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# EDITED TRANSCRIPT

ORLY - Q2 2019 O'Reilly Automotive Inc Earnings Call

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## OVERVIEW:

Co. reported 2Q19 EPS of \$4.51. Expects 2019 total revenues to be \$10.0-10.3b and EPS to be \$17.37-17.47. Expects 3Q19 EPS to be \$4.73-4.83.



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## CORPORATE PARTICIPANTS

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**Thomas G. McFall** *O'Reilly Automotive, Inc. - Executive VP & CFO*

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## PRESENTATION

### Operator

Good morning, and welcome to the O'Reilly Automotive, Inc. Second Quarter 2019 Earnings Conference Call. My name is Brandon, and I'll be your operator for today. (Operator Instructions)

I will now turn the call over to Mr. McFall. You may begin, sir.

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Thank you, Brandon. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our second quarter 2019 results and our outlook for the third quarter and full year of 2019. 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, 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, 2018, 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 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, is also present.

I'd like to begin our call today thanking Team O'Reilly for their continued dedication to providing the excellent service that earns our customers' business every day. Our team remains relentlessly committed to our customers and the growth of the O'Reilly brand in all of our markets.

In the second quarter, we generated a 3.4 comparable store sales growth as our core underlying business was very solid. However, we faced some adverse weather headwinds during the quarter, which resulted in comparable store sales coming in towards the bottom end of our guidance range. We saw a strong start to our quarter in April but experienced unseasonably cool and rainy weather in many of our markets as we moved through the quarter, which significantly impacted the demand we typically see in seasonal peak season categories.

As we called out in our press release yesterday, the significant precipitation we have seen thus far in 2019 has also delayed new store construction and pushed back our anticipated new store opening schedule, which Jeff will discuss in his prepared comments. The combination of these top line pressures, coupled with continued headwinds in SG&A expenses from an inflationary cost environment, resulted in our second quarter earnings per share performance of \$4.51, falling below our guided range of \$4.55 to \$4.65. We are not pleased whenever our actual results fall short of our expectations, but remain confident in the drivers of underlying demand in the automotive aftermarket and in the ability of our team to outperform our competition and grow market share.

Now I'd like to provide some additional color on the composition of our second quarter comparable store sales results. Both the DIY and professional sides of our business contributed positively through our comp growth in the second quarter with professional again being the stronger contributor. In aggregate, comparable store sales gains continued to be driven by increased average ticket as a result of continued increasing parts complexity and inflation. Comparable ticket counts for the quarter were flat with solid growth on the professional side offset by a pressure to the DIY ticket counts, consistent with our recent trends as customers on this side of the business remained more susceptible to rising prices.

On a year-over-year basis, we experienced product acquisition inflation driven by tariffs and other input cost increases passed on from our suppliers. As has been the historical practice in our industry, these acquisition cost increases have been rationally passed through to increase pricing.

During mid-June, the additional round of 15% tariffs went into effect, and we anticipate the related acquisition price increases will be passed along in selling price. However, we expect the incremental benefit in same SKU pricing will likely be offset by pressure to ticket counts and good, better, best product mix headwinds.

Next, I would like to provide some additional details on category performance and the cadence of our comparable store sales growth during the second quarter. As I previously mentioned, the quarter started off well but demand slowed as we moved into May and June. Typically, we see a seasonal increase during these months and heat-related categories such as air conditioning and refrigerants. However, with the unseasonably cool and rainy weather in many of our markets in May and June, we experienced sluggish demands in these categories. Excluding the headwinds we saw on these categories, we saw -- we continued to see solid demand in both sides of our business, in line with our expectations, and are pleased with the performance of key under car hard part categories, including brakes, ride control and chassis. We continued to have a positive outlook on the strength of our industry, including positive trends in core underlying demand drivers, steadily increasing miles driven and increasing aging complexity of vehicles. While weather conditions can cause short-term volatility on our business, our team remains focused on providing the best possible service to our customers every day in all of our markets, and this consistency in execution drives our ability to take share in all market conditions.

With more normal summer weather we have experienced thus far in the quarter, we're off to a solid start in the third quarter and are establishing our third quarter comparable store sales guidance in 3% to 5%. Based on the first half performance and our unchanged expectations for the demand conditions in our industry, we are maintaining our full year comparable store sales guidance of 3% to 5%.



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For the quarter, our gross margin of 52.8% was a 36 basis point improvement over second quarter 2018 margin and in line with our full year gross margin guidance.

