

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

EVENT DATE/TIME: JULY 26, 2018 / 3:00PM GMT



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

CORPORATE PARTICIPANTS

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

Jeff M. Shaw *O'Reilly Automotive, Inc. - Co-President & COO*

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

CONFERENCE CALL PARTICIPANTS

Benjamin Shelton Bienvenu *Stephens Inc., Research Division - Research Analyst*

Bret David Jordan *Jefferies LLC, Research Division - Equity Analyst*

Christopher James Bottiglieri *Wolfe Research, LLC - Research Analyst*

Christopher Michael Horvers *JP Morgan Chase & Co, Research Division - Senior Analyst*

Daniel Ray Wewer *Raymond James & Associates, Inc., Research Division - U.S. Hard Line Goods Analyst*

Elizabeth Lane Suzuki *BofA Merrill Lynch, Research Division - VP*

Kate McShane *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

Matthew Jeremy Fassler *Goldman Sachs Group Inc., Research Division - MD*

Michael Lasser *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Scot Ciccarelli *RBC Capital Markets, LLC, Research Division - Analyst*

Seth Ian Sigman *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Seth Mckain Basham *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Simeon Ari Gutman *Morgan Stanley, Research Division - Executive Director*

PRESENTATION

Operator

Welcome to the O'Reilly Automotive Inc. Second Quarter 2018 Earnings Conference Call. My name is John, and I'll be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded, and now I will turn the call over to Mr. Tom McFall. Mr. McFall, you may begin.

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

Thank you, John. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our second quarter 2018 results and our outlook for the third quarter and full year 2018. After our prepared comments, we'll host a question-and-answer period.

Before we begin this morning, I'd like to remind everyone that our comments today contain forward-looking statements, and we intend to be covered by and we claim the protection under the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You can identify these statements by forward-looking words such as estimates, may, could, will, believe, expect, would, consider, should, anticipate, project, plan, intend or similar words. The company's actual results could differ materially from any forward-looking statements due to several important factors described in the company's latest annual report on Form 10-K for the year ended December 31, 2017, and other recent SEC filings. The company assumes no obligation to update any forward-looking statements made during this call.

At this time, I'd like to introduce Greg Johnson.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

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

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts Second Quarter Conference Call. Participating on the call with me this morning are Jeff Shaw, our Chief Operating Officer and Co-President; and Tom McFall, our Chief Financial Officer. David O'Reilly, our Executive Chairman; and Greg Henslee, our Executive Vice Chairman, are also present.

It's my pleasure to begin the call today by congratulating Team O'Reilly on a strong second quarter and a solid first half of 2018. Our team's proven ability to provide superior service and the great value drove our second quarter comparable store sales increase of 4.6%, which exceeded the top end of our guidance range. As we discussed on our first quarter call, the second quarter got off to a difficult start as many of our markets experienced continued winter-like weather. But for the balance of the quarter, we benefited for more normal weather patterns as spring arrived and demand picked up at the end of April.

Our team of over 79,000 dedicated team members stepped up to the challenge by providing outstanding customer service and driving our strong sales results in the quarter. Our team remains committed to driving profitable sales growth with an unrelenting focus on taking care of our customers, and we are pleased to have driven an increase in the second quarter operating profit of 6.8% as compared to the second quarter of 2017, excluding last year's SG&A benefit from a legal reserve adjustment, which Jeff will touch on in a moment.

Our sales and operating profit performance, coupled with the continued benefit to net income from tax reform, drove an increase in earnings per share of 38% to \$4.28 per share, which also exceeded the top end of our guidance range of \$4.05 and is a testament to the unwavering commitment of Team O'Reilly to controlling expenses and providing the best customer service in the automotive aftermarket.

Now I'd like to provide some additional color on our second quarter comparable store sales results. We experienced weather-driven headwinds at the beginning of April as the unseasonably cold and wet winter in many of our markets pressured ticket counts, specifically on the DIY side of our business. With the onset of spring beginning at the end of April, our comp trends improved. And although April was the softest month for the quarter, it did contribute to our quarterly same-store sales growth. Our teams did an excellent job capitalizing on the pent-up demand and delivered our best performance of the quarter in May. As we move to the typical summer selling season in June, the hot weather in many of our markets was a contributor to the steady demand, and we have continued on a steady solid trend thus far in July, which is in line with what we would typically expect to see from a normal weather backdrop.

Similar to our first quarter, both our Professional and DIY sides of the business were positive contributors to our comparable store sales growth with Professional performing better as we saw strong ticket count growth on that side of our business again in the second quarter. As I mentioned earlier, our DIY ticket counts were pressured at the beginning of the quarter but stabilized with the arrival of spring weather. On a combined basis, our ticket count comps finished flat for the quarter. Average ticket continues to be a strong contributor to our comparable store sales increase, driven by the increasing complexity of vehicle repairs, a favorable overall business mix and continued effective pricing management. Similar to the past 2 quarters, we benefited from some modest commodity-driven inflation on same SKU pricing during the quarter.

