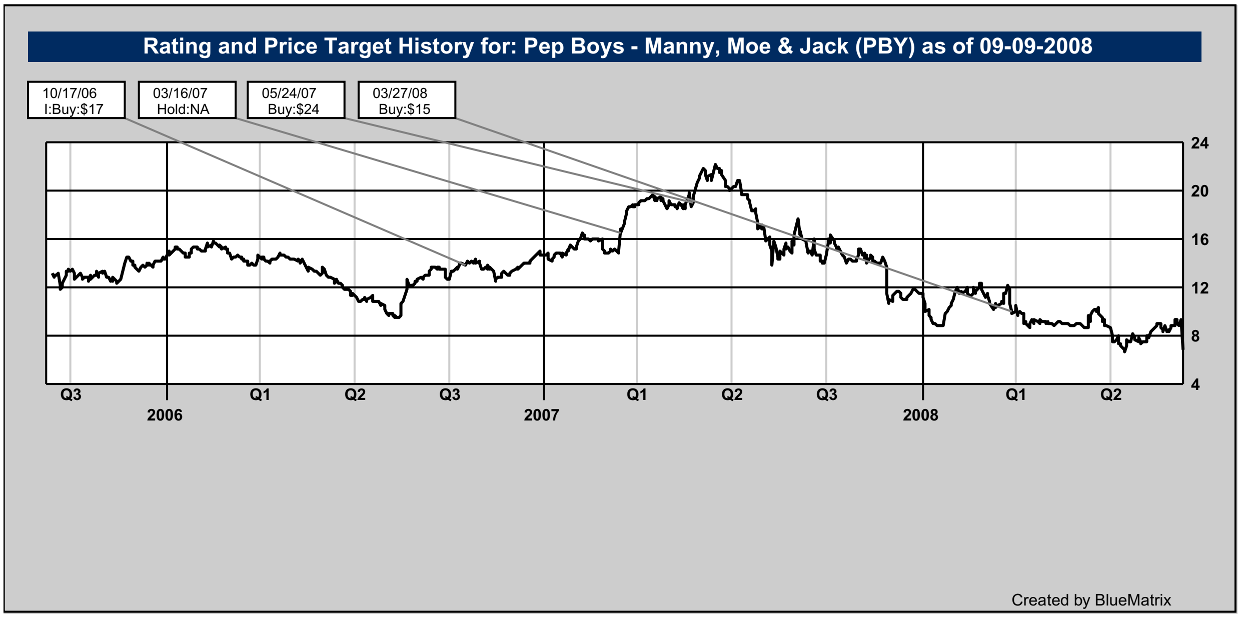
Pep Boys - Manny, Moe & Jack Quarterly Earnings Model

(In millions, except per share data)