During the quarter, our slower-than-anticipated seasonal sales resulted in a mix benefit to gross margin percentage, and the year-over-year stability in gross margin highlights our industry's ability to pass along acquisition price increases. For the year, we're leaving our full year gross margin guidance unchanged at 52.7% to 53.2% of sales. Although based on year-to-date results and second half expectations, we now expect to be above the midpoint.

Our operating profit dollar growth was 4% for the second quarter and 4.5% for the first half of 2019, and we continue to expect our full year operating profit as a percent of sales to be within our previously guided range of 18.7% to 19.2%.

For earnings per share, we're establishing our third quarter guidance at \$4.73 to \$4.83. We are maintaining our full year EPS guidance of \$17.37 to \$17.47. Based on our year-to-date results, expected headwinds from delayed new store openings and continued anticipating pressure to SG&A, we expect to come in near the bottom of the range. Our full year guidance includes the impact of shares repurchased through the 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 81,000 dedicated team members for their continued dedication and commitment to our customers. We remain very confident in the long-term drivers for demand in our industry, and we believe we're very well positioned to capitalize on this domain by consistently providing industry-leading services to our customers every day.

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

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

Thanks, Greg, and good morning, everyone. I'd like to join Greg in thanking Team O'Reilly for their hard work and steadfast method to outlasting the competition to earn our customers' business for providing the best service in our industry. Our team continues to successfully navigate a choppy sales environment by staying focused on the fundamentals of our business and ensuring we are doing everything possible to take care of our customers.

I'd like to begin my comments today by discussing our SG&A results for the quarter and provide some color on our approach to executing our business model and managing expenses. SG&A as a percent of sales was 33.6%, a deleverage of 64 basis points from 2018. On average per store SG&A basis, our SG&A grew 3.4%, which is higher than our expectations for the quarter, while total SG&A dollars spend was on plan. The majority of the deleverage from the prior year was expected as we continue to see structural cost pressure from rising wage rates and other variable costs in a tight labor market. At the same time, we continue to invest in our goals to continually enhance customer service both in-store and in our omni-channel and technology initiatives. The higher-than-expected per store SG&A growth is the result of delays in new store openings. When a new store's opening day is pushed back a month or 2, a portion of the staff for the new store has already been hired and is in training in an existing store. Adjusting for these delays is extremely difficult, especially in this tight labor market. Our field management teams have flexibility to adjust staffing levels to appropriately respond to persistent trends in our business but will not adjust drastically in short periods of time in an attempt to hit a short-term target. We're very confident in this strategy and feel that our consistency in delivering excellent customer service in all market conditions has been critical to our long-term success. However, we do encounter pressure to our SG&A when facing sales volatility, particularly when we experience significant weather-driven swings in the business in the short term. We constantly evaluate the opportunities we have to drive increased sales and profitability. We can and will prudently adjust expenses over time when appropriate for our business.

As Greg discussed earlier, as we look forward to the remainder of 2019, we continue to have a positive outlook for the demand in our industry and are maintaining our sales guidance. As a result, we're also maintaining our guidance range for full year growth in SG&A per store of 2.5% to 3% with the expectation we will come in towards the higher end of that range based on the results in the first half of 2019.

Next, I'd like to provide an update on our store expansion during the quarter and our plans for the remainder of the year. In the second quarter, we opened 43 net new stores, bringing our total 2019 store openings to 105 through the first 6 months of the year. While the construction,

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installation and opening of over 100 stores in the first half of the year is a result of a significant amount of hard work and dedication by our team, we unfortunately are well behind the planned schedule for new store openings we established coming into 2019. This shortfall is the result of the significant level of precipitation we saw in markets with new store projects in development. Consistent with our approach in previous years, our projected calendar for new store openings is more heavily weighted towards the front half of the year, which affords us the opportunity to put a new team in place and let them get their feet underneath them before entering the busy summer season.

We're accustomed to seeing and adjusting to delays for any number of reasons, including weather, and typically would not have a material impact to our overall schedule. Unfortunately, the wet weather in 2019 has been widespread and persistent enough on a week-to-week basis that it has delayed many projects for extended periods of time and has impacted our overall schedule significantly. As Greg mentioned earlier, this delay created top line pressure in our second quarter that will persist as we catch up in the back half of the year. However, we remain very confident we'll achieve our goal of opening at least 200 new net new stores for 2019.

