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# EDITED TRANSCRIPT

ORLY.OQ - O'Reilly Automotive Inc at Gabelli Funds Automotive Symposium

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## CORPORATE PARTICIPANTS

**Jeremy Adam Fletcher** *O'Reilly Automotive, Inc. - Executive VP & CFO*

**Mark Merz** *O'Reilly Automotive, Inc. - Senior VP of Finance*

## PRESENTATION

### Unidentified Analyst

So next up is O'Reilly Automotive. Headquartered in Springfield, Missouri, it's one of the largest aftermarket distributors in the U.S. 64 million shares at \$770, \$50 billion market cap. Net debt of \$4.4 billion, for an enterprise value of \$54 billion.

Speaking with us today is CFO, Jeremy Fletcher; and Senior VP of Finance, Mark Merz. Mark and Jeremy, thank you for being here today.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Thank you.

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## QUESTIONS AND ANSWERS

### Unidentified Analyst

Congratulations on another terrific year, outperforming estimates and a terrific quarter really. Can you begin with an overview of O'Reilly? Kind of what do you sell? Who are your customers? And how do they make buying decisions?

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**Mark Merz** - *O'Reilly Automotive, Inc. - Senior VP of Finance*

Sure. Absolutely. So O'Reilly started in 1957, started by the O'Reilly family. And we started out actually just as a supplier on the professional side of the business. Did a lot of jobber business, independent garage business. And that core business, how we started, robust distribution, significant parts availability was how we grew the business for the next 20 years or so. And over that period of time, it was really still just serving that independent professional customer.

Then in the late '70s and early '80s, we started noticing that more and more retail customers were coming into what were really just warehouse-type locations to buy parts. And so people like Ted Wise and Charlie O'Reilly said, "Why don't we just open the front of these locations up and start selling to the retail customer?" And so we did, and that's how our dual market strategy, which is how we operate the business today, really evolved.

But at our core, that focus on robust distribution, significant parts availability, getting parts to the customer faster than anyone can do in the industry, high technical knowledge, that really is our core business even today. Even though we serve both sides of the business, both the retail and the professional customer, at our core we're still a provider to the professional customer, and all those advantages of technical knowledge, parts availability benefit the retail customer.

By and large, what we sell is nondiscretionary. So specific to your question, what drives the a customer's buying decision, their car is broken, someone has to get their life back in order because their vehicle doesn't work. They depend on their vehicle for their livelihood. They depend on their vehicle to get to work. They depend on their vehicles to get their kids to school, to run errands. And when those vehicles don't operate, their life is disrupted.

So what our job is, is really a customer service business that helps people get their lives back in order. What drives the buying decision is who can help them solve their problem and who can help them solve their problem the fastest. So whether it's the retail customer who's trying to fix their

vehicle themselves, generally out of economic necessity, or the professional customer who is working on a vehicle for someone else and the success of their business depends on getting the parts that their technicians need quickly to repair those vehicles and turn their bays, the more times they can turn their bay in the day, the more profitable that business is. So we partner with them to help their business be more profitable and successful over the long term.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So in terms of just our growth and our size, we're 5,900 stores, around that, in the United States, in 47 states, and Mexico. Over the course of time, we've pursued both an organic and acquisitive growth strategy and continue to feel like we have opportunities to grow in our existing markets, probably underpenetrated most in the Northeast.

But then also entered Mexico with an expansion just prior to the pandemic a few years ago and have felt really good about the partnership we formed there with the Orendain family and the Mayasa company and the platform that we think that provides for us to continue to grow into Mexico.

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**Unidentified Analyst**

Perfect. And yes, we do want to address the growth. 30% 3-year growth rates, 7.6% quarterly comp. Can you talk about your overall strategy for growth from here? I know you've talked about an addressable market about \$140 billion. That kind of puts you the top 4 at maybe 50% market share, if you just use sales. Is the growth in the U.S.? Or is it Mexico and other countries, as you mentioned?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

We expect that we continue to have significant growth opportunities within the United States, both from an organic perspective. But really, our primary focus as an organization is to continue to drive growth out of our existing store base. Our best growth opportunity is execution of our business model and making sure that we're providing excellent customer service, leveraging industry-leading inventory availability and driving a value proposition that lets us gain more and more of our existing customers' business.

We see ourselves as a consolidator and a share-gainer within still a very fragmented automotive aftermarket in the United States, and we think that that's a primary driver of growth and our ability to grow faster than the market.

