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ORLY - O'Reilly Automotive Inc at William Blair Growth Stock Conference

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PRESENTATION

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

All right. I think we'll get started here. For those of you I haven't met, my name is Dan Hofkin, and I cover O'Reilly Automotive for William Blair.

We're delighted to have with us today Greg Johnson, Chief Executive Officer and co-President. Greg has been with O'Reilly for over 30 years, was named copresident in 2017 and was recently promoted to CEO and co-President.

Also with us is Tom McFall, Chief Financial Officer, who's held that position at O'Reilly for 11 years and was previously with Murray's and CSK. And we also have with us Eric Bird, External Reporting and Planning Manager.

Before we begin, I am required to inform you that a full set of disclosures is available on williamblair.com. Also after this presentation, there is a breakout session in LaSalle A on the seventh floor, one floor down.

And with that, I'll turn it over to Greg. Greg, welcome.

Gregory D. Johnson - *O'Reilly Automotive, Inc. - Co-President & CEO*

Great. Thanks, Dan. Welcome, everyone. I've got a few slides for you today. Tom is going to copresent here at the moment. So let's get right into it.

First is our safe harbor statement. I'm not going to read the entire statement to you. I'm sure you guys have seen this before. It is available on our website and in our 10-K, if you would like to review it.

So first, a little bit about our company. O'Reilly Auto Parts was founded in 1957 by the O'Reilly family. Charles Francis O'Reilly and Chub O'Reilly worked for an independent parts store in town, is going through some changes, and they decided to go out on their own, took the original founding 13 team members with them, started our first store in Springfield, Missouri, again, in 1957. We had our IPO in 1993 on NASDAQ. And we have had 25 consecutive years of comparable store growth, record revenues, operating income and EBITDA.

For the past 30-plus years, we've executed our dual market strategy, servicing both our "do it for me" customers and our do-it-yourself customers. So I'm going to talk more about our dual market strategy later in the presentation.

But just briefly, when we say "do it for me" customers, we're referring to professional shops that we sell parts to the shop, that they install those parts to the end user. So if you go to an automotive repair shop to have your car worked on, that's what we're talking about when we say "do it for me." When we refer to do-it-yourself, those are the consumers that work on their own cars that come into our store and buy those parts to do their own repairs.

A little bit of statistics of our company. In 2017, our sales were just over $9 billion. Total asset value was $7.6 billion. Our DIY, DIFM mix was about 58%, do-it-yourself and 42%, "do it for me", again, I'll have some more details on our dual market strategy here coming up in the presentation.

Our market cap, as of June 11, was $23.3 billion. We currently employ over 76,000 team members across the United States. And as of the end of the first quarter, we operate at 5,097 stores across the U.S. We also operate 27 regional distribution centers across the United States that service our stores nightly.

A little bit about our industry. Drivers for our industry, the #1 driver for our industry is miles driven. And if you look at the chart there, the green bars represent miles driven since 1997, and the blue bars represent fuel prices over that same period of time.

The reason miles driven is so impactful with our business is there's just not a comprehensive mass transit system in the United States today. While there is in some metro markets across the U.S., consumers depend on their vehicles to get themselves back and forth to work and wherever else they may need to go.

There's a 25% increase in miles driven over this period of time from '97 to 2017. And if you look at the chart, you'll see a slight dip during the recession period, 2018 (sic) [2008] through 2013, and miles driven started to trend back around 2014.

Over that same period of time, you can see the relationships of fuel prices to miles driven. So during the time that fuel prices were higher, miles driven were a little softer, that was also during a recessionary period and fuel prices stabilized over the past 3 years and lower than they were.

More on the industry. The green bars on this slide represent light vehicle population, and the blue bars represents new vehicles sales, you saw relationships in new vehicle sales.

So as you see here, I'll grab my glasses, it's pretty small. As you see here through 2016, a lot of this is from the Auto Care fact book that we get as an industry. So the 2017 numbers are not add-ons to some of these slides. So through 2016 is actuals, 2017 and beyond are projections.

Light vehicle population. Again, during that soft period of 2018 -- or 2008, I'm sorry, through 2013, was a little softer than before and after that period.

We've seen a growth in vehicle population since then, and that is projected to continue to grow, maybe not at the same pace that it grew over the last 4 or 5 years, but the projections are for that to continue to grow.