Now before I turn the call over to Tom, I'd like to provide an update on a couple of other expansion projects. During the second quarter, we successfully completed the conversion of 20 Bennett Auto Supply stores acquired at the end of 2018 and merged the remaining 5 stores into existing O'Reilly locations. The Bennett team has been a great addition, and we're pleased with the opportunities to continue to grow our business in Florida, which remains a key growth market for us.

Finally, I'm pleased to report that we continue to progress on schedule in the development of our 3 DC projects with planned new facilities in Twinsburg, Ohio, just South of Cleveland; in Lebanon, Tennessee in the Metro Nashville market; and in Horn Lake, Mississippi, just South of Memphis. We've established an aggressive schedule for these projects with a planned opening of Twinsburg in the fourth quarter followed by Lebanon opening in the first half of 2020 and Horn Lake opening in the second half of 2020. Our DC team has repeatedly demonstrated the ability to successfully manage multiple ongoing new distribution projects while consistently achieving the high standard of service to allow our stores to get hard-to-find parts in our customers' hands faster than our competitors. We're the industry leader in the investments we've made to establish a robust distribution infrastructure that supports the best parts availability in the aftermarket, and we will aggressively work to enhance our distribution capabilities to maintain this competitive advantage.

As important as the physical locations of our 27 DCs and our network of 350 hub stores are to our strategy, it's equally important that we execute our business model of deploying the right inventory at the right location within our supply chain and effectively and efficiently delivering the right part to our customers faster than our competitors. We're extremely confident in the ability of our teams to execute at a high level and lead the industry and inventory availability, but we will not rest on our past success as we strive to expand our industry-leading advantage. I'd like to once again thank our store and distribution teams for their continued dedication to providing the best customer service in our industry. Despite the fluctuations and industry demand we experienced in the first half of the year, our team has produced solid results, and we're in a great position to finish the year strong.

Now I'll turn the call over to Tom.

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### **Thomas G. McFall** - O'Reilly Automotive, Inc. - Executive VP & CFO

Thanks, Jeff. I would also like to thank all of Team O'Reilly for their continued commitment to our customers, which drove our solid results in the second quarter.

Now we'll take a closer look at our quarterly results. For the quarter, sales increased \$134 million, comprised of an \$81 million increase in comp store sales, a \$54 million increase in noncomp store sales, which includes the contribution from the acquired Bennett stores, and \$1 million increase in noncomp, nonstore sales and a \$2 million decrease from closed stores. For 2019, we continue to expect our total revenue to be \$10 billion to \$10.3 billion.

As Greg previously mentioned, our gross margin was up 36 basis points for the quarter as we saw benefits from product mix. On a year-over-year basis, second quarter gross margin also benefited from the sell-through of (inaudible) inventory that was purchased prior to the tariff-driven acquisition price increases which went into effect at the end of 2018 and the beginning of 2019 and the corresponding retail and the wholesale



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price increases. Within our guidance expectations coming into 2019, this benefit to gross margin was expected to be more significant to gross margin in the first half of the year. And as Greg mentioned earlier, we are leaving our full year guidance unchanged, but our actual results will be impacted by the most recent round of tariffs and the timing of corresponding market price increases. We remain confident that margins will remain rational in our industry as the nondiscretionary nature and immediacy of need of the parts we sell affords us and our competitors' significant pricing power.

Our second quarter effective tax rate was 23.9% of pretax income, slightly above our expectations and comprised of base rate of 24.4%, which was on plan, reduced by 0.5% benefit from share-based compensation, which was less than expected. This compares to the second quarter of 2018 rate of 21.5% of pretax income, which was comprised with a base rate of 24.5%, reduced by a 3% benefit for share-based compensation. For the full year of 2019, we continue to expect an effective tax rate of approximately 23.5%, comprised of base rate of 24.1%, reduced by a benefit of 0.6% per share-based compensation. While the benefit from share-based compensation will fluctuate from quarter to quarter, we expect these variations to even out over the course of the year and are leaving our full year tax rate expectation unchanged. We expect our base rate to be relatively consistent with the exception of the third quarter, which may be lower due to the totaling of certain open tax periods.

Now we'll move on to free cash flow and the components that drove our results for the quarter and our guidance expectations for the full year of 2019. Free cash flow for the first 6 months of 2019 was \$541 million versus \$632 million for the first 6 months of 2018, with the reduction driven by increased CapEx and a higher accounts receivable balance, which is timing related due to the date -- day of the week the quarter ended, offset in part by higher pretax income 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 billion to \$1.1 billion.