We still see attractive organic growth opportunities within the United States, and there are areas of the country that we're underpenetrated in and we think will be great markets for us. We've also continued to be able to add stores on a backfill basis into existing markets and have worked as a consolidator of the business in that way.

And also have accomplished growth goals through acquisitions. We're very opportunistic and work to find the right time to make those acquisitions. They have tended most of the time to be on the smaller size, although in the course of our history we've had some very significant kind of game-changing acquisitions for the company.

But we think all of those opportunities still exist for us in the United States. As we move forward, we will supplement that with a bigger and bigger part of our growth, still probably not the majority, but a bigger part of our growth, coming from expansion in Mexico. We're really ramping up the foundation and platform that we've got in Mexico to be able to add stores there and grow the O'Reilly brand there. And I think that that offers potential to help augment our growth as we move forward for the next 5, 10 years.

**Unidentified Analyst**

And just talking about those operations, I know that you mentioned distribution in your initial comments. It seems like you have the best-in-class distribution capacity, very few to be able to compete. Have you been -- have you taken share during the supply chain crisis? Have you been able to kind of excel in those fill rates? And is that share sticky?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes, we feel we have. Certainly, the last 2, 3 years have been incredibly disruptive in the aftermarket. Big shifts in spending in channel. A lot of changes in consumer behavior. DIY customers in the onset of the pandemic doing a lot of jobs themselves and working on bigger jobs than they have. For sure, a lot of disruptions from supply chain, but also from an execution perspective, having to weather challenges in workforces and the impacts of pandemic. A lot of that, I think, has caused a lot of disruption within the broader industry at the same time that our industry has benefited from a lot of growth.

We feel like we've been a beneficiary of that. The ability to ensure our consistency of execution has been a big driver for us to support both our professional and DIY customers. We certainly think that from a supply chain perspective, we weathered better than some. It's something we feel confident in saying, but still always a little bit of a challenge to say, we don't like to ever have any type of lack of perfect performance on the supply chain side. And we've struggled with the rest of the industry from a fill rate and a supply perspective, but likely have outperformed in a lot of ways because of our size, the great supplier relationships that we have and just our ability to work hard within every local market to be sure that we can take care of our customer and get the parts they need.

And for sure, that consistency of execution, Mark talked about it a little bit earlier, but our professional customers, they rely on us as an integral part of the financial success of their shop. They need a supplier that's consistent and can get them the parts when they need it. It helps them continue to be profitable. And being able to be consistent in executing on that proposition helps for that business to be sticky.

Most suppliers don't want to -- most shops don't want to think about how to swap out a supplier. They want it to be second nature that they're going to get the support that they need. And when you're able to do that and step in, in place of somebody that maybe has fallen down a little bit on that proposition, it puts you in a great position to retain that business and just be a problem solver for your customer.

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**Unidentified Analyst**

[Brett]?

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**Unidentified Analyst**

I guess, when you talked about acquisitions maybe filling in blank space, you did VIP and (inaudible) in the Northeast a few years ago, but there's still a lot of mid-Atlantic blank space. Is it more likely you'd do that via an Eastern (inaudible) distributor? Or do you see the opportunities that there are sort of smaller storefronts in that (inaudible)? Or is it (inaudible)?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

It's probably a combination of all of that, Brett. A lot of the smaller players that still exist up there skew a little bit more heavily on the professional side of the business, just the evolution of that market. But there are a lot of even those providers that are destination locations for the DIY consumer.

So we think that even in an instance where we might have a potential partner that's a heavier professional-focused company, often we can, over the course of time, put them in a little bit better locations, can leverage some of the kind of human capital they've got within an organization and can become a great retailer for those markets with an emphasis on it.

So we never really view it as a particular model that has to fit one way or the other. Most of that evaluation really comes down to how do we feel about the team that's in place, what type of relationships have they built, how are they going to market, can we leverage a provider that kind of does business the way that we do, but we have some opportunities to add value as we can invest dollars in inventory and systems and tools and things of that nature. Those are all the key considerations for us, and they can look a little bit different from partner to partner.

But for us, I think what often becomes the key factor is how can that partnership come together. It's an item that we're opportunistic on, but you can't always accelerate. It's got to be the right timing for us and them. And we think there could be some opportunities in Northeast. If those work out, that's always a great source of new talent for the company, new relationships in those markets, and we'd be happy to do that. But we also feel comfortable expanding greenfield into those regions as well and have been successful doing that.

