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# EDITED TRANSCRIPT

ORLY - Q3 2019 O'Reilly Automotive Inc Earnings Call

EVENT DATE/TIME: OCTOBER 24, 2019 / 3:00PM GMT

## OVERVIEW:

Co. reported 3Q19 EPS of \$5.08. Expects 2019 total revenue to be \$10.0-10.3b and EPS to be \$17.75-17.85. Expects 4Q19 EPS to be \$4.12-4.22.



OCTOBER 24, 2019 / 3:00PM, ORLY - Q3 2019 O'Reilly Automotive Inc Earnings Call

## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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## PRESENTATION

### Operator

Welcome to the O'Reilly Automotive, Inc. Third Quarter 2019 Earnings Conference Call. My name is John, and I'll be your operator for today's call. (Operator Instructions) And I will now turn the call over to Tom McFall.

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

Thank you, John. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our third quarter 2019 results and our outlook for the fourth 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 statements 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 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 Chairman, are also present.



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It's my pleasure to congratulate Team O'Reilly on her excellent performance in the third quarter and to thank every member of the team for their unwavering commitment to the our company's culture of providing excellent customer service to each and every one of our value customers. After seeing some weather-driven volatility in the first half of 2019, demand in our industry evened out in the third quarter, and our team did an excellent job of taking advantage of the solid industry backdrop to deliver a strong 5% comparable store sales growth in the quarter, which is at the top end of our guidance range. I'm pleased that our team was able to translate this top line performance into an 11% increase in operating profit dollars and a 13% increase in earnings per share to \$5.08 per share, which exceeded the top end of our guidance range by \$0.25. Our third quarter performance is the result of our team's relentless focus on excellent customer service and expense control. Year-to-date, our comparable store sales growth stands at 3.9%, which is consistent with prior year and in line with our full year guidance we have maintained throughout the year at 3% to 5%.

Now I'd like to provide some additional color on the composition of our third quarter comparable store sales results. Both the DIY and professional sides of our business contributed positively to our comp growth in the third quarter, with professional again being the stronger contributor. Part of the performance of the professional side of our business is the result of a calendar benefit from one less Sunday during the third quarter this year as compared to 2018. Sunday is our lowest-volume day of the week on the professional side and the impact of one less Sunday was a benefit of roughly 50 basis points to our total comp sales for the quarter. During the first quarter of 2019, we had one additional Sunday versus 2018. So through the first 9 months, we're even on Sunday and there's no impact to our year-to-date comps. Even adjusting for this benefit, we saw a robust comparable ticket growth in our professional business during the quarter, driven by strong performance in key undercar hard parts categories, including brakes, ride control and chassis, as well as more typical performance in hot weather-related categories.

Ticket counts in our DIY business continued to see pressure, consistent with our recent trends as customers on this side of our business remain more susceptible to the rising price environment. However, in total, our comparable ticket counts were positive for the quarter.

The long-term driver of increased parts complexity, coupled with the current inflationary environment, continues to drive increases in average ticket, which accounted for the majority of our comp increase in our third quarter. On a year-over-year basis, we have experienced product acquisition cost inflation driven by tariffs and other input cost increases passed on from our suppliers. As has been the historical experience in our industry, the nondiscretionary nature and immediacy of need in the products sold in the aftermarket has allowed our industry to rationally pass through these acquisition cost increases. The impact of those top line increases accelerated in the third quarter as the most recent round of tariffs went into effect and our industry began passing through these costs at the beginning of the third quarter. We would expect to see a continued tailwind from the benefit of these price increases in the fourth quarter, though to a lesser extent as we began to calendar price increases that occurred in the fourth quarter of 2018 driven by the first round of tariffs.

Including the additional price changes we began to see in the beginning of the third quarter this year, we now expect to see a larger benefit from increasing average ticket with same SKU pricing of 2.5% to 3% for the full year. As we have discussed on our last 2 calls, we continue to believe the pressure of rising prices to be a short-term constraint to DIY ticket count growth as much as our more strapped consumers react to deferred maintenance when possible, trading down to the good, better, best value spectrum when necessary repairs can be deferred. However, we believe that consumers will adjust to price pressures and the ticket count growth in our business will return to historical trends over time.