Inventory per store at the end of the quarter was 610,000, which was down slightly from the beginning of the year and up 1.6% from this time last year. We continue to expect to grow per store inventory in the range of 2% to 2.5% this year as a result of acquisition cost increases and the fourth quarter opening of the Twinsburg DC putting pressure on the growth percentage.

Our EPD inventory ratio at the end of the second quarter was 108%, which is up from 106% from the end of 2018. We still expect to finish 2019 at approximately 106%.

Finally, capital expenditures for the first half of the year were \$296 million, which is up \$71 million in the same period of 2018, driven by our ongoing investments in new distribution projects, the conversion of the bonds -- excuse me, conversion of the Bennett stores and new store growth and technology investments. We continue to forecast CapEx to come in between \$625 million and \$675 million of the full year.

Moving on to debt. We finished the second quarter with an adjusted debt-to-EBITDA ratio of 2.35x as compared to our ratio of 2.23x at the end of 2018. The increase in our leverage ratio reflects our May bond issuance and borrowings on our unsecured revolving credit facility. We're below our stated leverage target of 2.5x, and we'll approach that number when appropriate.

We continued to execute our share repurchase program. And year to date, we repurchased 2.6 million shares at an average share price of \$359.63 for a total investment of \$921 million. Subsequent to the end of the second quarter and through the date of our press release, we repurchased 0.2 million shares at an average price of \$380.79. We remain very confident the average price -- 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 to 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. And at this time, I'd like to ask Brandon, the operator, to return to the line, and we'll be happy to answer your questions.



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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And from Jefferies, we have Bret Jordan.

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

Just a follow-up on your inflation comments here. I mean I guess as we look at anniversarying last year's tariffs but then some potential new tariff additions this year, how do you see the inflation stacking up in the second half of the year?

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

So our second quarter inflation was a little bit over too similar to the first quarter. We would expect as these tariffs start hitting our acquisition costs that we will flow through that into price. So we would expect that we'll see a higher number, originally we thought too for the year with an easing in the back half, but that looks like there will be additional pressure there. It will depend on how long these tariffs stay in place. Our plan right now is that they will continue as is.

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

Okay. Great. And then a question, I guess, when you look around the market, you talked about even in this space of slow demand, pricing was pretty rational. Are you seeing any either passed through of tariffs than lower prices from competitors or more aggressive activity around, I do know, small commercial accounts or large national accounts?

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

Jeff, do you want to take that one?

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

Well, I mean for the most part, I mean, everybody is under the same pressure from the price increases. And what we're seeing in the field is everybody is adjusting to the process accordingly. I mean any time there's pressure on sales, you'll see some competitors try to use price as a tool to gain business. But for the most part, that's not the case.

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

Yes. I mean -- yes, I'm sorry. We -- it's been very rational, Bret, and to Jeff's point, any exceptions to that from some of these small regional players I wouldn't attribute to tariffs or inflation, it's just typically some of the things they do during the course of a quarter.

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### Operator

From Goldman Sachs, we have Kate McShane.



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**Katharine Amanda McShane** - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Just after these first 2 quarters of cost being closer to 3% and the 5%, we're wondering what you're seeing that gives you confidence that we could potentially still reach the high end of that range. And do you have an estimate of how much your business was impacted by the wet weather?

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

What we would tell you is when we look at our category-by-category performance that our underlying nonseasonal business has been very strong. Where we've run into problems are our seasonal business. We would tell you that absent the pressure we saw in the HVAC refrigerant category that Greg spoke to, we would have been happy with our comps this quarter. So when we look at the rest of the year we always plan for a normal weather and that core underlying demand for our harder parts remains good and gives us confidence in the last -- second half of the year.

**Katharine Amanda McShane** - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And just with the delayed store openings, I just can't, of the top of my head, recall a time when this has been the case before. Is it purely just weather? Or is it just -- is there more specific circumstances as to why this is happening now than maybe not happening before? Is it the timing of the number of stores versus...

**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

We had a fairly aggressive plan in 2019 front-loaded to the first half of the year, but it's entirely weather related. I mean we've always got issues year-to-year when you're making a plan and a forecast. I mean it could be environmental, regulatory, whatever the case may be. There is always weather issues and normally the second quarter is the most volatile quarter of new store openings during the year. That's when we have the most impact from weather, and this year was just extremely tough and widespread and persistent. What I would add to that, Kate, is all of the locations for the year are in progress. So we're not looking for additional locations. It's just how quick we can get the doors open on the buildings.