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### Unidentified Analyst

Is the post-pandemic timing, is there more activity, more conversation now that we've just come out of the surge and likely into a more normalized demand environment? Or is today no different than 3 years ago as far as M&A activity?

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### Jeremy Adam Fletcher - O'Reilly Automotive, Inc. - Executive VP & CFO

I don't know that it's really any different than how we would see normal circumstances. Maybe the only difference is in the height of the pandemic. I don't think anybody's focus was on those types of things. Most players, us, and potential targets were just navigating that environment. So there may be some degree to which people can turn their eyes and think about some of those things where they wouldn't have in 2020 and 2021.

But sometimes we get that question from time to time, is this market better, is that market better, just depending on some broader factors. For sure, if our customers' business is doing really well, it's -- or a potential target's business is doing really well, then it might be a more difficult sell for them to think about jumping off and the potential risk that they would have in the future. But often, the timing is driven more by specific circumstances, strategically how those partners think about the right time to sell. Often it's family businesses, so the right timing for that.

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### Unidentified Analyst

Great. And another trend we've been talking about here at the conference is just consumer inelasticity and the nature of the aftermarket. Can you kind of talk about how you've been able to continue to push price through? And if you've seen a gap between maybe some of your more discretionary categories versus maintenance and failure?

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### Jeremy Adam Fletcher - O'Reilly Automotive, Inc. - Executive VP & CFO

Absolutely. Mark talked to it earlier. We sell a lot of things that people absolutely need when they need them. And that's a great spot to be in.

And we're also a business that is largely driven off of being able to meet an immediacy of need. On the DIY side, it's helping a customer that might be economically strapped avoid a repair shop bill, but also supporting them to get the job done right and to be sure they have the right parts and the support they need to have it done and be able to get their car back on the road so that they can go to their job, take their kids to school and activities and things of that nature.

On the professional side of the business, we're a key partner. The economic success of a shop is dependent upon having a reliable supplier.

So all of those things drive a value proposition within our space that is heavily dependent on a lot of factors that don't involve price. And I think our industry has proven that we can command a premium level of pricing because we can help solve problems a lot of our customer base would face. And we've seen that be true as we've had a more heightened level of inflation, really starting with tariffs, but then, obviously, over the course of the last 18 months or so.

For us, that's true of generally most of our business. We will have some categories that are more discretionary appearance and those types of things that you might see over at the SEMA Show really on a different level than what we sell. But for those types of items, those have typically always been a smaller part of our business. Early in the pandemic, we saw those actually outperform and they've kind of come back in to more normalized levels. And I would tell you on the rest of what we see, there's still the same general inelasticity to demand for the things that we sell.

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**Unidentified Analyst**

Great. And then also, as we look forward, just there has been some thoughts that maybe there were some do-it-yourself categories at historically high levels just because of stimulus dollars that we might have seen in 2021. Do you feel as if that has normalized as we look forward to the future?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

We would assume that it has. Certainly, the significant majority of it has. It's a little bit tough to be able to say. Obviously, there's been a lot of volatility as we moved through the pandemic. I would say most of any excess demand on some of those really highly discretionary appearance types of categories probably worked its way out in 2021, and we may have seen some of the rest of that in the first part of the year. It's a little bit of a challenge in the environment we've seen, where customers wouldn't be spending on discretionary items, just to begin with.

But feel much more comfortable when we just look at the composition of our business today versus prepandemic and just the types of things we're selling to our customers and the makeup of what that kind of broader basket is, it's really more in line with what we would expect historically. And we'd tell you it's largely normalized for any of that fluctuation.

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**Unidentified Analyst**

Right. And another part of this conference has been what if we do kind of run into a more recessionary environment. Do you have thoughts on how O'Reilly will do in that time period? And kind of looking back historically, how did they do and kind of why?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So historically, both the industry and our company has performed well in those environments. The most negative impacts that we see in any type of downturn is to any degree that that impacts employment levels and can affect commuter miles, that can be a pressure to demand for our business.

On the other end of that spectrum, though, it really -- periods of economic uncertainty provide even more of an incentive for our customer base to invest in their existing vehicle to make repairs, maintain their vehicle at higher mileages. That value proposition always exists because vehicles are manufactured very well today. Interiors and exteriors look really good. And you can expect your vehicle to stay on the road for a long time.

