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ORLY - Q3 2018 O'Reilly Automotive Inc Earnings Call

EVENT DATE/TIME: OCTOBER 25, 2018 / 3:00PM GMT



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PRESENTATION

Operator

Hello, and welcome to the O'Reilly Automotive, Inc. Third Quarter 2018 Earnings Conference Call. My name is Senarra, and I'll be the operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now 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, Senarra. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our third quarter 2018 results and our outlook for the fourth quarter and full year of 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 estimate, may, could, will, believe, except, 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.



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

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts Third 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 President, are also present.

It's my pleasure to begin our call today by congratulating Team O'Reilly on a strong third quarter and a solid first 9 months of 2018. The sales momentum we experienced in the first half of 2018 continued through the third quarter and drove our comparable store sales increase of 3.9%, which was at the top end of our guidance range. As a reminder, we faced a headwind in the third quarter from an additional Sunday as compared to 2017, which had a negative impact of approximately 50 basis points since Sunday is our lowest-volume day of the week.

We're also pleased with our team's ability to generate year-to-date comparable store sales growth of 4% through their unwavering commitment to providing excellent customer service. Our sales growth, combined with our team's relentless focus on profitable sales and expense management, generated a 5% increase in operating profit dollars as compared to the third quarter of 2017 at an operating margin of 19.5%.

In addition to our solid growth in sales and operating profit, we also -- we were also the beneficiaries of a substantially lower tax rate than expected, which Tom will cover in his prepared comments. This combination of operating performance, along with our ongoing share buyback program, drove an increase in the third quarter earnings per share of 40% to \$4.50 per share, which exceeded the top end of our guidance range of \$4.30 and is a testament to our team's efforts to provide unsurpassed customer service.

Now I would like to provide some additional color on our third quarter comparable store sales results. The composition of sales in the third quarter was very similar to the second quarter, and really, the full year of 2018, as we have seen a very consistent and stable trend throughout the year. Both our professional and DIY sides of the business were positive contributors to our comparable store sales growth with professional performing at a stronger level as we saw strong ticket count growth on that side of the business again in the third quarter, with the only sequential difference versus the second quarter resulting from the headwind of the additional Sunday.

DIY ticket counts continued to see pressure as customers on that side of the business are more sensitive to increased gas prices and inflation and are more likely to defer maintenance or repairs in the short term, particularly for lower-income DIYers. Average ticket continues to be a strong contributor to our comparable store sales increase on both sides of our business, 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 in the quarter. We'll begin to see same SKU-inflation accelerate as our industry passes through cost increases for the parts subject to the latest tariff, which went into effect on September 24, although we are working with our suppliers to minimize and delay this impact.

Moving on to the cadence of our comparable store sales growth in the quarter. Our monthly results, after adjusting for the impact of the extra Sunday in September, were consistently solid throughout the quarter as we began the quarter with continued steady demand in our typical summer selling season and saw the rest of the quarter play out within our expectations.

On a category basis, we saw strong performance throughout the quarter on weather-related categories, such as batteries and air conditioning, as a result of the hot summer weather. We also continued to see solid performance in key hard parts categories, such as brakes and ride control, in line with our expectations of typical maintenance and failure-related demand following a normal winter.

As you can tell from our comments thus far, our sales trends have been very steady in the year, including a solid trend thus far in October, which is consistent with what we would expect from a normal weather cycle for our business and also reflects the core underlying strength of the automotive aftermarket.

From a macroeconomic perspective, if we continue to have a favorable outlook -- I'm sorry, from a macroeconomic perspective, we continue to have a favorable outlook for the long-term demand drivers of our business as employment remains stable and average vehicle age continues to



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increase. However, as we look to finish out 2018, we remain cautious on the short-term impact to miles driven from pressure consumers as they -- pressure to consumers as they respond to higher gas prices and economic uncertainty from rising prices and impacts of tariffs, which could lead to incremental pressure to ticket counts from the short-term deferral by lower-income DIY customers. Our business can also be more variable in the fourth quarter, based on the holiday season and weather volatility, and we face difficult comparisons at the end of our quarter as the last 2 Decembers have benefited from favorable winter weather.