**Operator**

From Wells Fargo, we have Zack Fadem.

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

You talked about the benefit of selling through pre-tariff merchandise at post-tariff pricing, curious how much of a tailwind this has been for you so far these year? And then as the more inflationary products start to roll in, in the back half, curious if you could walk us through the puts and takes here? And at what point do you think this dynamic could shift to a gross margin headwind?

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

So we would tell you that the faster-moving products there's less benefit because those are the ones we're most quickly reordering. So it's more of the back end of the lines where we're seeing the benefit. And we tell you that it's a modest benefit, and it's something that helps our gross margin. But ultimately, we look at last buy -- what was our last buy purchase price, and that's how we're managing our business. So when we look at the ongoing forward tariffs, we're going to take a look and make sure that we're priced appropriately for the market. And looking at what margin we think we need to make and should make based on GM ROI of each product to set those prices. So we think that the impact will not be a negative going forward. And we think we'll be able to sustain our margin percentage.





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

Okay. And on the SG&A side, how much of the 64 basis points of deleverage would you specifically assign to the delayed new store openings? And going forward with SG&A per store expected up about 3% for the year, are there any other buckets where you anticipate a step down in the growth rate from here?

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

So last year, we talked about SG&A -- people invest in SG&A with the part of the funds they receive from the tax reduction. And then going forward, if we saw higher-than-average SG&A growth, we would expect to see inflationary pricing in the top line being a benefit. And that's what we've seen this year as the labor market continues to be tighter. So when we looked at our guide this year, we were going to anniversary some of those investments we made last year in store payroll, primarily more heavily weighted in the first and second quarter as they ramped up. We would tell you that when we look at our guidance and you look at the guidance from the beginning of the year, the midpoint of our operating profit was an expectation of a decrease because of those pressures. We would tell you that when you look at the second quarter specifically that most of the deleverage was planned based on these higher structural store payroll numbers, but that -- a meaningful amount is due to slower comp sales than expected and later noncomp sales due to the store is not opening at that time.

**Operator**

From Stephens Inc., we have Daniel Imbro.

**Daniel Robert Imbro** - Stephens Inc., Research Division - Research Analyst

Just a follow-up on the last SG&A question actually. One of your larger peers has talked more recently about investing more heavily into supply chain and DC wages. Are you feeling any specific pressures from those kind of investments in that part of your business or is it more broad-based wage pressure?

**Thomas G. McFall** - O'Reilly Automotive, Inc. - Executive VP & CFO

I'd say it's across the board. And we're seeing some wage pressure in some of our store markets that's driven by minimum-wage changes where they're escalating some of those that are on the West coast. But across the country, across really in the corporate office and the DCs and in the stores, we're seeing wage pressures and wages moving up. One of the biggest areas we've seen some wage pressures is with our DOT truck drivers and our DCs. That's become a very aggressive market. Supply hasn't kept up with demand over the last couple of years, and we've seen a lot of inflation and wage pressure there.

**Daniel Robert Imbro** - Stephens Inc., Research Division - Research Analyst

Okay. And then I think it was last quarter or the call before that, you guys talked about the market becoming more rational and being able to raise retail prices to offset some of these wage pressures. So curious if you still think the market's in a similar place? Or what's changed to keep you guys being able to pass through either industry-wide cost pressures being able to pass it through in the form of inflation?

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

Well, I think we've spoken to the first and second quarter of same SKU inflation being up slightly over 2, which is a reflection of passing through the inflationary pressures across the cross retail through our pricing to cover both the tariffs and increase in expenses, and I think you see that in our increasing gross margin percentage.



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**Operator**

From Wolfe Research, we have Chris Bottiglieri.

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

What if we go into a little bit of tariffs? Just hoping you may be give us a lay of the land in terms of the percentage of SKUs affected and the levels of price increases. And then just for clarity, the next 15, those are the same SKUs affected or has that become more expensive SKU set? And then just like holistically thinking about this, given some of your reservations on deferred demand and customer trade down, is this something you've already seen in the first round of tariffs that's what gives you the confidence that you won't see comps accelerate on the next 15? That'll be helpful.