And being able to make a repair, being able to spend money to maintain an older vehicle and avoid that car payment has always been a benefit in our industry in periods when either it's really hard to buy new cars, used cars are expensive. Or when people are concerned about the broader macro, there's economic uncertainty, that continues to have folks invest in their existing vehicles. And it's been a positive. It creates volatility at some points and we'll see quarters, but by and large, as we move further through that period our business has done well as the economy recovers.

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**Unidentified Analyst**

Right. And then also supply chain. You touched on it, obviously, and meeting the fill rates better than I think your competitors or definitely your smaller competitors. Can you just talk about what you're seeing in terms of supply chain now? Any potential alleviation? Or thoughts on as we go forward more cost inflation?

**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So a couple of questions there. For sure, from an overall performance of supply chain, things have been getting incrementally better, better now than they were at this time last year for sure. We still have pockets, and you've heard Brent and Greg talk about it on our earnings calls. We still have pockets that are areas of improvement in certain suppliers, but much healthier and continuing [incrementally] to get better from a supply chain standpoint.

That's been coupled with a much more significant amount of inflation than we've seen in our industry in really several years. And I think we've seen that broad based. And we've been successful in passing that through to customers. And I think the rest of the industry has, too.

So would expect that we've seen some of that and we'll see what the outlook looks like for next year. And that's been a key focus, a lot of questions. We're going to wait a couple of months and on our next earnings call have a better picture of where we'll guide to that for next year. But certainly think that the broader dynamics of how the industry can respond to cost changes and passing along inflation are still consistent. Whether we see low or moderate or higher level, really feel like that dynamic of pricing power and inelasticity of customer demand will hold true as we move into next year.

**Unidentified Analyst**

All while maintaining great margins. And that brings us to another cost in the industry, one that's right now held by your suppliers, just as rising interest rates have impacted their factoring programs. Can you kind of talk about how you think about that and your willingness to accept price increases or your thoughts on how that dynamic will go, going forward?

**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So our willingness to accept price increases, I don't know that I've ever heard that terminology, a willingness. I don't think we've ever willingly accepted, I see Gary back there, willingly accepted a price increase ever from a supplier.

For us, I think the driving factor in how we think about that relationship with our supplier and the costs they pass through to us is making sure that we're competitive to the broader aftermarket, just like we know we need to be competitive in how we price to our customers.

And so I guess in that vein, we wouldn't view these types of cost pressures different than the price of raw materials or things of that nature. To the extent that it's broad based and a lot of the participants in the market experience it and it's being passed on, then we'll end up having to accept some of that and, in turn, passing it on to our customers.

I think we probably view it a little bit differently than the price of steel or lead or labor rates, in that it's truly not an operating cost. I know that some of the other financial statements might show it differently. For us, we view it as a cost of capital to support an investment that our suppliers have made in our partnership, and it lines up with the significant investment we've made in 5,900 stores and lots of distribution centers, in systems and training of our Team Members to be in a position that when the customer needs a part that we're there to supply it and be sure that it's the right part and it's when our customers need it. And we're a partner to our suppliers in that.

So that requires a lot of investment on our side, and it requires a lot of investment on the part of our supplier partners. And they've done that and you've seen that in the terms that we receive in the industry. To the extent that that gets more expensive for everyone and we see that pass through, then we'll have to adjust to that. There's absolutely a case where that's not true across the entire market. Not everybody utilizes the financing programs. Or not everyone is capitalized in the same way. We might find that there are competitive imbalances in how that works, and we would deal with that just like any other negotiation we have in accepting a cost increase.

But certainly, a willingness, there's no willingness involved, just so everyone is -- like, our merchants are down the road, and they would not want me to hear anyone talk about a willingness to accept a cost increase.

**Unidentified Analyst**

So back to fill rates, 220 days or so of inventory now. And look back historically, maybe 250 days. Do you have any thoughts on what's the optimal rate to optimize those fill rates? And is there a plan to kind of get back there?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Ultimately, we want to get back to what historical levels would have looked like for us. We are in a business that is heavily reliant upon having the part when someone needs it. So that becomes a significant pain point. And I think if you had a group of our operators in the room, folks running our districts and regions, and they heard this conversation about, I mean, it's great that you've maybe outperformed the market in having inventory availability that others haven't had, they would look at us like, "Are you kidding? I haven't had this and this and this." Even though a lot of those things have gotten better.