As a result of these factors, we are maintaining our fourth quarter guidance at 2% to 4%. While we do benefit from 1 fewer Sunday in the fourth quarter of 2018 versus 2017, the impact is offset by the timing of both Christmas Eve and New Year's Eve holidays, which fall on Mondays instead of Sundays this year, which will result in a lower professional sales volume as many shops run limited hours on those holidays versus a typical Monday. Based on our year-to-date results and fourth quarter guidance, we are raising the lower end of our full year comparable store sales guidance from a range of 2% to 4% to a range of 3% to 4%.

For the quarter, our gross margin of 53% was a 42 basis point improvement over the third quarter of 2017 margin, at the top end of our guidance expectations, built into our full year gross margin guidance. After seasonal mix pressures in the second quarter, mix was more favorable to our gross margin in the third quarter and we benefited from a lower LIFO impact, which Tom will discuss in more detail.

We continue to work with our suppliers to make incremental improvements in acquisition cost, but are also see modest inflation driven by commodity increases. However, we are pleased to see continued rational pricing within our industry to pass along those increases. We're beginning to see the early stages regarding the impact of tariffs, but expect to react to those cost increases in the same manner as any other source of inflation and remain confident in our industry's ability to pass through inflationary price increases.

We're leaving our full year gross margin guidance unchanged at 52.5% to 53%, but based on our third quarter results, we no longer expect to come in at the bottom half of that range. 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 fourth quarter guidance at \$3.60 to \$3.70, which at the midpoint, would represent a 4% increase over EPS of \$3.52 in the fourth quarter of last year, which included a \$0.62 benefit related to adjusting our deferred tax liabilities in conjunction with the tax law change. Excluding that benefit, our guidance midpoint would represent a 26% increase in the fourth quarter EPS. We're also updating our full year EPS guidance to \$15.95 to \$16.05, reflecting our third quarter performance and the shares we have purchased through the call today. I would remind everyone that our full year guidance includes the impact of shares repurchased 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 our team of over 80,000 dedicated Team Members for their solid performance thus far in 2018, and I'm confident our team will finish up the year strong. We remain very confident in the long-term drivers for demand in our industry, and we believe we are all very well positioned to capitalize on the demand by consistently providing industry-leading customer service to our customers every day.

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

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

Well, thanks, Greg, and good morning, everyone. I'd like to add my congratulations to Team O'Reilly on a solid third quarter and thank our team for their continued commitment to providing top-notch customer service. As Greg previously discussed, our sales trends in 2018 have been solid and very consistent, which reflects the unrelenting focus on customer service demonstrated by our teams every day in each one of our markets.

I'd like to begin today by talking about some exciting distribution center expansion news. When you truly focus on what excellent service really means for our customers, it's impossible to underestimate the importance of parts availability. Our ability to provide top-notch customer service in our stores is dependent on the work our distribution center teams do to get those hard-to-find parts in our stores faster than our competitors.



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Our long-term investment in a robust regional DC network is a key competitive advantage for us, and we're pleased to announce 2 new DC projects which will further strengthen our industry-leading position. First, we're pleased to announce we've acquired property in Twinsburg, Ohio, where we have begun to build our 28th distribution center. Twinsburg is located in the greater Cleveland area in Northern Ohio, approximately halfway between Cleveland and Akron.

As we've discussed often in the past, our greenfield expansion strategy has been to enter new markets contiguous to our existing footprint as we build toward a critical mass of stores to leverage a new DC in an expansion region. We followed that familiar game plan over the last several years as we've opened stores further east into Ohio, West Virginia and Western Pennsylvania, supported by our DCs in Indianapolis and Detroit. We've now reached the point where additional DC capacity is necessary to support continued store growth in this region of the country while also freeing up capacity in our existing distribution centers to allow us to take advantage of opportunities to backfill stores in existing markets.

The Twinsburg DC is a ground-up facility we plan to open in the fourth quarter of 2019 with the capacity to service approximately 275 stores out of a projected 405,000 square feet. In addition to adding overall capacity, the placement of this DC allows us to further leverage this investment by providing multiple same-day service to the approximately 130 stores in the important Northern Ohio market.

The second distribution project we're announcing today is our purchase of an existing facility in Lebanon, Tennessee, which is an eastern suburb in Nashville, and our plan to relocate our existing leased facility in Nashville and begin service out of this new DC in the first half of 2020. The new DC will be approximately 410,000 square feet and will have the capacity to service 300 stores.