Again, assuming things remained stable, assuming economy is good, miles driven stay stable and scrappage rates stay reasonable, you'll see that bullet point there reflects an average, over the past 10 years, the vehicle scrap rate has been about 4.95%. I think 2016 was around 4.2%. So as long as that scrap rate remains low and the economy remains stable, we expect that vehicle population to continue to grow.

Also on the bottom of the slide, you'll see that, that slide represents -- that chart represents the average age of the U.S. population. So you'll see that the age of the vehicle population continues to grow.

In 2017, it was a little over 9.5 years. And last year, it was a little over 11.5 years. And again, we see no reason that we'll not continue to grow the age of the vehicles.

This is kind of a busy slide. Several things I want to talk to you on this slide. First on the top left, that represents the store count for the top 10 auto parts chains in the U.S. and, again, that's based on store count.

So you can see within the top 10, the significant variance between AutoZone having 5,540 stores being the largest chain and Hahn Automotive being the tenth chain, having only 89. So there's a big swing.

If you look at the top 5, below the top 5, you drop down below 1,000, actually you drop down to 500. And below the top 3, you drop from 5,000 then to 1,000. So it drops off pretty quickly.

To the right of that, the industry slide there, represents the store count over the past 10 years in the U.S. And while there's been slight fluctuation, the store count over the past 10 years has stayed very close to that 36,000 mark.

What has changed is the ownership of those 36,000 stores. In 2007, approximately 41% of those stores were owned by these top 10 chains. In 2016, that grew to 53%. So there's been a lot of consolidation within our industry.

When you look at the size of the aftermarket, as defined by the Auto Care Association, they say the market is about $287 billion. That includes auto parts sales, that includes labor and repair, that includes tires and other things. We say that our addressable market is around $90 billion. We don't sell tires. We don't service vehicles. We don't sell glass. We don't sell body parts. When you strip those out, the remainder of the addressable market for us is around $90 billion. So we represent about 10% of that addressable market today.

Next, I want to talk a little bit about our business model. Our mission statement is to be the dominant auto parts supplier in all of our market areas.

If you ask any of our team members what our mission statement is, that's what they'll tell you, that's who we are. No matter how our business is performing, in any given market across the U.S., every one of our team member wants to grow the entitlement, grow our market share in each of their markets.

So there's 4 slides to follow before I turn this over to Tom, and I'm going to talk a little bit more about dual market strategy, and I'm going to talk about our inventory availability and our supply chain, then I want to talk about our capital deployment and our growth focus and wrap up on our culture-driven leadership.

So first, dual market strategy. As I described earlier, we sell parts through both channels, both the DIY channel and the DIFM channel. So if you walk in to one of our stores today, what you would see is you would walk into the store and, hopefully, most everyone in here has been in one of our stores. But as you walk in to one of our stores, you see a traditional retail-type environment, you'll see an auto parts counter with our service specialist there to help you with your transaction to help you determine what you need to repair your car. You'll see a storefront with a lot of self-service type items, accessories and then behind the counter is where all of our application-specific products are. Those are the products where you typically have to have an electronic catalog to look at those parts.

In other words, an alternator may fit to 2 different years of 1 application is all that fit. So we have to look those parts up for your car. So those are behind our counter.

What you don't see when you walk into our stores is another service counter in the back of our store. So in the back of our -- most of our stores in the back, you'll see another parts counter with a set of catalogs and telephones, with what we referred to as installer service specialist, who are back there interacting with our DIFM customers. They're interacting with those professional customers that operate in multiservice bay shops. And you'll see small white pickup trucks, cars, whatever we use in those markets to deliver products.

So as you walk into our store, you really don't know that other segment of the business exist. It looks just like a traditional auto parts retailer, but that's what our model looks like from within the store.

So that does several things for us. It provides greater market penetration and reduces vulnerability to competition. And it's a very scalable model. I mean if you go into some markets, there may be a store that is 80% retail and 20% DIFM. There may be another market that's 90% DIFM and 10% retail. In that market, we may have a smaller storefront than we would have in the other market because it's more of a commercial market area. So it varies by market, but it's a very scalable business model that we can scale to whatever market conditions we're in.

Sometimes those market conditions could be in a broad market. In a metro area, there may be one part of town where there's a lot of repair shops that we don't do much retail business, and another part of town that retail is growing in, where we do a lot of retail business out of that store.

It leverages our existing retail store locations and extensive distribution infrastructure, which I'll speak more to here in a moment. And enhance the service levels offer to our do-it-yourself customers. Again, those customers that come into our store to do their own repairs.