As I previously mentioned, we saw more normal weather patterns in the third quarter than we saw in the first half of the year. We would describe sales of seasonal products as being as expected and did not significantly benefit from catch-up of pent-up demand of seasonal products. Adjusted for the Sunday shift, the cadence of the third quarter sales were also very steady as we saw very consistent results, especially in core hard parts categories throughout the quarter and have seen a similar start to the fourth quarter thus far in October. Looking forward to the remainder of the year, we continue to have confidence in the strength of the broader aftermarket, characterized by stable employment in general macroeconomic conditions, low gas prices, modest increases in miles driven and increasing age and complexity of vehicles. In line with these market conditions and based our performance so far in 2019, we're establishing our fourth quarter comparable store sales guidance at 3% to 5% and reiterating our full year comparable store sales guidance of 3% to 5%. As always, our team remains focused on providing the best possible service to our customers, and we remain very confident in our ability to gain share and generating results which outperform the market.

For the quarter, our gross margin of 53.3% was a 35 basis point improvement over the third quarter of 2018 margin and was a high end -- or was at the high end of our expectations for the quarter. We continued to see stability in gross margin even in light of pressure from tariffs and other



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input cost increases as pricing remains rational in our industry. We are leaving our gross margin guidance for the full year unchanged at 52.7% to 53.2% of sales though, as Tom will discuss in his prepared comments, would now expect to come in near the top end of that range. Our operating profit dollar growth was 11% for the third quarter, which represents our strongest quarter growth since 2016. We also expect our operating profit as a percentage of sales to come in at the top end of our previously guided range of 18.7% to 19.2%.

Moving on to earnings per share. Our third quarter EPS of \$5.08 was an increase of 13% over last year. And on a year-to-date basis for the first 3 quarters, our EPS of \$13.63 was an increase of 10% over 2018. We're establishing our fourth quarter guidance at \$4.12 to \$4.22 based on our strong sales and profit results for the quarter.

Our expectations for the fourth quarter profit and EPS tailwinds from shares repurchased, we're raising our full year EPS guidance to \$17.75 to \$17.85. Our full year guidance includes the impact of shares repurchased through this call but does not include any additional share repurchases. Again, I would like to thank our team of over 82,000 dedicated team members for the outstanding third quarter performance.

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 begin today by echoing Greg's comments on the dedication of Team O'Reilly. As a result of the hard work and commitment of each of our store and DC team members, we were able to produce strong results in the third quarter, at the top end of our expectations. In my comments today, I'll provide some color on our performance in the third quarter and discuss our organic store and DC expansion plans, and I'll also touch on the exciting plans we have to expand our company's footprint into Mexico with our upcoming acquisition of Mayasa Auto Parts. Our success has been built on the foundation of the O'Reilly culture of excellent customer service, and we remain very confident in our team's ability to seize own growth opportunities as we expand into new markets.

I'll begin my comments today by discussing our SG&A results for the third quarter. We were pleased to be able to leverage SG&A expenses 22 basis points during the quarter as a result of the strong comp performance and the effective expense management by our teams. On an average per-store basis, SG&A grew 2.5%, which was in line with our expectations for the quarter.

As we discussed on last quarter's conference call, we've experienced continued pressure in SG&A this year from rising wages and other variable costs in the current tight labor market and those pressures continued in the third quarter. However, the year-over-year comparisons eased as we calendar against the increased payroll spend in 2018 from our reallocation of the savings from the tax reform, which had ramped fully by the third quarter of 2018. We're maintaining our guidance range for full year growth in SG&A per store of 2.5% to 3%, and we expect to come in towards the higher end of that range based on the ongoing inflationary environment, which is consistent from our second quarter call. Our strategy for managing our operating expense spend for 2019 continues to be focused on ensuring we are equipping our store teams with the resources they need to provide excellent customer service while also driving omnichannel and technology initiatives to capitalize on opportunities to drive increased sales and improve efficiency and operating profit.

Next, I'd like to provide an update on our store expansion during the quarter and our plans for the remainder of the year and for 2020. In the third quarter, we opened 76 new stores, bringing our total year-to-date 2019 store openings to 181 net new stores and significantly closing the shortfall to our quarterly plan for new store openings, which was caused by weather-related construction delays in the first half of the year. We remain very confident we will achieve our goal with opening 200 net new stores in 2019. We're very pleased with the performance of our new stores and continue to be excited about our opportunities to identify great locations and great store teams to profitably grow our business in markets across the country.

A key factor in our successful expansion is the consistent industry-leading support of our distribution teams. Our ability to provide the best parts availability in the aftermarket is the result of the excellent job our distribution teams do on a daily basis to support our stores, coupled with our ongoing commitment to enhance our distribution advantages through continued investments in distribution infrastructure and technology. We continue to progress on schedule with our 3 DC projects and we'll open our new facility in Twinsburg, Ohio, just south of Cleveland, during the fourth quarter. Our ability to deploy the right inventory at the right location within our supply chain and get parts in the hands of our customers



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faster than our competitors is one of the keys to our success. We're very confident in our team's ability to successfully manage the distribution expansion projects currently underway and to continue to capitalize on our advantage in parts availability.