Nashville and its surrounding markets have been very strong growing markets for us, and the additional capacity in our new Nashville DC will allow us to take advantage of continued profitable growth in the region and accommodate a broader SKU capacity to provide even better breadth of hard-to-find parts to our store teams in this market.

Before I move on from our discussion of these upcoming DC projects, I just want to express the confidence I have in our distribution operations teams, who have proven time and again their effectiveness in planning, building and seamlessly opening new distribution centers, often successfully executing multiple DC projects at the same time. With the dedication and support of this team, we're confident these projects will roll out with the same degree of efficiency that our past projects have delivered.

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 33.5%, deleverage of 62 basis points from 2017. On an average per-store basis, our SG&A grew 3.7%, which was at the high end of our expectations, as we continue to see pressure to wages and variable compensation as well as headwind in fuel expenses driven by increased gas prices and delivery miles driven. On a year-over-year basis, the deleverage resulting from higher-than-normal per store SG&A growth has been the result of our plan to allocate a portion of the savings from the new tax law to incremental operating expense dollars in 2018 to further enhance our best-in-class customer service.

As we are now well into 2018, we feel these additional investments have been prudent, and we're 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 continued strong performance. We remain on the same path to finish out 2018 in the fourth quarter and continue to expect full year growth in SG&A per store of 3% to 3.5%.

Finally, before I turn the call over to Tom, I'd like to finish with some comments about our store expansion thus far in 2018 and our plans for the remainder of the year and for 2019. We've successfully opened 171 net new stores in the first 9 months and are on target to hit our goal of 200 net new stores in 2018. As Greg announced in our press release yesterday, we've also set a new store target range of 200 to 210 net new stores for 2019. Our store openings in 2018 have been spread across 33 different states, and we continue to be pleased with our opportunities to identify great locations and open with great store teams to profitably grow our business in markets across the country.

Our 2019 store growth will follow a similar strategy to the past few years, with a balance between our expansion markets in Florida, Ohio, Pennsylvania, the Mid-Atlantic and the Northeast; and backfill in existing, more mature markets. As I mentioned earlier, our store expansion would not be successful without the amazing support of our distribution teams, and I'm confident we will continue to equip our new store teams with the tools they need to provide outstanding customer service, including the best parts availability in the industry.



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As I close my comments, I want to thank all of Team O'Reilly for their 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 by out-hustling and out-servicing our competitors, and I'm confident in our team's ability to do just that.

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 continued commitment to the outstanding customer service, which drove our solid performance in the third quarter. Now I will take a closer look at our quarterly results and update our guidance for the last quarter of 2018.

For the quarter, sales increased \$143 million, comprised of a \$90 million increase in comp store sales, a \$57 million increase in non-comp store sales, a \$3 million decrease 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.

Our gross margin was up 42 basis points for the quarter as we continue to experience stable merchandise margins and benefited from the LIFO comparison to the prior year. We did not see a LIFO charge during the quarter versus a \$3 million charge last year. And for the remainder of the year, we do not expect to have a LIFO charge as a result of our expectation of the impact of tariff-driven cost increases. Tariffs have had a minimal impact to our comps and gross margin thus far in 2018, but the list of parts subject to the 10% tariff is more extensive. However, we continue to expect to pass along cost increases from tariffs to our customers.

The Tax Cuts and Jobs Act of 2017 had a dramatic impact on our third 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 third quarter was 19.6% of pretax income, including the benefit from tax deductions for share-based composition, which reduce our tax rate by 3%. Excluding the tax benefit from share-based compensation, our effective tax rate of 22.6% was better than our expectations as we continue to refine our estimates of the impact of the Tax Cuts and Job Acts on our ongoing tax rate.

Also as a reminder, the third quarter rate is typically lower than the remainder of the year due to the tolling of certain open tax periods. We now expect full year tax rate to be 21% to 22% of pretax income. Please keep in mind, changes in the tax benefit from share-based compensation will create fluctuations in our quarterly tax rate as we've seen in the first 3 quarters of 2018.

Now we'll move on to free cash flow and the components that drove our year-to-date results in our guidance expectations for the full year of 2018. Free cash flow through the first 3 quarters was \$959 million, which was a \$254 million increase over the prior year, driven by higher pretax income, lower cash taxes and a higher 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 \$605,000, which was up 1% 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 store sales growth we generate.