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

Chris, I'll take the first part of that and let Tom back to back-end question. There's been a total -- I think, this is the fourth round of tariffs. The first was more of a component tariff increase and then we hit more and more SKUs in the second and third round. The third round was the most impactful. It was a 10%. And this latest round is an additional 15% on the 10% for basically the same base of SKUs. As we said in previous quarter calls, just because there was a tariff increase, either at the component level or at the SKU level of 10%, that doesn't mean that we're going to take the full 10% tariff on that. We direct in for a very smaller subset of our SKU base. Most of our direct -- most of our import lines coming from China flow through one of our suppliers facilities here in the U.S. So the impact of tariffs is a little less for us than if we directly imported all of that product. So what we would expect and what we've seen thus far is this next round of 15%, we would also take a less than 15% increase on this round.

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

In relation to your second question, we started to see some inflation on commodity-type items second quarter of the last year. And as prices go up, especially on items that are more discretionary, what we see is pressure on our lower-end consumer, our DIY consumer, and that's been reflected in pressure around their traffic counts. We see less of that pressure on our professional side of the business as the general demographic there is less impacted by price increases. So when we look at rolling through this additional round of tariffs, we'd expect the professional side of business to be less impacted on traffic and see a benefit there in average ticket. On the DIY side, you will see the ticket average go up, but we would expect to see additional pressure on traffic as people work harder to defer to save money.

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

Got you. That's helpful. And then just a quick strategic question. Is there anything you can do to address this? I know like a tool (inaudible) difficult, but is there any way to diversify outside of China so you're not exposed to 1 country? Is that something that's feasible? Or would you lose some of the benefit of scale from doing that and it's just not a road worth traveling?

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

So it's definitely an option. It's just not a short-term option. We try and for years we've tried to diversify where we buy our products across multiple suppliers to mitigate risk and where we can across multiple countries to also mitigate some of that risk. So for brake category, for example, we've got brake products coming in from China, from India and from some other smaller countries. So we're continuing to work with our suppliers to see what alternate sourcing locations we have, but that's just typically not a short-term change because it's not like the capacity sitting there. And these other countries, they have to build that capacity.



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**Operator**

From Crédit Suisse, we have Seth Sigman.

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

I just wanted to clarify on the full year guidance. So I think the earlier comment was that you're expecting EPS to now be at the low end of the range for the year. Is that due to the first half performance or are you actually modifying your expectations for the second half as well?

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

Well, I think the specific word we used was lower. It's based on really 2 factors that are different: second quarter results and our expectation that we're going to continue to be -- have a drive from new store openings where we're not going to generate as many noncomp store sales dollars as we expected as we both catch up and stores that open later in the year don't generate quite as much revenue as they have a later date to sort of ramping up their business.

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

Okay. Makes sense. And then a follow-up question on the gross margin. Can you just talk about the performance in the quarter, specifically you highlighted mix as a benefit. If you can quantify that, that would be really helpful. And then I think previously you talked about gross margin being flattish for the second half of the year. Is that still the right way to think about it? I mean you do have higher pricing now, I guess, incremental to what you expected previously. So should we actually expect that, that could be a little bit higher for the year or at least for the back half of the year?

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

We've maintained our guidance. We think we'll be a little bit above the midpoint of the guidance. Seth, I'm sorry, will you repeat the first question?

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

The first part was just around the gross margin performance in the quarter. You highlighted mix. I'm just wondering if you could quantify that.

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

I'm sorry about that. We're not going to get into the nitty-gritty of the details, but what we would tell you is that a lot of the seasonal products in HVAC and refrigerant are big-ticket items but carry a lower gross margin percentage. So not having those sales hurt our comps but help our gross margin percentage mix.

**Operator**

From Wedbush Securities, we have Seth Basham.

**Seth Mckain Basham** - *Wedbush Securities Inc., Research Division - MD Of Equity Research*

My question is around the trends between DIY and DIFM. If you could give us a sense of whether or not the performance gap of comps between those 2 customer segments widened this quarter relative to the last quarter, that would be helpful.



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

Yes. Overall, the spread was very similar to what we saw last quarter with professional outcomping DIY.

**Seth Mckain Basham** - *Wedbush Securities Inc., Research Division - MD Of Equity Research*

Right. And as you look back further in 2018, was it a narrower gap than we've seen thus far in 2019?

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

It's been pretty similar for the last 4 quarters.

**Seth Mckain Basham** - *Wedbush Securities Inc., Research Division - MD Of Equity Research*

Got it. And just lastly, as you roll forward, do you think about the impacts of tariffs and the pressure on DIY customer? Do you think this next round leading to higher price increases and more pressure on the DIYers pocketbooks is going to lead to a further widening of the gap?