As Greg announced in our press release yesterday, we've set a new store growth target of 180 net new stores in 2020. Our 2020 new store growth target is slightly below our growth number from the past several years, which reflects the significant effort and resources that we will direct towards our international expansion into Mexico. As we announced in August, we've entered into a definitive agreement to purchase Mayasa Auto Parts headquartered in Guadalajara, Mexico.

First, to update on the progress of the transaction. We're working diligently through the customary closing conditions and regulatory approvals and still expect to close before the end of the year. As we've discussed for the past few years, we view expansion outside of the U.S. as a natural next step in our long-term growth strategy, and we focused on evaluating opportunities closer to home in North America in both Mexico and Canada, which have similar vehicle populations. Our processes involve both evaluating the potential opportunities present in the automotive aftermarket in these countries as well as understanding the competitive landscape and potential acquisition targets to partner with for our expansion strategy.

Throughout our history at O'Reilly, we've taken pride in sticking to the fundamentals and making sure we grind out the day-to-day blocking and tackling of executing our business, and we've taken the same detailed approach working through our evaluation of international expansion. The results of this process have only served to reaffirm to us that we have a great opportunity in Mexico to enhance value for our shareholders as we mailed our proven business strategies in partnership with an outstanding company in Mayasa.

From their beginnings over 65 years ago, Mayasa's history has mirrored our own history at O'Reilly as a family-owned company that has grown into a very successful supplier in the aftermarket by focusing on the same fundamental culture values of hard work and excellent customer service. The (inaudible) family has built a strong, highly respected business through its 5 distribution centers, which support 20 company-owned stores in an expansive independent jobber customer base across Mexico. At this time, Mayasa's company-owned stores represent the smaller portion of the business and the overall magnitude of this transaction is not material in comparison to our existing U.S. business. However, this partnership represents a tremendous foundation for us to grow upon from the platform that Mayasa has established to expand the base of company-owned stores over time and become a major competitor at a national level in Mexico. As we look forward to executing this strategy, we're excited to partner with Mayasa's seasoned management team who will continue to operate the business in conjunction with O'Reilly's experienced leadership team. While we're anxious to close the transaction and get started, we will be cautious at the pace at which we move forward in Mexico. Just as it was during our evaluation process, we will be very focused on ensuring we take the time to learn the Mexican market, work with the Mayasa team to develop the growth strategy and invest in developing solid leadership and infrastructure that will move us forward in Mexico. We're very happy to welcome the over 1,100 hard-working and dedicated Mayasa team members to the O'Reilly family, and we look forward to the closing of the transaction in the fourth quarter.

To close my comments, I would like to once again thank Team O'Reilly for their outstanding performance in the third quarter and continued dedication to our customers. Our team's execution has driven solid results in the first 3 quarters of 2019, 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 strong results in the third quarter.

Now we'll take a closer look at our quarterly results. For the quarter, sales increased to \$184 million, comprised of \$122 million increase in comp store sales; a \$57 million increase in non-comp store sales, which include the contribution from the acquired Bennett stores; a \$7 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.

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As Greg previously mentioned, our gross margin is up 35 basis points for the third quarter. On a year-over-year basis, third quarter gross margin benefited from the sell-through of on-hand inventory that was purchased prior to tariff-driven acquisition price increases, which have gone into effect in stages starting in the second half of 2018 and continuing throughout 2019 and the corresponding retail and wholesale price increases. When we established guidance for 2019 at the beginning of the year, we expected this gross margin benefit from the sell-through of lower-cost inventory to be bigger in the first half of the year based on the then current tariffs and pricing environment. However, with the most recent round of acquisition cost increases, driven significantly by the last round of tariffs but also by other inflation being passed on by our suppliers, we are seeing an additional benefit to our gross margin. This benefit will continue in the fourth quarter of 2019, which is the driver of our expectation that gross margins will be at the top end of our full year guidance range, as Greg mentioned earlier.

While we are not yet prepared to provide gross margin guidance for 2020, we would expect this tailwind to gross margin to carry forward into next year but decrease quarter by quarter as we turn the low-cost inventory and anniversary tariff price increases. Our expectations are based on the current tariff and inflation landscape, but the impact on our gross margin will ultimately be determined by the timing of inflation, tariffs and any corresponding market price changes. Most importantly, we continue to be pleased with our industry's ability to retain rational pricing and pass through cost increases and are confident, based on the nondiscretionary nature of demand for the products we sell, we will be able to sustain this strategy moving forward.