On a category basis, we saw a solid performance broadly across hard part categories, with strength in categories such as ride controller brakes, in line with our expectations of typical maintenance and failure-related demand after a normal weather. As you would expect, we also saw good performance in typical spring maintenance categories as we move through the quarter as well as strong performance on hot weather categories, particularly HVAC and refrigerants in the back half of the quarter. However, these heat-related categories present a mix headwind to gross margin, which I will discuss in a moment.

We view the impact of weather we've experienced thus far in 2018 as in line with normal weather cycle for our business, and our expectations for the remainder of the year include an assumption of continued typical weather. Ultimately, swings in the weather balance out over the long term, and the strength of the automotive aftermarket is determined by the core underlying drivers of demand in our business of miles driven, the number in average age of vehicles and health of the consumer.

As we have indicated, outlining our comparable store sales guidance on the last 2 calls, we have a favorable outlook for these drivers in 2018 as employment and the economic outlook for consumers remain stable and the average vehicle age continues to increase. However, we expect to



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

face some short-term pressures to miles driven as consumers adjust to higher gas prices or otherwise respond to economic uncertainty, including any temporary disruptions to the economy from rising prices or the impact of tariffs. In addition, our guidance incorporates the headwind we will face from an additional Sunday in the third quarter of 2018 as compared to 2017. Sunday is our lowest volume day of the week and it's impacted -- and the impact of additional Sunday has historically been approximately few basis points headwind to the quarter comparable store sales. As a result of these factors, we're establishing our third quarter guidance at 2% to 4%. Based on our year-to-date results, our third quarter guidance and the difficult comparisons we face in the fourth quarter, we are maintaining our full year comparable store guidance to 2% to 4%.

For the quarter, our gross margin of 52.5% was an 8 basis point improvement over the second quarter of 2017 margin, which was within our expectation built into our full year gross margin guidance. As I discussed earlier, in the second quarter, we faced some gross margin headwinds from strong sales of hot weather categories, such as HVAC and refrigerants, which were significant contributors to our comparable store sales and gross profit dollar growth, but on average, carry a lower gross margin percentage. This mix headwind as well as continued headwinds from increased transportation cost were offset by a lower LIFO impact, which Tom will discuss in more detail.

We are leaving our full year gross margin guidance unchanged at 52.5% to 53%. However, we expect to continue to see some pressure from the mix dynamic moving forward, and we now expect to come in at the bottom half of that range. We continue to see rational pricing within our industry. We are closely monitoring the impacts of tariffs as well as other sources of potential inflation and remain confident in our industry's ability to pass through inflationary price increases. We also continue to expect our full year operating profit for 2018 to be within our previously guided range of 18.5% to 19% of sales. For earnings per share, we're establishing our third quarter guidance at \$4.20 to \$4.30, which, at the midpoint, will represent a 32% increase over EPS of \$3.22 from the third quarter of last year. We are also updating our full year EPS guidance to \$15.70 to \$15.80, an increase of \$0.40 at the midpoint, reflecting our second quarter comparable sales and gross profit performance and the share repurchase through the call today. I would remind everyone that our full year guidance includes the impacts of shares repurchase through this call but does not include any additional share repurchases.

Before I turn the call over to Jeff, I would like to again thank the Team O'Reilly for their solid performance in the first half of 2018 and continued dedication to consistently providing exceptional service to our customers every day. We remain very confident in the long-term drivers for demand in our industry, and we believe we are very well positioned to capitalize on this demand and increase our market share.

I'll now turn the call over to Jeff Shaw. Jeff?

Jeff M. Shaw - O'Reilly Automotive, Inc. - Co-President & COO

Thanks, Greg, and good morning, everyone. I'd like to begin today by congratulating Team O'Reilly on a solid second quarter and thank our team for their continued commitment to providing top-notch customer service. As Greg previously discussed, we saw a pickup in our business as we move through the quarter, and we're very pleased with the hard work and dedication of our team, which resulted in a 4.6% comp store performance in the second quarter.

Now I'd like to spend a few minutes discussing our SG&A results for the quarter. SG&A as a percent of sales was 33%, a deleverage of 54 basis points from 2017. However, as we discussed last time -- or last year at this time, our second quarter of 2017 included the nonrecurring benefit of \$9 million for a reduction to a legacy legal reserve. Excluding this onetime benefit from the prior year results, our SG&A delevered 15 basis points, which was better than we anticipated as our team drove strong sales while maintaining strong expense discipline. On an average per-store basis, also excluding the legal reserve benefit in 2017, our SG&A grew 3.2%, which was in line with our expectations.