So for us, one of the things that I think is really key as we move past this period of time where we've seen a lot of disruption is to not allow COVID-level expectations or allowances to set in and become a permanent part of how we operate. We have to go back to a level of execution and a standard that existed before we were all in a position where we just had to do the best that we could in the conditions that we were in.

And that involves supply chain. It involves execution. Really, all throughout our company. And that's a big emphasis for us right now, is to ensure that we're getting back to where we need to be from that standpoint.

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**Unidentified Analyst**

And just staying on the balance sheet, you repurchased \$2.9 billion of stock this year, thank you, and currently only hold about 1.8x net debt to EBITDA. So going forward, kind of what are your capital allocation preferences? Are you willing to buy -- what are your capital allocation preferences?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

I'm going to stop hogging the mic and dodge this question for Mark.

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**Mark Merz** - *O'Reilly Automotive, Inc. - Senior VP of Finance*

Well, we have -- we bought -- through the date of the call, we actually crossed the \$3 billion mark in share repurchases this year. So certainly a new record for us.

From a capital allocation standpoint, nothing has changed. Our first priority has always been and will continue to be reinvesting in the business. That's been the best return for our shareholders over the long term, is to continue to execute on our model and grow the business, and that's going to continue to be the first use of capital.

Consolidating the industry is also a high priority for us. But as Jeremy talked about earlier, those opportunities at the right valuation don't come along all the time. We certainly consistently look at opportunities that are out there, but we don't do every deal that comes along because it doesn't generate the return that we would expect over the long term.

So after we've successfully reinvested in the business, to the extent we can get a great return, we're very fortunate to generate more cash than we can use to reinvest in the business. And so we use the last best use of our capital, which is our share repurchase program. For us, it's the icing on the cake. Growing operating profit dollars over the long term by executing our business model is what drives long-term shareholder value. The share repurchases just adds incremental benefit to that.



We don't -- we hadn't planned to be at the leverage ratio we are today. We wouldn't expect to be at that, and we will continue to move towards our stated 2.5x when it's appropriate. We've been in a very fortunate situation over the last couple of years to generate a heck of a lot of cash out of the business because of the strength of our operations. Because of the strength of our store operators, the high service levels, we've grown very profitably over the last few years and had used that cash that we've generated from the business for the last best use, which is share repurchases. It doesn't make sense for us to take on debt just for the sake of taking on debt if you don't have a good use of those proceeds to grow the business.

So we do still feel like that 2.5x is the right ratio to run the business. Our opportunities for capital allocation haven't changed. And we'll continue to redeploy the cash that we generate in the business to generate a good return. And to the extent we could get back into a borrowing position over time, then we intend to do so.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Maybe the only thing I would add is as we think about the cadence and timing of share repurchase program, I think our overall thought process and strategy of that is still the same as it's always been. We always evaluate the levels at which we're willing to buy the stock back based upon how we view the prospects of the business and how we model out future cash flows and view those from a discounted perspective versus the buyback.

I think for us, I think foundationally, one of the things that we think is very valuable and important about our repurchase program is our ability to be a consistent repurchaser because of the cash flow dynamics that Mark talked about. Significant consistent cash flows allows us to be buying on a regular basis in a lot of market conditions. And we think that's supported by the value of our stock and is an appropriate way to run a program like that. We think that from a long-term perspective that makes the most sense for our business.

At the same time, that we will take opportunities to take advantage perhaps of times when we think there's a spot to be more aggressive. And we're very detail oriented. We're opportunistic in everything that we do. We like to say it's always a good time to buy O'Reilly stock. Some times are better than others. And when we see a time that we think is particularly opportunistic, then we'll deploy more. And we've had some of those opportunities this year, and we'll see moving forward.

But we certainly feel like the stock price that we could buy at today is supported by our outlook for the business, and we would continue to have some level of execution of a foundational part of our buyback program.

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**Unidentified Analyst**

And just to highlight that cash, I mean, \$3 billion of EBITDA in 2021 and only \$440 million of CapEx. So great job.

We did run over time. Thank you so much for being here, and thank you for doing so well this year. It's been impressive.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Thank you.

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**Mark Merz** - *O'Reilly Automotive, Inc. - Senior VP of Finance*

Thank you.

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