Our AP to inventory ratio at the end of the quarter was 108%. We expect our AP to inventory ratio to moderate slightly during the fourth quarter as a result of seasonality, but we expect to finish the year at approximately 107%.

Finally, capital expenditures for the first 9 months of 2018 were \$350 million, which is on par 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 third quarter with an adjusted debt-to-EBITDA ratio of 2.15x as compared to our ratio of 2.12x at the end of 2017. The increase in our leverage reflects our May bond issuance and borrowings on our unsecured revolving credit facility. We are below our stated leverage target of 2.5x, and we'll approach that number when appropriate.

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We continue to execute our share repurchase program, and year-to-date, we've repurchased 4.9 million shares at an average per share price of \$269.52 for a total investment of \$1.3 billion. We remain very confident that the average purchase price is supported by the expected discounted future cash flows of our business, and we continue to view our buyback program as an effective means for returning available cash to our shareholders.

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

This concludes our prepared comments. At this time, I'd like to ask is Senarra, 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 comes from Matt Fassler from Goldman Sachs.

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

My first question relates to gas prices. So you cited gas prices and miles driven as a risk last quarter. You nonetheless came in towards the high end of your same-store sales guided range. Any thoughts as to how this is playing out in terms of consumer's mindset? And anything you can see in the traffic in the stores or the kinds of categories that are ebbing and flowing that would suggest that the increases in gas prices over the past several months have had any impact on the business?

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

Sure, Matt, be happy to answer that. We really have the same concern going into the fourth quarter that we had going into the third quarter. And that is that the -- with fuel prices rising, the impact is most likely on the lower-income DIY customers. And this quarter and third quarter and even earlier in the year, the professional side of our business has outperformed the cash side of our business. And we just -- I don't know if there's any specific evidence in the third quarter to substantiate that, but it is an ongoing concern. As fuel prices continue to increase or stay at a high level for a longer period of time, there's a better chance that it will impact the spending habits of our cash-strapped DIY customers, specifically in -- with them deferring regular maintenance and maybe postponing repairs where they can.

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

Great. And then as a quick follow-up. I know that the car park evolution really plays out over a period of years, but presumably, you have insights based on what you're selling as to whether we've seen a bottoming in the supply of vehicles best suited to your mix. Any sign -- if you think, not necessarily Q3 versus Q2, but this past quarter, the past couple of quarters versus the prior that -- versus the few that preceded it, as to whether the drag that the oil industry had experienced from car park vintage might be bottoming, if not turning.

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

Sure, in the past -- if you look back at 2017, as we've said, there were several, several things that impacted sales in 2017, one of which we felt was the impact of the SAAR bubbling in the car park. We have seen evidence this year, as we've reported, that the professional side of our business is improving, and that's where we expected to see the first improvements, was on that side of our business, as those cars that are coming out of the warranty cycle are more likely to go back to the shops to be repaired at that time. So the improvement in the professional side of our business is evidence that we're trending out of that bubble.

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Operator

Our next question comes from Mike Baker from Deutsche Bank.

Michael Allen Baker - *Deutsche Bank AG, Research Division - Research Analyst*

Two margin questions. One, when you adjusted the LIFO numbers that you give, it looks like your gross margins, excluding LIFO, were up this quarter. And that looks like an inflection point versus the last 4 or 5 quarters. So is that all just mix or are you taking prices? Is there something else to explain that inflection point?

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

Well, when we see inflationary prices, our industry has historically been able to pass those on. So we remain competitive on our pricing. What we would tell you is that the improvement year-over-year is primarily mix driven for the third quarter.

Michael Allen Baker - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And then as a follow-up to the margin question, as we look ahead to next year, can you provide any early insight into how we might think about gross margin and operating margin for 2019? After -- I think this year will be -- 2018 will be the second year in a row of declines. Any insight into whether this year will be the trough? Or how we should think about next year?

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

Well, there's a lot of activity that's going to occur between now and the end of the year, and there's another round of tariffs that potentially could go into a pack -- effect, excuse me, in January. So before giving guidance, and typically, we'll give our guidance on the fourth quarter call, there's some things that have to transpire for us to better be able to put numbers around that.

Michael Allen Baker - *Deutsche Bank AG, Research Division - Research Analyst*

So tariff outlook will have an impact, you think, to that outlook.