Our third quarter effective tax rate was 22% of pretax income, which was below our expectation and comprised of the base rate of 22.5%, reduced by 0.5% benefit for share-based compensation, both of which were better than our expectations. This compares to the third quarter of 2018 rate of 19.6% of pretax income, which was comprised of a base tax rate of 22.6%, reduced by 3% benefit for share-based compensation. As a reminder, the third quarter is typically lower than the remainder of the year due to the tolling of certain open tax periods and the better-than-expected base tax rate this quarter as the result of positive resolution of certain tax matters in the quarter. For the full year of 2019, we now expect an effective tax rate of 23%, comprised of a base rate of 23.8%, reduced by a benefit of 0.8% for share-based compensation. However, changes in tax benefit from share-based compensation could create fluctuations in our quarterly tax rate.

Now we'll move on to free cash flow and the components that drove our results for the quarter and our guidance expectation for the full year of 2019. Free cash flow for the first 9 months of 2019 was \$995 million versus \$959 million in the first 9 months of 2018. As Greg noted in yesterday's press release, a big driver of the year-over-year increase in free cash flow relates to our investment in solar projects that generate investment tax credits, and the timing of these investments can create unevenness in our cash flows. Based on when these solar projects come online, we expect this timing difference in free cash flow to normalize during the fourth quarter. Absent of this timing effect, free cash flow is lower year-to-date, with the reduction driven by increased CapEx, offset in part by higher pretax income. 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 618,000, which is up 1% from the beginning of the year and up 2.1% 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 a Twinsburg DC putting pressure on the growth percentage. Our EPD inventory ratio at the end of this quarter was 108%, which is up from 106% from the end of 2018. We now expect to finish 2019 around 107%.

Finally, capital expenditures for the first 9 months of the year were \$481 million, which is up \$131 million from the same period of 2018, driven by our ongoing investment in new DC projects, the conversion of the Bennett stores, new store growth and technology investments. We continue to forecast CapEx to come in between \$625 million and \$675 million for the full year.

Moving on to debt. We finished the third quarter with an adjusted debt-to-EBITDA ratio of 2.28x as compared to our ratio of 2.23x at the end of 2018. The increase in our leverage reflects our May bond issuance and the 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 continue to execute our share repurchase program, and year-to-date, we repurchased 3.6 million shares at an average share price \$364.84 for a total investment of \$1.3 billion. Subsequent to the end of the third quarter, and through the date of our press release, we repurchased 0.1 million of shares at an average price \$393.33. We remain very confident that the average repurchase price is supported by expected discounted future cash flows to our business, and we continue to view our buyback program as an effective means of returning available cash to our shareholders.



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Before I open up our call to your questions, I'd like to thank the O'Reilly Team for their outstanding performance in the third quarter and for their continued dedication to our company and our customers.

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

### QUESTIONS AND ANSWERS

#### Operator

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

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

I wanted to ask a little bit about the DIY business and sort of what you're seeing on the sequential trends in the do-it-yourself business. As you pass along more price increases, what have you seen from an elasticity deferral perspective? In one hand, prices are higher. But on the other hand, miles driven have generally picked up since bottoming in the back half of last year and we think that's a nice driver of that business and the overall business. So how does this balance out in terms of deferred expanding?

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

Sure, Chris. Third quarter, we were up slightly on the cash-to-DIY side of our business. If the tariffs and inflation persists, we feel like the more cash draft consumer will have to make some decisions, not much different than what we faced with rising fuel prices and ordinary inflation. And while we haven't seen a lot of evidence of deferred maintenance, it would be somewhat likely that, that will be a decision that, that consumer might make if they were having financial difficulties to defer -- not complete those maintenance cycles but defer those and extend those maintenance cycles will bit longer. So we haven't seen a lot of evidence. Those more elastic categories are more than maintenance categories like oil and things like that. And we haven't seen any evidence that there's been a big shift there, but that could happen these tariffs and inflationary issued this inflationary environment continue.

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

What I would add to that, Chris, is ticket comps were up slightly on the DIY side. Total comps were relatively strong, although as Greg mentioned in his prepared comments, the professional business continues to lead the way in total comps. When we look at our category performance, items that can be deferred, especially on the DIY side, are a little bit lagging, whereas our hard parts business, things that you need to run your car, continue to be good on both sides of the business.

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

And then as you think about -- have you tried to disaggregate the strength in the hard parts business between price and unit to try to tease out how the car park improving this year and even more so next year, if that's -- how much of that is driving the -- this commercial comp acceleration, which is accelerating on a stock basis?