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

I think it likely will. And it's not just that, Seth. It's the complexity of products that are impacting that as well. And it's not just our industry. We talk a lot about the average DIY consumer. Their spend is being impacted in everything they buy because of these tariffs. So their discretionary income and discretionary money they have to spend on nonessential items is just -- it's less than it was. And they will likely postpone any repairs that they don't have to make.

**Operator**

From Oppenheimer, we have Brian Nagel.

**David Leonard Bellinger** - *Oppenheimer & Co. Inc., Research Division - Associate*

It's David Bellinger on for Brian. So first, I want to push a little further on the monthly cadence of sales. Anything in particular there that you can point to in terms of underlying demand improving as the quarter progressed? Maybe certain category trends or geographical trends they could get into to help give us further comfort that comps in the back half of the year could potentially track better than what we've seen so far in the first 2 quarters?

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

Sure. David, I'll take that and then I'll let Jeff speak to the regional trends. On the last call, the team talked about a more normal winter with the follow up -- with the normal weather, you have road conditions deteriorating and breaking of under car products, things like that or product categories rather. And that's to Tom's point earlier, that's what we saw on the quarter. So we had a more normal weather pattern for April. So April was the strongest month of the quarter. And then May and into June, those weather patterns changed, and it was a cooler weather than we normally see during that time of year, and much wetter across most of the country than we normally see. And that impacted primarily those heat-related categories that Tom spoke to and I said in my prepared comments. So what we would say is from a cadence standpoint, April would have been our strongest month of the quarter followed by June and then May would have been the softest month in the quarter.



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**David Leonard Bellinger** - *Oppenheimer & Co. Inc., Research Division - Associate*

Got it. And then on the continued expense pressures you're seeing mostly on the wage side, are there any indication that those impacts are subsiding in any way? And how should we think about overall expense growth over the next couple of quarters if comps potentially track towards that lower end, the 3% to 5% range, and also as we begin to look more towards 2020?

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

So our expectation is that payroll will continue to be a pressure item as unemployment stays very low. People are out there competing for folks. When we look at our SG&A, your expectation is that we're going to have solid sales for the last 2 quarters, absent -- with the exception of some pressure from new store opening timing but our comps will be solid and that our SG&A will come in at the high end of our average SG&A growth per store for the full year, which means being on plan for the third and fourth quarter.

**Operator**

From JPMorgan, we have Chris Horvers.

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

So just want to -- I want to follow up on the gross margin with respect to the tariffs and understand your comments, Tom. So is it that -- why wouldn't gross margin -- you see the similar gross margin benefit. So asked another way, are people not raising ahead of it and sort of waiting to roll into that acquired inventory and then raise the price on it? And is that sort of the different behavior in the competitive marketplace around pricing?

**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Well, what we see is an uneven application of the increase of price. So some of it has to do with weather was underwater, it depends on how much is in your supply chain here. What we've typically seen is that when the faster-moving items, which are the higher-value items, when you're starting to reorder those and then you sell through it, obviously, at a much faster rate, when you're reordering those at the higher prices and starting to sell through and that's when we're seeing the prices be addressed in the market. So the slower-moving items that you have many more days of supply are the items where you get that benefit.

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

And the first time around last fall, did the prices go up more quickly on the slower-moving items?

**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Well, they go up across the line. Typically the tariffs will be addressed across the line. It's just when you are ordering them. What I would tell you is that the first round of tariffs, you -- the pass-through is more on even than what we see here in the latest round of tariffs. Obviously, it's a bigger number. We've all gone through this process so we are expecting a more even, probably quicker application of those price increases.

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

So does that suggest that -- so it seems like people in the marketplace are sort of feeling their way through this price increases. Is that the right way to think about it?



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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes.

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

Got it. And then in terms of -- understood. And then in terms of -- I'm not sure, just 2 follow ups. With May negative and then also from a regional performance, was this Midwest with the flooding and the rains, is it California, which is cooler versus the Northeast? Not sure if you touched on that yet.

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

Yes. May was not negative. We didn't have any negative months or weeks during the quarter. May was just softer than June and April. And Jeff, do you want to take the regional?

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

On the regional performance, really, the underperformance performance we saw in the quarter was consistent across most of our markets as you'd expect with the weather conditions across the majority of the country. Where we experienced the most unfavorable weather we saw more impact our business, especially our DIY business, and it's calling out the areas that were most impacted, that would be really the center part of the country and the West Coast.

**Operator**

From Morgan Stanley, we have Simeon Gutman.