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

I think it'll have an impact on -- it will have an impact on what we see our average ticket doing, our comps doing and also our expenses.

Operator

Our next question comes from Scot Ciccarelli from RBC Capital Markets.

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

So we know that SG&A growth is exaggerated this year because of a bunch of labor investments. Obviously, you highlighted that almost a year ago at this point. But if we kind of think about past '18, what are your expectations for SG&A per store growth? Is it something similar to what we've seen this year, just given the incredibly tight labor environment? Or do we get something back to a similar cadence as we saw in, let's call it, 2017, 2016, et cetera?



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

Again, we'll give our 2019 outlook on our next call. As we talked about within this year and in relation to SG&A, we saw a step-function increase in our SG&A as we proactively looked at primarily our IT spend and our store payroll and raised those without the expectation of significant inflation in our selling price. On a go-forward basis, we would expect SG&A pressure to be reflected also in the goods that we sell, as is typical in retail.

Operator

Our next question comes from Matt McClintock from Barclays.

Matthew J. McClintock - *Barclays Bank PLC, Research Division - Senior Analyst*

I understand the conservatism that you're putting in your guidance from rising gas prices, and that makes sense, but how should I think about that lower-income consumer and the impact of rising gas prices at the same time; that the unemployment rate's at an all-time low and wage pressure that you're experiencing, and the rest of the retail industry is experiencing, everyone's experiencing, should actually increase their purchasing power.

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*

Okay. Gas price is one of the factors that will impact their discretionary income and their ability to fund their life. And when those costs go up, gas prices and expected impact of tariffs in average pricing of auto parts, they have historically attempted to defer maintenance. And we would expect that there's a potential that they will take a look at those inflationary price increases and stretch out their intervals of repair or delay repairs as long as they can. So that's what we've seen in the past. We will see how they react to these inflationary pressures as -- because it will also be a computation of what happened to their wages.

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

And Matt, to add to that, I mean, there were other components, too, that impacted our guide, other than just the inflation component and gas prices. As we discussed, December is a volatile month from us and it's really dependent a lot on weather patterns. And the past 2 Decembers have come with very cold weather, which has driven strong sales. And we're very hopeful for cold, wet winter; a cold wet December; early winter again this year. Also, we talked about the impact of the holidays. We talked about New Year's Eve and Christmas Eve falling on a Monday this year as opposed to a weekend last year, and that will result in some of our professional customers likely either being open shorter hours on a weekday, which are typically higher-volume days, or being closed altogether on those holiday eves. So there's several factors that impacted our fourth quarter guidance over and above just the rising fuel prices and inflation.

Operator

Our next question comes from Seth Basham from Wedbush Securities.



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

My question is also around inflation, specifically thinking about the potential for tariff rates going to 25% in 2019. I understand your confidence in your ability to pass along cost increases related to inflation, whether it be tariff-related or otherwise, but there's also the potential, as you called out, for demand destruction. In this instance, with such a large potential inflation ahead of us, would you consider not fully passing along some of those cost increases you face to keep the impact on demand to a minimum?

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

Seth, we have had very good success, as you pointed out, passing along what we've seen thus far. And thus far, this last round in September hit a lot more of our product categories than the first 2 rounds. The first 2 rounds were more so related to components and the third round in September was more related to finished goods. What I would tell you is that we push back on our suppliers, both from a -- the amount of tariff they're passing along to us and the timing of what they're passing through. And we didn't experience a full 10% and we don't expect to experience a full 25%, should that go into effect after the first of the year. But our plan is to try to push all that through.

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

Okay, fair enough. And my Follow-up question is thinking about some of the strategic implications of one of your large competitors, Advance Auto, forming a strategic partnership with Walmart. Would you guys ever consider forming a strategic partnership with any online marketplace? And what are your thoughts as it relates to that idea?

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

The concept of us partnering with an e-commerce company or a larger retailer is not something that we've considered. The Advance-Walmart deal is still relatively new, and frankly, we probably know as much or less about that than you guys do. All we know is what we've read. But today, we have really not even considered partnering with anyone outside of our own company and our own channels to sell auto parts. We are very focused on our omnichannel initiatives and e-commerce initiatives to make inventory more readily available to consumers over which ever channel that they decide to buy auto parts. But we've had no discussions about going outside of our company to sell parts on the Internet.