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

So not to break down the individual numbers, but when we look over the last few years with the later SAAR years coming into the professional side of the business really entering our market, which tend to be -- to the newer to the car, sooner it's off warranty. The higher propensity is to be



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serviced by a professional. That put pressure on us over the last couple of years, when we were seeing that abate. When we look at our category type performance, specialty items like brakes which are routinely repaired or changed out after they come out of warranty, we continue well on that side. So we think the -- that bubble moving into our years and then higher SAAR years coming into our market off warranty bodes well has been a positive this year or not a negative, and we'd expect that to continue into the next year.

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**Operator**

Our next question is from Matt McClintock from Raymond James.

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**Matthew J. McClintock** - *Raymond James & Associates, Inc., Research Division - Research Analyst*

I was wondering, just given the magnitude of this being your first time going into a different country, if you could just remind us how you think about the Mexican market overall, the opportunities there, how it's different than the United States market? Just give us a little bit more context just so we can frame it in general.

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

Sure. Great question, Matt. One of the things, kind of going back, we've been talking about having market outside of U.S. for a few years now. And we've been looking, obviously, in Mexico as well as in other North American countries for that right opportunity. What I would tell you is that the Mexico opportunity seem to come about more quickly than other areas of North America. And as we move into Mexico, we really were looking for acquisition candidates that check several boxes that we have checked. And some of those include they need to have a solid store base. They need to have a leadership team that was grounded and understood the marketplace very well. They needed to be a good culture fit for our company. And they needed to have scalable systems. And while we looked at some companies along the way that were larger than the Mayasa organization, the Mayasa organization seemed to check all of those boxes. So very solid leadership team. As Jeff said in his prepared comments, they've been in business for well over 60 years. The leadership team in Mexico will remain in place and will work very closely with our company's leadership to direct our future opportunities down there.

Now what I would tell you is we haven't closed on the deal yet and there is much work to be done, which, as Jeff said, was one of the reasons that we reduced our store count outlook for 2020, is because of the level of effort that goes into preparing for growth in Mexico. And again, the Mayasa organization gives us the ability to do that. They've got distribution. They've got the knowledge of the marketplace. But our real estate team and operations teams have a great deal of work to do to really understand -- to fully understand that marketplace and learn from the (inaudible) family and the leadership to drive our future growth in Mexico. Jeff, did you want to add anything to that?

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

No. I mean, you covered it pretty well. I mean it's obviously a new market when you've got a lot to learn. But when you go down there and visit the markets, I mean, it's like the U.S. a couple of years ago. I mean it's a highly fragmented market. There's really not that many change of any size, AutoZone being the biggest. But there's just a ton of small independent jobber business. So it's obviously a much smaller market than U.S., but we're very excited about entering the market and growing our business down there.

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**Operator**

Our next question is from Greg Melich from Evercore ISI.





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**Gregory Scott Melich** - Evercore ISI Institutional Equities, Research Division - Senior MD

I'd love to follow up a little bit more on the pass-through of inflation and the response from both DIY and do-it-for-me. Specifically, you mentioned already some of the potential deferral. What have you guys been able to do to help offset or mitigate that by maybe growing private label or offering a different sort of assortment both in hard parts and maybe more traditional maintenance stuff?

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

Okay. Thanks, Greg. This is Tom. Just to clarify one item on Chris' question earlier when he asked about DIY ticket trends. What I meant to say was the trend was slightly positive but continues to be under pressure. To answer your question, Michael (sic) [Greg], we continue to look for ways to entice our DIY customers to repair their vehicles. We do a lot of work online with how to repair vehicles. We're promotional in our industry. But really, we think our best opportunity is to continue to grow that base as to provide great customer service, know-how, tool loaners, testing, so that as these consumers feel the pinch of higher prices, they feel more confident in their ability to repair their vehicles and save money that way.

**Gregory Scott Melich** - Evercore ISI Institutional Equities, Research Division - Senior MD

Do you see indirectly any of that happening on the hard part side where you're getting the unit demand but people are maybe changing the mix on older cars?

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

Not any more than what we've normally seen. When you look at the life cycle of our good, better, best product levels, as the vehicle gets older in that life cycle, the consumer tends to buy more towards the good or better end of the spectrum. There's exceptions to that, but overall leading into the higher-end vehicles would tend -- and the professional side of our business would lean more towards the higher end of that good, better, best spectrum. And then the older the vehicle gets, the more likely they are to trade down to the lower end of that spectrum.

**Gregory Scott Melich** - Evercore ISI Institutional Equities, Research Division - Senior MD

Got it. And then my follow-up was on Mexico on the grander scheme of the growth algorithm. I think you mentioned stores now being about 180. Is that the number you guys said in the beginning?

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

No, company-owned stores is 20 in Mexico.