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

X the weather, if we look at the first half in total, not just the second quarter, do you have a sense of where the comp would end up? Would it be at the midpoint or could have been at the high end of the full year guidance?

**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

We're not going to get into details that specific. What we would tell you is, especially given the second quarter, weather was more normal in those categories that were impacted performed okay, we would be happy with our comps.

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

Okay. That's fair. And I forget what the first quarter, did you make the similar comment that weather -- you underperformed. I remember there was a soft part of that quarter as well, maybe February. So look, I was just trying to get a sense of...

**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So when we look at the first quarter, we had a deferral of a lot of the spring weather into April, which was a positive. And that get out and clean up in the spring as more of a DIY side of the business. And we caught up on that in April. When we look at the drivers of hard parts, we had a more



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normal winter from a precipitation standpoint, spring didn't break quite as early. So when we look at the first quarter and the second quarter, we look at the core categories that really display long-term demand in our business, the ware parts, the under tire parts, our people taking care of their vehicles, if there's wear and tear on their vehicles, those categories have looked solid all year and thus translated into a more solid professional side of the business. The seasonal categories, when spring hit, how much air-conditioning business that we do, those have been a little bit of a headwind when we look at the back half of the year, that core underlying demand for the key categories in our industry is what gives us confidence to reaffirm our guidance for the year.

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

Okay. That's helpful. My follow-up is your view on -- towards larger chains. I think it seems like the consolidation at the shop level is picking up a bit. And I know in the past, you've tend to veer away from some of these chains because it's not been good for margin. Just wanted to see if that's still the case?

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Well, there's a tremendous amount of shops in the country. And there has been some consolidation. When we look at performance, there's a lot of regional chains that do a fantastic job. When we partner, we want to partner with people that are providing great customer service, have a model that were efficient in supplying. And we've got a lot of regional and national customers. At that end, we do a lot of great business with them. So I wouldn't say that we would shy away from any of that business. We're going to make sure that we lead with service in all the business we do.

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**Operator**

And from UBS, we have Michael Lesser.

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

So thus far you've done a 3.3% comp or so in the first half. Last year, you did 3.8% comp for the full year. This year, you've had 100 basis points of incremental inflation. [Adjusting] that units are below where they were last year running at a slower pace of growth than they were last year. But why would that...

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

I'm sorry. Did you cut off there, Michael?

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

So my question is it seems like you're seeing a greater elastic demand to the price increases than what's suggested or than what's perceived by -- what you had assumed in your guidance. Your comp year to date are running below where they were last year. And this is with more inflation than you experienced last year.

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

So what we would tell you is our professional business continues to be strong. We're seeing more of that volatility on the DIY side of the business. A lot of DIY business also carries a very low average ticket with high volumes when you look at some of the maintenance items and attend some of the appearance items that we do business in. So appearance, obviously, has been under pressure with -- the late March weather wasn't very



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good. And when you look at things like oil changes, a lot of volume, not as high a ticket. Those are items that either the customer can forgo or defer and that has created pressure on DIY traffic. What we'll tell you is that the hard parts category has continued to perform well.

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

So when you look at the second half of the year, do you -- is your expectation that consumer is not going to defer these projects as much, and that will -- that's what will drive an improvement in the business?

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**Thomas G. McFall** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

In the second half, when we look at it, there is less seasonal categories that drive our business than in the first half.

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

Okay. And then coming back just to the longer-term outlook. It's been several years since O'Reilly has comped up 5%. Is the business now just in a different stage as the industry has become more consolidated, you're doing higher per store volume that it's just going to be more difficult for O'Reilly to come up 5%?

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

We had the same question in 2010, 2011. What we would tell you is that our business is a cyclical business, kind of 7-year cycles. The professional size of the business is much more stable. When we see good DIY years for many different reasons, whether it's new weather-driven, whether it's increase in miles driven, wages, when we have those good DIY years, that's when we see the industry outperform. When that DIY consumer is under pressure, you see the industry put up numbers not quite as good. And I tell you that at the current phase, we're in that beginning part. If we -- that second part where DIY customer is under pressure. If we look back 3 years, we saw a run of 3 years where the DIY business swung up. And it will go through these cycles over time.

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**Operator**

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

Thank you, Brandon. We'd like to conclude our call today by thanking the entire O'Reilly team for your 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 third quarter results in October. Thank you.

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**Operator**

Thank you. And ladies and gentlemen, this concludes today's conference. Thank you for joining. You may now disconnect.





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