Operator

Our next question comes from Brian Nagel from Oppenheimer.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Bigger picture question. As sales have -- as you've commented in your prepared remarks, sales in this -- so far in this year have been much better and then much steadier. So clearly, a nice rebound from what was occurring several quarters ago. But as you look at the data, and you've mentioned, too, that you think the overall environment's getting better, whether it be the car park or other factors. But as you look at these larger, more macro, external factors, are sales now tracking with where they should be, given those factors?

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

Brian, yes. The short answer is yes. We always want those numbers to be higher. We're never, never pleased with our sales and we also always want to deliver higher sales than what we did the previous quarter. It's what we strive to do every year. But this -- we're tracking on plan this year. We're performing where we felt like we would perform throughout both the third quarter and the year-to-date. So we're relatively pleased.



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Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Okay. And then my second question is somewhat of a follow-up to Seth's question from a second ago. But with regard to tariffs, and clearly, you and your industry have had a very good history of passing along higher costs. But is there the potential now, with increased price transparency out there, that, that could limit, to some extent, your ability to pass along these costs? And have you looked at that or -- and considered that factor as we think about these potential tariffs?

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

Tom, do you want to take that one?

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

When we look at the base cost of the products we sell, no matter what outlet they're going through, those tariffs are going to hit those products the same amount. So there is disparity between what you can buy a part online for and you can buy a part in the store for. And there's also a tremendous amount of service that comes with the immediacy of need, our professional parts people, ability to test parts. Some parts, we'll change out for you. Ability to return something that didn't work, ability to pick up the same day something that you didn't have. And there's a tremendous value in that. So the effect that tariffs raise the price of all the goods sold, to us, we look at what's that price differentiation and what's the value? But we also have to remember that most of the price comparisons that we see out there are in branded parts, which are really not the DIY parts. Those are primarily professional parts. And there is an entry level private level product in virtually any category that's a much more economical fix, it meets OE specs, but much more economical fix for our DIY customers.

Operator

Our next question comes from Chris Bottiglieri from Wolfe Research.

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

Very good quarter, but I had just one metric I wanted to focus in on a little bit. Your new store productivity metric, as measured by the [difference in] revenue and comps divided by square footage, seemed to fall off a little bit. I know that nonstore decline is probably a piece of it and perhaps maybe slower DIY growth. Was there any timing in store count or anything else you can kind of call out that would have impacted the ramp up from new stores?

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

I would tell you that you should look at the numbers from my script, and they will be in the Q on -- what, nonstore, noncomp were. That was the big driver that had to do with just the timing of year end and how we do our new sales return reserves. But we are pleased with our new store performance. They continue to achieve and surpass our expectations. So we're going to continue to move forward. As Jeff talked about, we're going to go to arrange 200 to 210 new stores next year. And again, it's that accounting noise that's creating issues in your calculation.

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

Got you. The 6,000 -- I think you've historically said 6,000 was the right store potential and 6,500 if there's consolidation. Is that still the way you're thinking about kind of the long-term store potential when you think about your business?



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

It is at this point, yes.

Operator

Our next question comes from Michael Lasser from UBS.

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

Based on what you know now and all else being equal, if you pass through the tariff price increases you're getting into next year, what do you think the inflation contribution to your business, based on a like number of units, would be?

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

Again, we have another round of tariffs that may or may not come into effect. We also -- most of our suppliers have online -- or on-shore inventory, so we haven't seen all the price effects of the tariffs that we're going to see. We're also actively working to mitigate those. So making comments on next year's inflationary pressures at this point would be premature. So we will update everyone within our guidance, which we give detailed guidance, probably the most detailed guidance in the industry, and give quarterly numbers. So we will provide all of that information on our fourth quarter call.

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

And talk to -- could you, like, give us the contribution from inflation in the third quarter? And was there any impact from the tariffs as of yet?

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

Touch on that in my prepared comments. Inflation this year has been around 1%, pretty consistent per quarter. The tariff impact has been very minimal year-to-date, minimal in the third quarter. They've been primarily commodity-based. And we will see how it plays out in the fourth quarter, but expectation is that we will see more inflation.