As we outlined in our initial 2018 guidance, we're significant beneficiaries of tax reform and feel it's appropriate to allocate some of these savings back into the business to continue to improve the levels of service we offer our customers. The cost of these investments is the key driver of our higher-than-normal year-over-year SG&A per store growth. These investments are heavily weighted to enhancing store level, payroll and team member benefit plans. And we remain very confident that our commitment to taking care of the customer by ensuring that we're hiring, training and retaining the very best professional parts people in the industry will drive our continued strong performance. We continue to expect to follow our previously disclosed plan regarding these incremental investments, and we're reiterating our guidance for full year growth and SG&A per store of 3% to 3.5%.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Now I'd like to spend some time talking about our store expansion for the first 6 months of 2018 and our plans for the remainder of the year. We successfully opened 128 net new stores in the first 6 months and are on target with our goal of 200 net new stores in 2018. We continue to be pleased with the performance of our new stores and continue to be successful in identifying great locations across the country, with our store growth in the first 6 months of 2018 spread across 29 different states. Our store growth continues to be balanced between our expansion markets, with the heaviest concentrations in Florida, Ohio, the Mid-Atlantic and the Northeast and backfill in existing more mature markets, including Texas and the Western U.S.

Our ability to effectively enter new markets while also selectively expanding our presence in existing markets continues to give us a great advantage in selecting new sites, and more importantly, identifying, hiring and training outstanding store teams to provide excellent customer service in our new stores.

Our success in new store expansion wouldn't be possible without the continued outstanding support provided by our distribution teams. A key to a successful entry in a new market or the ability to remain the dominant supplier in existing markets is to equip very solid store teams with industry-leading parts availability. The teams in our 27 DCs located across the country set the industry standard with 5 night-a-week service to our stores, along with multiple deliveries throughout the day to our local stores and our hub stores, ensuring that we can be the first supplier to provide access to those hard-to-find parts. I'd like to congratulate our DC teams on a strong second quarter and thank them for their continued outstanding customer service. We'll have the opportunity to highlight the great work of one of our distribution teams when we host our upcoming Analyst Day in August at our Greensboro, North Carolina facility. This DC was opened in 2009 and was recently expanded from 300,000 to 500,000 square feet in 2017 to support our continued growth in the Southeast and Mid-Atlantic.

As I close my comments, I want to thank all of Team O'Reilly one for your continued dedication to our company's success. We've had a solid year so far, and we're in a great position to finish the year strong. Our current and future success is dependent upon providing the best customer service in our industry, and we won't rest on our past success but instead remain committed to outlasting and outservicing the competition, earning our customers' business each and every day.

Now I'll turn the call over to Tom.

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

Thanks, Jeff. I'd also like to thank all of Team O'Reilly for their hard work and dedication, which drove good second quarter results and a solid first half of the year. Now we'll take a closer look at our quarterly results and update our guidance for the full year.

For the quarter, sales increased \$165 million, comprised of \$103 million increase in comp store sales, a \$59 million increase in noncomp store sales, a \$4 million increase in noncomp nonstore sales and a \$1 million decrease from closed stores. For 2018, we continue to expect our total revenues to be \$9.4 billion to \$9.6 billion. As Greg had mentioned earlier, our gross margin was up 8 basis points for the quarter as we face the headwind from mix but benefited from LIFO. During the quarter, we continue to benefit from reducing acquisition cost in many areas, but these benefits were offset by increases related to commodity prices. As a result, we did not see a LIFO charge during the quarter versus a \$10 million charge last year. For the remainder of the year, we now do not expect to have a LIFO charge. However, this will be highly dependent on potential inflation on commodity pricing and tariffs.

The Tax Cuts and Jobs Act of 2017 have dramatic impact on our second quarter earnings and will continue to have a significant positive impact on our tax rate on a go-forward basis. Our effective tax rate for the second quarter was 21.5% of pretax income, including the benefit from tax deductions for share-based compensation, which reduced our tax rate by 3%. Excluding the tax benefit from share-based compensation, our effective tax rate of 24.5% was in line with our expectations. Year-to-date, our tax rate was 22.2% of pretax income, and we now expect our full year tax rate to be 22% to 23% of pretax income. Please keep in mind, changes in the tax benefit from share-based compensation will create fluctuations in our tax rate.