**Gregory Scott Melich** - Evercore ISI Institutional Equities, Research Division - Senior MD

Got it. But for the company, now we're going to do 180 net new stores next year?

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

Yes.



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**Gregory Scott Melich** - *Evercore ISI Institutional Equities, Research Division - Senior MD*

And so should we be -- is that just like in the -- is that because next year you're doing Mexico? And should we think about the 180 as a step-down that could step up again? Or is it more of like look at -- look for the U.S. business to do 3.5% footage growth and now the additional point of footage growth might come out of Mexico?

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

What I would tell you is we still feel like we can operate somewhere in the neighborhood of 6,500 stores in the U.S., and our U.S. growth over time will continue as we approach that number. But what we're going to do is we're going to kind of blend that growth between the U.S. and countries outside the U.S., the first being Mexico.

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

To add to Greg's comment, we felt like it was prudent having gone through a number of acquisitions, knowing how important it is to get the foundation of that acquisition right before we move forward. That we, as a company, are going to allocate a lot of time to understanding the Mexican market, developing our plan and to make sure that we can put the appropriate amount of focus on developing and starting that plan. We're going to backup new stores just for this year though they could indicate anything about future years of what we're going to do. We're going to run our business with the mind of continuing to grow our store base profitably and set that going forward, but we wouldn't say that this is an indication. We think the total number of stores we can open in U.S. or our ability to open stores has changed.

**Operator**

Our next question is from Scot Ciccarelli from RBC Capital.

**Scot Ciccarelli** - *RBC Capital Markets, LLC, Research Division - MD & Consumer Discretionary Sector Analyst*

Scot Ciccarelli. I guess I have a bigger picture question for you guys. So historically, this industry kind of viewed a sweet spot for cars entering their initial repair stage at maybe 6 to 8 years old for the pro side of the business. But a recurring theme for a long time is we keep hearing about, let's call it, sluggish ticket counts being offset by higher average ticket. So my question is this, with parts continuing to be made better and lasting longer, should we start to think about that initial repair stage maybe starting later in the vehicle's life? In other words, could we have seen -- or are we seeing, I should say, the sweet spot maybe shift to 7 to 9 years or 8 to 10 years where they really come into that kind of initial repair stage for your pro customers?

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

Yes. Scot, what I would tell you is I don't know the starting point of that sweet spot. Sweet spot doesn't move that much. But I think the sweet spot itself has expanded because vehicles are just lasting longer. If you look at whether it's 5 to 7, 6 to 8, 6 to 10, I think that, that initial inflection point of the sweet spot is driven by the vehicles coming off of warranty. As soon as those vehicles come off warranty, a lot of those maintenance and repair items go to the professional installer. And then over time, as those vehicles get older, we benefit on the DIY side as well. But vehicles are just lasting longer, vehicles lasting between 11 and 12 years now. And a lot of times vehicles that are on their second and third ownership pattern are being maintained as well as they were when they came off the assembly line.



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**Scot Ciccarelli** - *RBC Capital Markets, LLC, Research Division - MD & Consumer Discretionary Sector Analyst*

Okay. Just conceptually like you owned the -- yes, I understand that it comes off the warranty and then you start taking it somewhere other than the dealer and you start using aftermarket parts but, I don't know, let's call it is the breaks and the starter. Maybe it doesn't need to be changed, right, at 6 years. You really can last till 7 or 8 or 9 years. I guess that was the thought process.

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

So what I would add to that, Scott, is a lot of the routine maintenance items, when you look at oil change intervals, fluid change intervals, when you look at tuneup-type items, those have definitely expanded with different technologies that cost more to do but don't happen as often. When you look a lot at our core items: brakes, belts, hoses, rotating electrical, batteries, that hasn't changed dramatically. But some of those categories that have changed and have been spread out, example oil changes where you speed 3,000 miles and now your car tells you when you should change your oil with synthetic or semi-synthetic, those had a lot -- have a lot of ticket count but don't have the per-transaction value that hard part repairs have.

**Operator**

Our next question is from Simeon Gutman from Morgan Stanley.

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

So you're on track to hit, looks like, your midpoint of your comp guidance of about 4%. You mentioned there's a little bit of help from price hitting 2% to 3% now for the full year, if I heard that right. So if you look at it that way, the underlying growth is more like 2% -- maybe 1% to 2% arguably. And if you look in the past, your business seemed to have averaged something a little bit higher than that with no inflation, 2% to 3% or even better than that with no inflation. Do you diagnose it in that same way? Or how do you diagnose it? Is underlying demand softer? And then when we start to lap some of these pricing, will the units go back up? I don't know if that's how it should work but curious to hear your thoughts on that.