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

And my follow-up question is if we look at the spread between O'Reilly's comp, GPC's comp, the retail sales data from the Census Bureau, the spread narrowed a bit this quarter now. Some of it's the timing of when the Sunday fell, but do you -- can you give us a sense for why your share gains might be decelerating a bit?

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

Jeff, do you want to take that one?

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

Yes. Well, I mean, we're pretty pleased with our quarter. I mean, we guided 2% to 4% and we came in at a 3.9%. So as Greg said earlier, we can always do better and we're always focused on doing better, but we're pretty happy with the results of the quarter. As far as what's going on in the field, I mean, we don't really see or hear anything on the street that would indicate that we're losing any share. The business is a -- as we spoke to



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in the past, is a highly fragmented business, especially on the DIFM side with 37,000 parts stores out there and there's really no underserved market. We have a tremendous amount of respect for all our competitors. But really, we focus on our business model, and that's really doing the best we can on the retail and the professional side of our business in each one of our stores all across the country every day.

Operator

Our next question comes from Christopher Horvers from JPMorgan.

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

How do you -- following up on the gross margin. How do you expect the mix to play out in the fourth quarter? Do you expect that mix benefit to continue? And then on the current price increases, is there any near-term potential benefit to capture some merchandise margin benefit on your existing inventory cost as you pass along the price increases, perhaps, ahead of that next order?

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

Yes. On the gross margin, we always plan for normal. So we would expect to have normal fourth quarter gross margins. On the price increases and capturing additional margin, it will depend on the cadence of prices that go out. What I would tell you is because there's so many price increases, we are working very hard with our suppliers do try to defer these price increases so we're actually paying them either through the inventory that we have or through the inventory that our suppliers have on shore. So I don't think there's a huge opportunity to raise prices in advance, and don't think that, that's our best approach.

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

Understood. And then just thinking longer term about passing through price increases. Is the pricing increase such that you expect to be able to maintain the merchandise margin rate? Or is the expectation that you get the inflation in the top line, and that drives better leverage on the fixed costs and in gross margin, and that allows you to maintain or potentially expand gross margin.

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

When we look at the straight math, our goal is always to maintain our gross margin percentage because we also have expenses that have the same inflationary impact on them.

Operator

Our next question comes from Bret Jordan from Jefferies.

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

Could you talk about regional performance dispersion, strong markets versus weaker markets?



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

Sure. Jeff, do you want to take that?

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

Well. I mean, really, it was about what you'd expect coming off a more normalized winter and a better summer across most markets. It was fairly consistent across the country. A couple of markets I would call out is the North and the Northeast had a very solid quarter. And the only other comment I would make would be that our Western markets maybe weren't quite as strong as the rest of the company. But that really is due to tougher compares from last year, and they really had a milder summer than normal out west. That didn't help, either.

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

Okay, great. And then a follow up. When you think about the environment with tariffs and the big players making more omnichannel push, does the M&A environment potentially get more active? I mean, as some of those smaller players might have a harder time just competing in this environment, do you see either more interested sellers? How you all be thinking about the next 12 months?

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

The players that are still out there that we would be interested in are good operations that have weathered a lot of storms and have good management teams and are well-capitalized. When we look at those opportunities, what we've seen over the last 2 or 3 years is that we're, as everyone knows, an opportunistic acquirer and consolidator and had success in that realm. But we need a motivated seller. And these companies that are out there, we're still looking at, are good companies, and it's more a timing thing for them than the economic environment.

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

Yes. Bret, I would add to that. Every year, we'll buy a few 1-, 2-store operations. And this year has really been -- the cadence of this year's acquisition is really no different than we've seen in the past few years. So I wouldn't attribute any change to tariffs or inflation.

Operator

Our next question comes 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*

I wanted to ask a question around the new DCs. Could you remind us what happens to the surrounding stores when you open up a new DC? Do they get a comp lift of any kind? And what happens with the DC capacity currently used for the nearby stores?

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

Well, historically, I mean, the stores that are serviced out of a hub store that do have a new DC open in their market, they've got a much greater SKU offering. They move from somewhere in the neighborhood of 60,000 to 70,000 SKUs up to 150,000, 160,000 SKUs. So they just have much more availability readily in the market. And historically, we have seen a little bit of a comp lift in those markets.