Now we'll move on to a free cash flow and the components that drove our year-to-date results and our guidance expectations for full year of 2018. Free cash flow for the second quarter was \$632 million, which is \$181 million increase from the prior year, driven by higher pretax income, lower



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

cash taxes and a reduction in our net inventory investment. For the full year, we're maintaining our free cash flow guidance in the range of \$1.1 billion to \$1.2 billion. Inventory per store at the end of the quarter was 601,000, which was up slightly from the beginning of the year and from this time last year. We continue to expect to grow per store inventory in the range of 1% to 2% this year as our ongoing goal is to ensure we grow per store inventory at a lower rate than the comparable stores store sales growth we generate. Our AP-to-inventory ratio at the end of the second quarter was 107%, which we anticipate we'll be able to maintain through the end of the year. Finally, capital expenditures through the first half of the year were \$224 million, which was down slightly from the same period of 2017 and in line with our expectations. We continue to forecast CapEx to come in between \$490 million and \$520 million for the year.

Moving on to debt. We finished the second quarter with an adjusted debt-to-EBITDA ratio of 2.2x as compared to our ratio of 2.12x at the end of 2017. The increase in our leverage reflects our May bond issuance in borrowings on our unsecured revolving credit facility. We are below our newly stated leverage target of 2.5x, and we will approach that number when appropriate.

We continue to execute our share repurchase program, and year-to-date, we've repurchased 4.2 million shares at an average price per share of \$259.42 for a total investment of \$1.1 billion. We remain very confident that the average repurchase price is supported by expected discounted future cash flows of our business, and we continue to view our buyback program as an effective means of returning available cash to our shareholders.

Before I open up our call for your questions, I'd like to thank the O'Reilly team for their dedication to the company and our customers.

This concludes our prepared comments. And at this time, I'd like to ask John, the operator, to return to the line, and we'll be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question is from Christopher Horvers from JPMorgan.

Christopher Michael Horvers - JP Morgan Chase & Co, Research Division - Senior Analyst

Can you talk about the weather a little bit more? Understanding that April was weak on the DIY front in the Upper Midwest and Northeast did have a very strong hot trend during the quarter. But as you look ahead, it would seem like your heavily weighted markets like Texas and the West Coast have really seen a spike in the heat, and I think that's expected to continue, particularly on the West Coast. So as you think about that, does that provide sort of this extended hot season, where you could continue to see that -- the performance in the hot weather categories and just driving the overall comp?

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

Sure, Chris. This is Greg. What I'll tell you is in the colder weather markets earlier in the quarter, we benefited from some of the failure breakage-type parts. When you're looking at chassis under car steering-type component, strong sales in those categories. And then in the hot weather markets -- and a lot of those cold weather markets, to your point, they were [particularly] hot, we had strong sales and rotating electrical HVAC, refrigerants, things like that. We certainly hope that the hot weather continues. And in our southern markets and markets where we've seen hot weather, we've seen favorable sales results, and we would expect that to continue if we continue the weather trend we have.

Jeff M. Shaw - O'Reilly Automotive, Inc. - Co-President & COO

Greg, I might add that the West Coast was hot last year, so we're up against some tougher comparables out there.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

And then so as you think about this, I mean, sort of a speculative question, but if you didn't have this 50 basis point headwind from the extra Sunday here in the third quarter, would you have considered guiding perhaps 3% to 5% in this quarter versus the 2% to 4%?

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

Chris, this is Tom. The 50 basis points is just math and calendar-based, as Greg talked about in his comments, and we put in our press release. We're also seeing some rising gas prices, which historically tended to dampen miles growth, and also it will impact especially our low-end consumer and their ability to afford items. So I think it's the combination of those items that led us to continue to give 2% to 4% guidance when we had a strong second quarter.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

But is it fair to say that the miles driven impact hasn't necessarily shown up in terms of trend?

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

That will be fair to say. Obviously, we don't have the latest miles driven data, but we haven't seen that in our business yet, but we're on a short period of the quarter.

Operator

Our next question is from Dan Wewer from Raymond James.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - U.S. Hard Line Goods Analyst*

Greg, I wanted to ask you about pricing strategies for our ship-to-home revenues as part of your online program. We look at these each week. This week, you're not offering any promotions. A couple of weeks ago, you're offering different types of promotions, 15% to 20%, depending on the ticket size. What are your thoughts about using this discounted strategy for ship-to-home and if there's any risk that it maybe jeopardizes the integrity of in-store pricing? And how do you think you'll go forward with the promotions on ship-to-home sales channel?