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

So when we look at our business, I think we've been pretty clear that the professional side of the business where the average consumer or end consumer is less price sensitive, continue to see good unit growth and average ticket growth, and that's why that side of the business continues to lead. On the DIY side of the business, we have pressure on our ticket count from rising prices so that is limiting what the comp is on that side. So we still feel very good about a 5% comp in the third quarter. When we look at annualizing these price increases, I think our direction is similar to where we see [Jackson] gas prices. We would expect that the DIY side will -- the average consumer will become adjusted to what the current prices are and that we will see, as we annualize these increases, less pressure on account.

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

Okay. So I think it just -- if I could paraphrase, it seems like there's really no impact to the do-it-for-me demand side or unit count. It's really the do-it-yourself sort -- would explain maybe some of that -- some of the underlying the softness, I guess?

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

Well, I don't know that we would characterize it as soft when we deliver 5% comps. We're very, very happy with that result.



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

Fair enough. Can I ask this one follow-up? Have you thought about a scenario on which tariffs get revoked? I don't know if you plan for that or thinking through that, but what percentage of the price increases could the industry -- do you think the industry could keep?

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

Well, we'll have to see what happens with tariffs. As we talked about on our quarterly calls, starting with the first quarter, our guidance anticipates that the current inflationary/tariff environment will remain. And we will adjust our business accordingly when those changes occur. But to speak about something that hasn't occurred or may not occur is probably not the appropriate thing to do.

**Operator**

Our next question is from Michael Lasser from UBS.

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

There was a little bit of confusion in terms of some of the commentary about the consumer response to the price increases. And on the one hand, it seems as though there was a comment that you're anticipating some muted unit demand destruction from the price increases. On the other hand, there was indication that some categories that were deferrable, like motor oil and some other areas were -- actually mean some unit demand destruction from price increases. So could you clarify what category -- if there's actually seeing some elastic response and what categories right now?

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

Yes. Michael, we're not seeing any. Again, our professional side of our business was very strong. So what we've been talking about here is the DIY side of our business. And we haven't seen any of the elastic categories take a big hit because of this. What we would say in summary is if inflation persists, again, no different than ordinary inflation or gas prices or what have you, that, that consumer may have to make some decisions and what those decisions may be would be deferring or extending maintenance cycles on those categories. Some Of which are more elastic or perhaps trading down from a good, better, best spectrum on required repairs.

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

Okay. And so is the way to characterize what happened this quarter is everything remained largely stable. You didn't see as much of a negative impact from the weather plus you had a slightly higher benefit from pricing this quarter and then -- and that's all adjusting out for the extra Sunday. Is that a fair way to think about it?

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

I think it is, yes.

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

Okay. And then my last question is for Tom. Is there a scenario in 2020 where SG&A per store doesn't grow 2.5% or above? And what's the likelihood of that?



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

Well, we're not going to -- we're not giving guidance for 2020. But I'll reiterate what we've said on previous conference calls is to the extent that the labor market remains tight, we would expect to continue to have pressure on our SG&A growth. That's the biggest expense that we have in that line. And really, that pressure of higher wages impacts everything that we do in a business does. But we would expect to see, if that were the case, continued inflation in selling price to help offset that.

**Operator**

Our next question is from Seth Sigman from Crédit Suisse.

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

I wanted to follow up on CapEx. So obviously, this year, there was a big increase related to some of the DC work and store conversions. I'd assume some natural step-down next year, particularly with less U.S. store growth. But can you just discuss some of the capital requirements related to Mayasa and whether there's going to be a need for any sort of meaningful investment within that chain at some point?

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

So this is Tom. We would expect to have a lower CapEx level next year just based on not having 3 ongoing DC projects although it will continue to be elevated because 2 of the projects will still be ongoing. To speculate on Mayasa right now and what we'll do next year is pretty immature. We haven't even closed on the business. But our expectation over time is that we have a great opportunity to grow a large store base in Mexico and we'll deploy capital successfully in Mexico. But to just earlier comments, we really want to make sure we understand the market, have the team in place, have the infrastructure in place before we commit additional capital to start growing that store base robustly.

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

Got it. Understood. Okay. And then I just want to follow up on pricing. How would you guys categorize the competitive landscape today from a pricing perspective? Do you feel like it's rational? Have competitors followed some of your moves on pricing? And then sort of related, when you analyze your price gaps versus some of the emerging competitors in the space, whether that's pure-play online companies or whoever that is, have you seen any major change in those price gaps as you guys have taken pricing up?

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

Sure. So what I would say is we've seen very little change in the competitive landscape. Our industry still is very rational from a pricing perspective. And there are categories that we lead and move up in. And typically, our competitors will follow, and I guess, vice versa that holds true as well. But we -- our industry has always been very rational and continues to be very rational from a pricing perspective.