Parts availability is key in our industry. We have to be competitive on price. But the key driver to making buying decisions in our industry is inventory availability. So we have a very robust supply chain at O'Reilly Auto Parts. We operate 27 regional distribution centers, and over 330 hub stores locations to supplement that.

So if you look at it as a layer distribution model, your average spoke store would link either directly to a distribution center or to a hub store, which gives them a second layer of parts availability. So those 27 distribution centers, they provide overnight delivery to all of our stores within the continental U.S. every night. The exceptions would be Alaska and Hawaii. We don't service those markets 5x a week because those are service by ocean freight.

But for that, the U.S.-based -- continental U.S. stores, they get replenishment orders and special orders for hard to find parts 5 nights a week. They also get multiple deliveries per day from either their linking hub store or distribution center.

So if you walk into one of our stores today, and you need a part, it's a hard-to-find part, and we don't have stock in our store, there's a really good chance that we could have that part for you within an hour or so, either from a hub store or distribution center.

If it's a really hard-to-find part that we haven't before deployed to a hub store, and there's not a distribution center in that market, we'll tell you, we can get it for your typically the next day through our distribution. So that overnight replenishment also aids in those hard-to-find parts getting those to the customer next day.

So from a SKU count perspective, our distribution center stock an average of 157,000 SKUs. Some of our smaller distribution centers would stock less than 157 [157,000]. Our larger regional distribution centers would stock up to over 170,000 SKUs.

Next, I'll talk a little bit about our growth focus and our capital deployment. First and foremost, as I said earlier, if you go into any markets that we do business in, we are always looking for market entitlement. We are always looking to grow our competitive market share in that market.

So for every store we have out there today, we feel like there's an opportunity to grow our market share in those markets. In addition to that, we have plans to continue to expand our operations further into existing markets as well as into new markets.

In 2017, we opened 190 net new stores, we ratcheted that back a little bit from 210 the prior year because we made a strategic acquisition in the Northeast, and we had to convert 48 stores to the O'Reilly model from the Bond Auto Parts bottle. We bond auto supply in New Hampshire and Vermont, had to convert those stores, change the storefront, do all the product changeovers and everything, and we're still able to open 190 net new stores.

In 2018, we plan to open 200 net new stores. And then beyond that, we continue to focus on consolidating the industry through strategic acquisitions.

In 2008, we acquired CSK. We made acquisition since then, smaller acquisitions like bond. There's not anymore acquisitions out there through the scale of CSK, but there are some smaller regional acquisitions that we would consider as well as expanding beyond the U.S. borders.

So first and foremost, from a capital deployment standpoint, we deploy our capital to grow our business, to grow our store count, to grow the number of distribution centers we have, to provide a higher level of service and grow ourself. Beyond that, As Tom will speak to, we use that sometimes to buy back stock beyond with our free cash flow.

My last slide is about our culture-driven leadership. It's something that I'm very passionate about. Having spent 32 years -- or 36 years with the combined companies. I've been in the automotive aftermarket for 36 years, the first 19 were at Mid-State Automotive Distributors in Nashville. Mid-State was acquired by O'Reilly in 2001. I came to O'Reilly with that acquisition and have been with O'Reilly now for over 17 years.

But one of the things that coming in from the outside that I noticed, was the focus on the culture, and that dates back to the O'Reilly family. I mean, our culture values are not something you just see on a banner on the wall. It's something we believe in. It's something we live every day.

And our corporate office, if you sit on a meeting in our corporate office, we start those meetings talking about our culture, telling culture stories, things that we've seen, things that we've done, things that we've experienced in our day-to-day lives that represent our company culture. It can be stories about Charlie O'Reilly walking into a store 20 years ago. And he may have visited 8 stores that day and knew every team member's name in every one of those stores. Or Charlie O'Reilly, who was our president at the time, walking around the parking lot picking up cigarette butts. There's just countless stories about the O'Reilly family and the things that we've done to build this business, to build a strong business culture that we practice at O'Reilly, and we're very proud of that.

Another thing that we're very proud of is our promote from within philosophy. We do a really nice job of bringing people into our company at entry-level positions. Greg Henslee and David O'Reilly started at the grassroots. Greg started out working the parts counter, I started out stocking shelves in the distribution center.

We bring people in to entry-level jobs. We provide them with technical training and give them opportunities to grow with the company, and it's a win-win. It creates career opportunities for our team members, and it allows us to grow leadership within our company that's extremely knowledgeable about our industry at all levels. These are people that have done the jobs.

So if you look at our district managers today, the makeup of our district managers, every one of those district managers were our very best store managers, and the same story holds true as you move up the ladder.