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

Sure, Dan. That's a great question. Glad you picked up on that. One of our competitors changed their strategy. They announced the strategy change last quarter, I believe. And we just anniversary-ed the rollout of our new website a couple of weeks ago, and we had some significant increases on our online -- through our online channel during the first year. But having anniversary-ed that, we're looking at different options, and we're testing a few things. To your point, we're testing different types of promotions online, and we're testing periods where we're not running promotions online. So we're in the process -- we just started that a few weeks ago. So we're in the process of really measuring the sales impact of the varied promotions as well as the on-off promotion cycle. What I would tell you about the price transparency to in-store pricing is, on a run rate, about 60-plus percent of our transactions are by online pickup in store. Even though we're running historically promotions online to provide consumer a discounted price online, those consumers are still ending that transaction our store. And we felt confident that one of the bigger reasons for that is, one, the immediacy of need; and two, the need for interacting with our professional parts people on the counter to get help with the installation to make sure they have all the parts they need to complete the job the first time.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - U.S. Hard Line Goods Analyst*

Okay. And this is a follow-up question on the tariff. We went through the 200 pages of items on this proposed list, and I was surprised how many auto parts were included. Can you talk about the elasticity or the inelasticity of demand you would expect if you were to attempt to pass prices through to the consumer?

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

Yes. First of all, Dan, I'll kind of give you a little history as to where we are in that process. When the tariffs were first announced, we immediately reached out to our supplier base and started trying to understand which categories would be impacted. And broadly, when you look at that 60-plus page document, there's a lot of categories that, at face value, you would expect to be included in the tariff rate. To date, we've only had a couple of suppliers that have imposed any type of tariff on us and a couple or more that are coming during early fourth quarter. And none of those tariffs to date have been at full 25%. They've been fractional based on either being a component of the product that were subject to tariffs or other varied reasons based on their overhead manufacturing cost. So far, we haven't seen a big impact, but what I would tell you is, historically, our industry has done a really nice job of passing that along. And thus far in the year, both from an inflation and a tariffs standpoint, we have been able to pass that along.

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

And to add to that, where we see pricing being more elastic are on commodity items and performance in dress-up, items that are necessary to run your vehicle where you can extend that maintenance cycle. And oil, obviously, has gone up and down a lot over the years. And as the price goes up, we see people extend how long they'll do -- how often they'll do oil changes, but most of the parts are required to operate the vehicle safely.

Operator

Our next question is from Ben Bienvenu from Stephens, Inc.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

I wanted to ask, you made some commentary around seasonal maintenance repairs, but I wanted to get a sense as to whether or not you're seeing any evidence of carpark-related maintenance repairs that might give you a sense that the background trends and the secular environment are improving as it relates to the car park?

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

Yes. We see -- when we look at our partners through the quarter, there's a lot of things that are contributing to our increased sales this quarter. We talked about some of those things, and one of them would be the car park. And each of our inventories and each of our stores is really customized for that store based on specific VIO. Some of the repairs, it's hard to differentiate if it's a result of winter weather, for example, or breakage or just the cycle of doing those routine repairs. But I would say that there are categories that we have seen some improvement. I think brakes would be one of those. I think battery replacement would be another.

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

In aggregate, last year was a softer-than-expected Professional business as those vehicles from the late SAAR years continue to enter the beginning of really our sweet spot. And the younger the vehicle, the more apt it has to be repaired by a professional. So the strength year-to-date in the Professional business makes us feel good that we've seen the worst of the SAAR years come into our market. And as opposed to being a headwind, it should be flat and then, over time, return to a tailwind.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

Understood. That's helpful. And then I wanted to ask a question about the traffic versus ticket mix of your business. You delivered strong comps year-to-date. Primarily, ticket-driven, that's not inconsistent with the past. But I'm curious about what environment you would need to have to see traffic perk up in your business over a given period of time?

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

When we look at our traffic versus average ticket this year, the strength of our average ticket is really driven by strong performance in our under car categories and more extensive repairs, especially on the professional side of the business, which carries a higher average ticket. In aggregate, from a ticket standpoint, to see stronger positive results, we will need to see stronger DIY counts because of the lower average ticket but higher traffic volume, which has a bigger impact on our overall business as we saw in '14, '15 and '16.

Operator

Our next question is from Simeon Gutman from Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

I wanted to ask first on DIY, which looked pretty strong. I wanted to just ask generally why. Tom, you mentioned that you're not seeing any impact yet from gas prices. So is the strength more weather-related? Or do you think your share gains are accelerating there?

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

Well, we'll take a look and see what other people report. Obviously, we've always liked to do more business. The DIY really was the side of the business at the beginning of April that was under a lot of pressure as winter weather didn't allow people to get out and do normal repairs. And some of that business was just deferred to May. When you look at people getting out and cleaning up their cars, that business is lost for the season. But we continue to feel like we execute very strongly in the DIY side of the business, and we're going to do everything we can to take all the market share we can.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

My follow-up, it could be for Jeff or for you, Tom. Jeff mentioned the 3% to 3.5% SG&A per store growth. You're going to stick to that. I think that was about 70-or-so basis points of investment. It's probably early to talk about 2019, but I wanted to ask if we should expect this to basically just fully go away next year. Is that the right expectation? And is there any debate or logic to having you maintain some level of elevated expenses next year?