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

Kate, to add to that, what you're going to see as we move to an expansion market is the stores within a reasonable distance from the DCs will have same-day, multiple times a day, access to that DC inventory. And to really add to what Jeff said, from a hub store perspective, not much difference on the outside stores. They're receiving -- that are outside of that perimeter, they're receiving inventory from a different DC. That doesn't really impact them. The real benefit is to the stores that are within a city counter service area of the DC.

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

Okay, great. And if I could just ask just another comp lift, market share question. In the press release and in your commentary, you mentioned you're opening another 200 to 210 stores, based on your comp lift, increased market share. Is there something different that you're seeing in the market for these new stores that you're opening versus what you've done in the past with store openings?

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

As Jeff said in his prepared comment, we don't go into any underserved markets. So every market is competitive. We continue to have a lot of confidence in our business model and how we execute and our ability to take share in any market we go into. But we would tell you that it's been pretty consistent for a number of years, the competitiveness of each market. The one thing I would tell you is that when we look at the Northeast, as we saw on the West Coast, is that development time to get stores open take longer.

Operator

Our next question comes from Zach Fadem from Wells Fargo.

Zachary Robert Fadem - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Could you speak to the impact of weather and Hurricane Florence in the quarter compared to Harvey last year, particularly on the DIY side? And do you foresee any notable impacts of Hurricane Michael or the flooding in Texas to play out in your business in Q4 and ahead?

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

As far as Florence, I mean, we had roughly 100 stores that were closed during the event, mainly due to mandatory evacuations. So there's no doubt that it cost us some business. Our goal in any natural disaster is to get back in the stores as quick as we possibly can, ensure our team members' safety and then -- and they get back in the stores. Even though it might be a skeleton crew, at least get the doors open to be there for our customers. So we try to open back in the markets as quick as anybody to provide the post-hurricane supplies that the customers desperately need. I mean, there's a tremendous amount of goodwill created when your doors are open and you've got a family that's without power, potentially without power for days or weeks, and we can supply a generator where they can keep their food from spoiling or have some lights on. So anything that we would lose in the pre-hurricane, there's always some tailwind after the event. But it normally -- as we seen in the ones last year, it was somewhat of a push.

Zachary Robert Fadem - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Got it. And on the SG&A line in the quarter, I just want to confirm that the step change is -- it's primarily wages and some IT investments. And for Q4, is it fair to expect that the SG&A per store will come back to that 3% to 3.5% range that you've spoken about for the year?



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

That would be a fair estimate, and the components will be the same. We had some additional pressure on some other lines that put us above 3.5% in the third quarter.

Operator

Our next question comes from Simeon Gutman from Morgan Stanley.

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

Follow-up on the do-it-for-me business. You mentioned, I think, ticket positive. I missed it if you talked about traffic -- how traffic is trending, or I guess, transaction count in do-it-for-me.

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

Yes. So on the DIFM side of the business, both were positive.

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

Okay. And is that rate -- has that rate changed a bit during the year? Is it accelerating? If you could -- to sort of support the comment that we're getting past that bubble.

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

It's remained pretty solid.

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

Okay. And then just thinking about demand for next year, looking at the sweet spot. I don't know if there's a nuance, but how do you look at it between 6 to 11-year-old vehicles, just the 12? Do you look at vehicles only? Or do you include light trucks? And I'm asking because if you kind of run the waterfall, it does produce all healthy but different magnitudes of outcomes. Curious if there's one version that you're relying on more than another.

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

Well, we've talked about coming -- we talked about last year that the bubble was a pressure to us, especially on the professional side of the business because it was the weight of the tailwind of more vehicles was being offset in the professional side by that bubble. And that bubble worked through over time. But we felt like 2018 would -- that headwind we faced had abated. We would expect, as those years to go through, that we'll see some pressure, it will end up being more in the DIY side. We see relief on the professional side this year. But we'd expect, on a go-forward basis, to start -- to not have that headwind, to have a little bit of a tailwind. As far as the years, as you said, there's many ways to look at it. We tend to look at 5- to 15-year-old cars and light trucks.

Operator

Thank you. We have now reached our allotted time for questions. I will now turn the call back over to Mr. Greg Johnson for closing remarks.



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Thank you, Senarra. We'd like to conclude our call today by thanking the entire O'Reilly Team for their continued hard work and delivering another solid quarter. I'd like to thank everyone for joining our call today, and we look forward to reporting our 2018 full year results in February. Thank you.

Operator

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

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