	FY 2007	Q1 May-07	Q2 Aug-07	Q3 Nov-07	Q4 Feb-08	FY 2008	Q1 May-08	Q2 Aug-08	Q3E Nov-08	Q4E Jan-09	FYE 2009	Q1E May-09	Q2E Aug-09	Q3E Nov-09	Q4E Feb-10	FYE 2010
Total Revenues	**$2,272.2**	**$539.6**	**$552.1**	**$535.4**	**$517.6**	**$2,144.7**	**$498.0**	**$500.0**	**$497.4**	**$502.8**	**$1,998.3**	**$501.5**	**$510.9**	**$516.1**	**$525.5**	**$2,054.1**
% Increase	1.6%	-3.1%	-4.6%	-2.8%	-11.7%	-5.6%	-7.7%	-9.4%	-7.1%	-2.9%	-6.8%	0.7%	2.2%	3.8%	4.5%	2.8%
Cost of Goods Sold	1700.4	400.3	403.4	397.9	406.6	1608.2	370.1	369.6	366.3	370.2	1476.2	369.4	373.5	377.7	387.0	1507.6
As % Sales	74.8%	74.2%	73.1%	74.3%	78.5%	75.0%	74.3%	73.9%	73.6%	73.6%	73.9%	73.7%	73.1%	73.2%	73.6%	73.4%
Gross Profit	**571.8**	**139.3**	**148.7**	**137.4**	**111.1**	**536.5**	**128.0**	**130.4**	**131.1**	**132.5**	**522.1**	**132.1**	**137.4**	**138.4**	**138.5**	**546.5**
Margin	25.2%	25.8%	26.9%	25.7%	21.5%	25.0%	25.7%	26.1%	26.4%	26.4%	26.1%	26.3%	26.9%	26.8%	26.4%	26.6%
% Increase	7.2%	0.3%	2.5%	-0.2%	-26.0%	-6.2%	-8.1%	-12.3%	-4.6%	19.3%	-2.7%	3.2%	5.3%	5.6%	4.5%	4.7%
Operating/SG&A Expense	546.5	123.2	131.8	127.1	123.3	505.4	119.0	122.6	121.0	121.0	483.6	118.5	123.5	125.0	125.0	492.0
As % Sales	24.1%	22.8%	23.9%	23.7%	23.8%	23.6%	23.9%	24.5%	24.3%	24.1%	24.2%	23.6%	24.2%	24.2%	23.8%	24.0%
Operating Profit	**31.5**	**16.1**	**16.9**	**9.8**	**(12.2)**	**30.6**	**9.0**	**7.8**	**10.1**	**11.5**	**38.5**	**13.6**	**13.9**	**13.4**	**13.5**	**54.5**
Margin	1.4%	3.0%	3.1%	1.8%	-2.4%	1.4%	1.8%	1.6%	2.0%	2.3%	1.9%	2.7%	2.7%	2.6%	2.6%	2.7%
% Increase	NA	122.0%	40.6%	NA	NA	-3.0%	-44.3%	-53.6%	2.9%	NA	25.8%	51.5%	77.5%	32.7%	17.3%	41.6%
Interest Exp./(Inc.)	50.8	12.7	12.3	11.5	8.8	45.3	8.2	6.5	6.5	6.5	27.6	6.5	6.5	6.5	6.5	25.8
Other Exp./(Inc.)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Non-Operating Exp./(Inc.)	-7.0	-1.9	-1.8	-1.0	-0.5	-5.2	-0.3	-1.2	-1.2	-1.2	-3.9	-1.2	-1.2	-1.2	-1.2	-4.8
Pretax Profit	**(12.3)**	**5.3**	**6.3**	**(0.6)**	**(20.4)**	**(9.4)**	**1.1**	**2.5**	**4.9**	**6.3**	**14.8**	**8.3**	**8.6**	**8.2**	**8.3**	**33.5**
Margin	-0.5%	1.0%	1.1%	-0.1%	-3.9%	-0.4%	0.2%	0.5%	1.0%	1.3%	0.7%	1.7%	1.7%	1.6%	1.6%	1.6%
Taxes(benefit)	-3.8	2.1	2.3	0.1	-7.4	-2.8	0.5	1.2	1.8	2.3	5.7	3.0	3.1	2.9	3.0	12.0
Rate	31.2%	40.0%	37.3%	-9.5%	36.0%	29.9%	43.6%	46.3%	36.0%	36.0%	38.3%	36.0%	36.0%	36.0%	36.0%	36.0%
Net Income--Operations	**(8.5)**	**3.2**	**3.9**	**(0.7)**	**(13.1)**	**(6.6)**	**0.6**	**1.4**	**3.1**	**4.0**	**9.1**	**5.3**	**5.5**	**5.2**	**5.3**	**21.4**
Margin	-0.4%	0.6%	0.7%	-0.1%	-2.5%	-0.3%	0.1%	0.3%	0.6%	0.8%	0.5%	1.1%	1.1%	1.0%	1.0%	1.0%
EPS--Operations	**(0.16)**	**0.06**	**0.08**	**(0.01)**	**(0.25)**	**(0.13)**	**0.01**	**0.03**	**0.06**	**0.08**	**0.17**	**0.10**	**0.11**	**0.10**	**0.10**	**0.41**
Shares Outstanding (mm)	54.3	53.6	52.3	51.8	51.9	52.1	52.2	52.2	52.2	52.2	52.2	52.3	52.3	52.3	52.3	52.3

Source: Company reports and Morgan Joseph Estimates

Required Disclosures



Price Target

Our price target is $12 .

Valuation Methodology

Our $12 price target reflects Pep Boy's current per share tangible book value of about $9 plus roughly $3 per share, or $174mm, for deferred gains on sales of assets.

Risk Factors

- High fixed cost structure and relatively expensive labor force.
- The aftermarket is susceptible to seasonality and unpredictable weather.
- The automotive aftermarket is highly competitive and dominated by a few retailers.
- PBY's commercial business can provide conflicts of interest.

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		Investment Banking Services/Past 12 Mos.
Rating	**Percent**	**Percent**
BUY [B]	**56.18**	**34.00**
HOLD [H]	**42.70**	**31.58**
SELL [S]	**1.12**	**0.00**

Meaning of Ratings	A) Buy means reasonable outperformance relative to the market over 12-18 months. B) Hold means market-type risk adjusted performance; potential source of funds. C) Sell means expected to underperform the market.

Other Disclosures

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