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

Okay. A lot of that will have to do with what the labor market looks like. This year, we talked about making that investment because we've had additional dollars to work with from the tax change. When we look at next year versus this year, this year, we didn't anticipate a lot of tailwinds from inflation within our top line. To the extent that there's broad-based inflation in 2019, we'd expect to have to drive expenses higher, but we'd also expect to have more tailwind in our top line performance to drive comp gross margin dollars to offset that.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Operator

Our next question is from Seth Sigman from Crédit Suisse.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

A couple of follow-up questions here. First, just in terms of commercial versus DIY. So your comps overall accelerated in the second quarter versus the first quarter. I'm just wondering, did you see that acceleration in both commercial and DIY? Obviously, DIY was impacted earlier in the quarter. It's just not clear if the comp was actually lower in Q2 versus Q1.

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

Yes, Seth. Both professional and DIY were positive. But DIFM, the professional side, was a larger contributor to the comp than the DIY side.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Got it. And then just outside of the risk statement around potential impact from gas prices. Is it fair to say that you feel better about the state of the DIY business once you got through that April weather? And just sort of where you are now?

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

Yes. I mean, we've seen -- and while it wasn't as strong as the professional side of the business, we're fairly pleased with the DIY side of our business, thus far.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Okay. And then just a follow-up on the investments. When you look at the employee count in the release, it does seem like it stepped up quite a bit this quarter. Could you just give us a sense of where you're investing? Is that store labor or other areas?

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

Yes, we're investing [ups] in store labor with the opening of all the new stores and increased focus on customer service. Also some headquarters department, adding staff to support omni channel initiatives and IT primarily.

Operator

Our next question is from Kate McShane from Citi.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

Just a follow-up on the question about the incremental investments. Just what are you expecting to see more of a return from those investments? Would it be as early as the second half of the year? Or would it be more meaningful for 2019?



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

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

Well, Kate, that's a great question. When we look at this year, our comps have accelerated from last year, and we think part of that is due to some of the pressures we saw last year, having more normal weather this year. But also that acceleration has to do with providing better customer service. So we feel like we're seeing a return on our investment. Now as Jeff mentioned in his prepared comments, in the second quarter, we spent the SG&A dollars we anticipated, drove higher sales, which speaks to controlling those expenses and leveraging better than we had anticipated.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

Okay. Great. And then my follow-up question is just on the macro drivers, gas prices are higher, as you mentioned. Is there anything else in the macro environment outside weather you're keeping an eye on or seems like it's changing? And is resulting in you keeping guidance at 2% to 4%, is it primarily just higher gas prices at this point?

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

I think you hit on the big one there, Kate. Gas prices and the potential impact, overall, miles driven would be the big economic concern that we will be seeing. Tom or Jeff, do you have anything to add to that?

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

We're in a different environment, and we haven't seen proposed tariffs like this in the past. Obviously, a lot of them are proposed. And yesterday, there was talk of pulling some of those back, so that creates some uncertainty. We'll continue to monitor that situation closely and take the appropriate actions.

Operator

Our next question is from Bret Jordan from Jefferies.

Bret David Jordan - *Jefferies LLC, Research Division - Equity Analyst*

As you look at this sort of more expansion on Ohio and Mid-Atlantic, how do you think about sort of distribution infrastructure servicing that market that's a bit further from the Devens DC? And I guess I'll ask my follow-up question. As you look into those central state markets, is the M&A environment materially different or better there? Are there potentially more targets?

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

Yes, Bret. We are constantly monitoring our distribution capacity across all of our market areas. And I'm going to kick this off -- I'm passionate, as you guys know, about distribution. I like to talk about distribution. But in fairness to Jeff, I'm going to kick this back to him in a minute. So we continue to look for opportunities. We still have capacity in Devens, and we've added capacity, obviously, as Jeff mentioned in his prepared comments, to Greensboro. But we do keep a very close eye on our distribution capacity and are planning accordingly. Jeff, do you want to add to that?

Jeff M. Shaw - *O'Reilly Automotive, Inc. - Co-President & COO*

You pretty well covered it. I mean, there's obviously a geographical void there that we're going to have to do something about here one of these days.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Bret David Jordan - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And I guess the M&A question, I mean, obviously, it smells like eastern down there in the Mid-Atlantic. But are there, in those markets, more targets that you would think about? Or maybe you could talk about how you think about M&A in general right now.

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

Every time we go into a new market, we look to see who's selling parts in the market. It might be one store, it might be a chain of stores, and see what the opportunity there is to team up with somebody to acquire existing relationships. And we have a very technical business, and having parts people is a challenge to continue to generate those internally, so we look for an opportunity to do that. What I would tell you on the M&A front is we are a very disciplined buyer, so we are always looking, but we are going to make acquisitions that makes sense for us from a return standpoint.