As far as online, really haven't seen a lot of change there, except for the method by which some of the brick-and-mortar retailers price online. I think it's become more typical that our price points are the same or very similar to what we have in the stores. And we offer discounts across the ticket to be more competitive with pure online retailers. And again, a lot of times there's a perception out there that when you're looking at brand to brand, we might not be competitive from a pricing standpoint. But when you look at it from an application-to-application standpoint, we are consistently very competitive from a price point standpoint. That consumer is buying products online. For price, we'll be able to go out and look for a part for his vehicle that maybe we have on a proprietary brand at equal to or sometimes less than what the pure online retailers are selling at.



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**Operator**

The next question is from Chris Bottiglieri from Wolfe Research.

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

I guess first question is kind of wanted to think through the impact of opening DCs. It's great to see opening DCs again. It's been a while. Kind of what are the impact on comps that you've observed when you open a DC? Is there any kind of quantifiable uplift in that market?

And then two, how do we think about the margin cadence? I would think maybe initial headwind of some kind and then it becomes a tailwind but is kind of curious how you're thinking about the net of this.

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

I might take the first part. This is Jeff, and then I'll let Tom or Greg chime in. But any time you open a DC in a given market, I mean, that market could be serviced by a hub store carrying somewhere from 45,000 to 65,000, 70,000 SKUs and opening that DC, when we have availability same day -- several times a day availability to 160,000 to 170,000 SKUs. So when you have that inventory available, you're just able to say yes to the DIY customer or the professional customer or fill the -- fulfill the B2B ticket more times than not where before it would have been available overnight. So I don't know if it's exactly quantifiable, but it's sure another tool in the tool box for those stores in that given market serviced by that new DC.

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

And from a cost perspective, our history has been to continue to grow our store base and expand DCs really beyond the range that's ideal from efficiency standpoint for them to run and to overload their store count, which makes them internally inefficient before we open a new DC. So as we open these new DCs and unload the stores from overloaded DCs, that makes their labor more efficient. It makes the miles driven more efficient. So we don't see a real big impact in our gross margin on a comparative basis.

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

Okay. A quick follow-up on the gross margin commentary from tariffs you said earlier. I just want to kind of confirm, maybe it through a little bit more. So you expect the gross margins to be up year-over-year and accelerate the Q4 and then decelerate but still positive year-over-year into 2020. Is that the right way to look at it? Like -- or how should -- like maybe just clarify a little bit. I wasn't quite sure what the answer was.

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

So we're seeing a benefit in our POS margin as prices have moved up with the tariffs. So we have a slow-turn industry. So we have an amount of inventory that we purchased before the tariff increase will make a higher gross margin. So that was a benefit here in the third quarter, will be a benefit in the fourth quarter. As we sell through that merchandise and reduce that amount that was basically sitting in LIFO, we will see that tailwind diminish quarter by quarter next year --

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

Got you. Okay. But still up, that was the answer? Or no?

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

The answer for the fourth quarter is we expect to see strong gross margins, which will drive us to the top end of our gross margin -- full year gross margin guidance.

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**Operator**

Our next question is from Seth Basham from Wedbush Securities.

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

I have a question as it relates to the number of employees. On a per-store basis, we saw a bit of a decline year-over-year this quarter. Is that because of the mix shift towards full time? Or are you managing your employee base a little bit differently?

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

I think we fielded this question on a few different conference calls. We have, obviously, a large employee base and that number is a point-in-time number. So depending on the time of the week it ends, depending on how many jobs we have that are open and the fluctuation, especially on the part time, that number can fluctuate, but it's not an indication of any actual a change in our business staffing philosophy. And for that, I'll turn it over to Jeff.

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

Really, I mean, we run our business one store at a time and have the operate staffing to take care of the business in that market. And then that easily ramps up and ramps down depending on the time of the year. Obviously, we're kind of in the ramp-down mode a little bit coming out of summer, going into fall and winter. So nothing's changed structurally on how we run our business. We've always ran our business for the long haul, provide excellent customer service each and every day.

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

Got it. And just a follow-up, a clarifying question. Tom, did you say that DIY ticket count, so traffic on a comparable store basis, was up or down this quarter? And how did that trend relative to the last 2 quarters?

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

Yes. I'd make sure I get it right this time. The number continues to be under pressure, so it was negative. It was slightly improved from the second quarter is what I was attempting to say.

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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, John. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued hard work in delivering a strong third quarter. I'd like to thank everyone for joining our call today, and we look forward to reporting our fourth quarter and full year results in February. Thank you.

**Operator**

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

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