So there's a few stats on here. If you look through here, we've got 10 divisional managers with 18 years of service; 190 senior managers with 19 years of service; 244 corporate managers, with an average of 16 years of service; and 496 district managers who averaged 12 years of service.

That's very important to us. So if you ask me today what the secret sauce was at O'Reilly Auto Parts, what it enables us to perform the way we do, execution is a big part of it. Supply chain, our supply chain model is a big part of it. But fundamentally, I think some of the key components of our success are our company culture, our promote from within philosophy and our professional parts people.

So with that, I will turn it over to Tom.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO & Principal Accounting Officer*

Thanks, Greg. We'll finish up with a few highlights from our financials, and then move on to Q&A. Q&A is downstairs. Right, Dan? Okay.

So first quarter, we performed pretty much right in the middle of our guidance, 3.4% comp, 18.5% operating profit. We did buyback $0.5 billion of stock. As Greg talked about, we're going to use the combination of average buy and opportunistic acquisitions when we buy back stock.

Just as a reminder, our guidance going forward doesn't include any future share repurchases. When we look at our capital deployment, our capital deployment strategy hasn't change.

First thing we're going to do is invest in our existing store base and our existing distribution infrastructure to make sure we can maintain great comparable store sales growth. Then, we're going to open stores. Third, we're going to opportunistically execute acquisitions. And last then will be share buyback.

When you look at the second quarter guidance that we are right in the middle of our guidance for the first quarter. Our second quarter guidance is in line with the beginning of our year plan, 2% to 4% comp, earnings per share of $3.95 to $4.05. And our full year guidance remain unchanged, except for the flow through of the additional shares that we've purchased in the first quarter.

Profitable long-term growth. So we did a big change in our tax rate this year, about $215 million of cash savings with the newer lower tax rate. We're going to reinvest part of that in the business. Our strategy is to continue to grow profitable business, we try not to take on any business that we can't sustain at the margins and the service levels that we initially offer.

When we look at that reinvestment, we will reinvest approximately $30 million in CapEx by nearly related to technology both from a corporate standpoint and in-store technology. And about 70 basis points of operating profit headwind for this year, primarily related to store payroll, and we expect to continue to see pressure on entry-level wages, and that will cascade up through our wages, making sure we maintain a technically proficient staff of high-quality motivated people that live the O'Reilly culture is key to continue to take care of customers.

We're going to continue to execute and enhance our omnichannel strategy, the way by which we attract customers. Our store continues to change and evolve as we change and evolve as consumers.

We continue to believe that the vast majority of auto parts will be sold through a store. On the professional side of the business, they're looking for 30-minute delivery to keep the tax busy. On the DIY side of the business, people want to come to the store because they need technical advice, they need immediacy need, they need [owner fuel] program, they need to have returns, they need a lot of help to make sure that they can execute their program and maintaining that professional parts person is critical to our success. And then the last item is improving in-store technology. We do a lot to monitor productivity by team members. And to the extent that we can give those team members tools to be more productive, it enhances our service levels.

Do we have a minute here, Eric? Dan, do we have a minute? Okay. So we usually start with a culture statement, as Greg said. So we're going to finish our meeting with an O'Reilly culture statement. So here's our culture statement, and I'm going to pick safety in my culture value. So as Dan told us, 2012 was the last time we were here at this conference. So this is my example of safety, at O'Reilly safety is important.

Greg Henslee and I flew in to do the conference, and we picked up a rental car, and we get halfway here. And we realized, they gave us a rental car with no gas. So we had to pull over and we had to get gas. And we're from Springfield, Missouri, it's not quite the metropolis that Chicago is, and the traffic was really bad and you were going to be late. So we're driving, and we're almost here, and I'm driving. And we pulled up. And I reached -- well, we're about a block away, and I reached back into the backseat to get my coat, and I heard a big rip. And I'm like, "Oh, Greg, did I rip my shirt?" He was, "Oh, it's not that bad, don't worry about it." I said, "okay." So we get here, we pull up, we splurge on valet because we're really late, and we go up to the room, and I take my jacket off, my shirt is just totally ripped down the side.

And I said, "Greg, my shirt is ripped terribly, why did you tell, it wasn't that bad?" He said, "I want to make sure we got here safely." So that's our culture statement for today. We appreciate you guys sitting down and taking time. We're going to go downstairs to answer your questions. So thank you very much.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Breakout is in the LaSalle A (inaudible)