Operator

Our next question is from Elizabeth Suzuki from Bank of America.

Elizabeth Lane Suzuki - *BofA Merrill Lynch, Research Division - VP*

Can you just expand a little further on a comment about short-term pressure on miles driven? It seems like that trend has actually been slowing for quite sometime and over the last few years despite lower average gas prices and in 2014. So do you think this is really a short-term issue? Or are there some longer-term headwinds at play here that could impact the growth of the auto aftermarket?

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

Yes, and what I would say to that -- and I watched an industry analysis on this yesterday. Some of you may have seen the webinar as well from NPJ. I think the 3 years around the 2014 time that you alluded to were a period of higher-than-normal miles per driven growth across the U.S. And I think we're -- while this year we're probably lower than the normal increase in miles driven, I don't see that as a long-term trend. Fuel prices have increased for sure and may continue to increase. But I think the consumer has adjusted to these short-term 1, 2, 3 year swings in fuel pricing, and they don't see that, that fuel price will have a long-term impact on their ability to operate their vehicles.

Elizabeth Lane Suzuki - *BofA Merrill Lynch, Research Division - VP*

Great. And just as you've gone through that list of imported products proposed for tariff, the 10% tariff through that longer list, how much of an impact could there potentially be, assuming no change in where you source your product or prices you would negotiate with vendors or the prices that you could charge to the consumer?

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

We really haven't -- like I said earlier, there is a lot of uncertainty across our suppliers, primarily in China, where the bulk of these tariffs are falling. We're working closely with them. We don't know at this point what that exact impact will be. But again, we feel very confident that we'll be able to pass those increases along.

Operator

Our next question is from Chris Bottiglieri from Wolfe Research.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Christopher James Bottiglieri - *Wolfe Research, LLC - Research Analyst*

I wanted to start off -- it was interesting to hear the inflation being passed through on pricing. I was wondering if you could quantify what like-for-like pricing has contributed to comps this year, maybe as a proxy for how you could handle inflation next coming years. And I'll start with that.

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

Tom, do you want to take that one?

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

In the aggregate, it's less than 1%. What I would tell you is that category-by-category, it's been significantly more than that. Even though we have deflation in aggregate over the last 3 or 4 years, we've had certain categories that have had pretty big moves, and we've been successful at passing along those acquisition increases and maintaining our gross margin percentage.

Christopher James Bottiglieri - *Wolfe Research, LLC - Research Analyst*

Got you. That's helpful. And then just given where you're ignoring tariffs, just looking more like steel's price right now, aluminum, resin, oil, et cetera, I would take that your suppliers, even the Chinese ones, are seeing higher input cost. So can you maybe talk about how those discussions are trending and kind of like to what extent you think you're ignoring tariffs like you could see some inflation in the back half or into 2019?

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

Sure, while there may be more discussions taking place, they're really trending very similar to the way that they always trend. We don't openly take price increases. We push back to our suppliers every day during negotiations. And typically, those conversations will start at a given rate increase and end up either with no increase or a much lower rate increase through the hard work of our merchandise team.

Operator

Our next question is from Seth Basham from Wedbush Securities.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

My question is just on the guidance, the comp guidance, and your decision to hold it flat for the year. And when you think about weather, which you said was normal this quarter and you expect it to be normal in the balance of the year for your guidance, and you're also seeing a benefit from inflation, what's leading to the hesitation to increase your -- or keep your guidance flat despite the strong year-to-date performance? Is it simply your concerns about potential macro effects? Or is there something else?

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

Sure, Seth. When you look at the quarter, and as I said in my prepared comments, July started out solid, and we're pleased with the results thus far, and solid. That -- or in July, rather. That said, we're roughly 30% through the quarter, and there's a lot of quarter ahead of us. And based on the rising fuel costs that we've talked about, based on potential threats of tariffs, based on all of the things we talked about that contribute to this, and obviously, the thing we talked about most is the extra Sunday in the quarter that has historically had around a 50 basis point impact, we just felt it prudent to guide it 2% to 4%.



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

Operator

Our next question is from Scot Ciccarelli from RBC Capital.

Scot Ciccarelli - RBC Capital Markets, LLC, Research Division - Analyst

Scot Ciccarelli. A couple of questions on your private label business, specifically is your private label mix much different online than it is in the stores? And then secondly, have you historically seen your private label mix change much in an environment of rising gas prices/lower miles driven?

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

Yes, Scot. Our private label offering would be the same in store as it would be online. We offer -- with the exception of products that are really heavy that have high shipping cost or were unable to shift because of restrictions. Pretty much our full product offering that's available in the store will be available online.

Scot Ciccarelli - RBC Capital Markets, LLC, Research Division - Analyst

I guess I wasn't asking about what was available. I guess I was asking about kind of sell-through and mix.

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

It's similar. The mix is similar.

Scot Ciccarelli - RBC Capital Markets, LLC, Research Division - Analyst

Got you. And then have you typically seen -- or how much -- maybe the right question, Tom, is how much have you historically seen private label mix change in an environment of rising gas prices or lower miles driven? I would assume there's some sort of the trade-down effect. Just trying to get a feel for how much.

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

Well, every time we see economic uncertainty, there is some pressure on the high end grades. From a, clearly, private label standpoint, what I would tell you is really the significant growth in our private label is centered around the volume which we do and our ability to source high quality house brand products in a private label pack. Those have been the biggest drivers of the growth in that. But always during economic uncertainty, we see some trade down, which obviously creates a little bit of headwind on our sales. But those products tend to carry a higher gross margin percentage.

Operator

Our next question is from Michael Lasser from UBS.

Michael Lasser - UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines

You talked about a 1% contribution to your comp from inflation. It sounds like that was more than you saw in the first quarter. So was the bulk of the acceleration that you saw in your comps in 1Q to 2Q driven by accelerating inflation? And what have you factored in for the full year guidance into your comps about inflation?



JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

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

Tom, do you want to take that?

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

I may have misspoke, but the number is less than 1%, and it was pretty consistent through the first and second quarters and primarily related to commodity-driven items. Our expectation is that it will continue to see muted inflation within our guidance to the extent that we don't -- or we see acceleration of inflation across a broader bands. We'd expect to have more tailwinds in our top line sales.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

And Tom, as it happens, how will that impact your gross margin?

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

Whenever we take price increases, our expectation is that we are going to generate more gross profit dollars. There may be some slight pressure on gross the margin percentage, but our anticipation is that we're going to drive better comp gross margin dollars. We still anticipate that we will be within the range, as Greg said, but in the lower end of our previous stated gross margin range.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

And my follow-up question is, can you give us some sense for how much lower April was in the quarter overall in terms of the comp?

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

We don't give specific numbers, but what we did say in our prepared comments is that we generated positive comparable store sales in April. May was a better month, where we saw that pent-up demand released. So that's our comment on that.

Operator

Your next question is from Matt Fassler from Goldman Sachs.

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

I have 2 of them today. First of all, you're talking about gas prices, and obviously, we see the year-on-year increases. We've heard a lot over the past several years as gas has bounced up the bottom about thinking about both percentage changes in gas prices but also thinking about kind of magic levels be it \$3, \$4, what have you. Based on your observations of how consumers have responded to this initial round of energy price increase just really over the past year or 2, which do you think at this point is more important? And are you more focused on this now that we're kind of (inaudible) \$3 or certainly did so at the seasonal peak a few weeks ago? (inaudible)

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

Yes, Matt. We typically don't talk about a given price point at which the consumer changes driving habits because of fuel cost. We talk more about -- and what we think is more important is the rate of price increase, and it's been a fairly steady increase. You have some swings based on holiday,

JULY 26, 2018 / 3:00PM, ORLY - Q2 2018 O'Reilly Automotive Inc Earnings Call

travel, things like that. But looking forward, if fuel prices continue to rise at a faster rate, then a lot of our lower income consumers will be very selective on when -- where they spend their dollars. If that trend either starts to drop or rise at a very slight rate, we feel like the consumer will bake us much of that into their budget as they can.

Matthew Jeremy Fassler - Goldman Sachs Group Inc., Research Division - MD

And then my follow-up question relates to the car park you spoke, I think, generally speaking about the car park likely being responsible for the stabilization and perhaps improvement in the commercial side of the business. I know that you have a very good visibility to the demographics of the cars that you are servicing, your make and model, et cetera. Are you seeing within that evidence that this is starting to go your way, that as you make your way through that pause in the flow of older vehicles, that the right kind of cars are coming into your stores?

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

So 2 comments on that. As we talked about at the beginning of the year, we expected that, that headwind from the late SAAR years was going to neutralize this year, and we think we've seen that. What we also see on the professional side of the business is from the normal winter weather that we had seen a normal under car repair level of business, which is primarily a professional job. The -- where we would expect it to be after being down the last few years.

Operator

And we've reached our allotted time for questions. I will now turn the call back over to Greg Johnson for closing remarks.

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

Thank you, John. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued dedication and customer service in the second quarter. I'd like to thank everyone for joining our call today, and we look forward to reporting our 2018 third quarter results in October. Thank you.

Operator

Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating, and you may now disconnect.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2018, Thomson Reuters. All Rights Reserved.