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PRESENTATION

Operator

Good morning, and welcome to the O'Reilly Automotive Fourth Quarter and Full Year 2019 Earnings Conference Call. My name is Zanera, and I'll be the operator for today's call. (Operator Instructions)

I will now turn the call over to Mr. Tom McFall. Tom, you may begin.

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

Thank you, Zenara. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our fourth quarter 2019 results and our outlook for the first quarter and full year of 2020. 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.

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

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts fourth 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.

To begin today's call, I would like to congratulate all of our team members on their solid results in 2019. As a result of your commitment to our dual market strategy and the O'Reilly culture values, we generated full year comparable store sales growth of 4%. In a difficult macro environment of rising selling prices, rising acquisition costs and rising expenses, your focus on profitable growth while maintaining expense control resulted in full year sales growth of 6.4% and an increase in operating profit of 5.8%.

For 2019, we generated our 27th consecutive year of comparable store sales growth, record revenue and operating income, every year since becoming a public company in 1993. And I'd like to thank Team O'Reilly for your many contributions to support our growth and success in 2019.

Before I get into the results, I would like to call out our press release from August 20, announcing we entered into an agreement to purchase Mayasa Auto Parts headquartered in Guadalajara, Mexico. And report to you that the transaction has closed and Mayasa became a part of Team O'Reilly at the end of November. Mayasa is an amazing family-run business, founded over 65 years ago and has a very similar history and culture to O'Reilly. They currently operate 21 Orma branded auto part stores and supply over 2,000 jobbers through their 6 distribution centers. Because of their current mix of business, they run at a lower margin than the O'Reilly U.S. stores, so they are slightly diluted to our operating metrics in the fourth quarter, but did not have a material impact on our earnings per share results for the year.

2020 will be a learning and planning year as we work with the experienced Mayasa leadership team to develop our future expansion plans, and as a result, our Mexico operations will be dilutive to our operating metrics in 2020, but will not have a material impact on our earnings per share. That said, we're very excited about the addition of the 1,100-plus Mayasa team members, and we have a great opportunity to grow our footprint in Mexico over time.

Now we'll cover our fourth quarter results and key expectations supporting our 2020 guidance. Our comparable store sales for the fourth quarter grew at 4.4%, which was in line with our expectations as both DIY and professional contributed strongly to our comparable store sales growth with professional continuing to outperform DIY.

From a comp store sales progression standpoint, sales of our key undercar categories remain strong all quarter, in line with the trends we saw throughout 2019. However, the lack of winter weather in most of our markets in December resulted in below expected levels of sales for cold weather categories. This marks the second year in a row that December sales have been below our expectation.

Now we'll move on to the impact of inflation on our 2019 results, how we anticipate it will affect 2020 and the other drivers of sales we expect in 2020. For the fourth quarter, same SKU inflation was at 3.5% for the full year -- I'm sorry, it was a 3.5%. And for the full year, inflation was 3%, which was above our beginning of the year estimate of 2% as additional rounds of tariff increases went into effect. This higher-than-expected rate of inflation didn't affect our comparable traffic, which came in slightly above our expectations, but it did have a marked effect on the composition of our average ticket.

Because of the increasing complexity of replacement parts on newer, more advanced vehicles, we historically have seen robust growth in our base average ticket without the benefit of same SKU inflation. In 2019, we experienced meaningful same SKU inflation and some consumers reacted by buying down the value spectrum and consciously limiting the number of items per ticket, resulting in a lower-than-expected growth in the base average ticket. The combination of higher-than-expected same SKU inflation and lower base ticket growth resulted in total average ticket growth slightly below our expectations.

For 2020, we expect same SKU inflation to be 1% as we annualize last year's price increases and are not planning for changes in the current tariff structure. With the lower year-over-year selling price increases, we expect traffic count to improve and average ticket to remain a steady contributor to comps as the diminishing tailwind from same SKU inflation is mitigated by a return of the base underlying growth in average ticket to a more historical growth rate.

Historically, we focused on growing our per store inventory slower than comparable store sales we generate. We're going to change that for 2020. Ongoing SKU proliferation and the inflation related to increases to acquisition costs, we feel we have an opportunity to improve our store-level inventory position and build upon our industry-leading parts availability. In addition to the growth in inventory we would normally see in 2020 from new stores and product additions, we'll be adding through the course of the year just over $100 million of additional inventory to our store and hub network, and from past experience, we know this will enhance the service we provide to our customers and drive sales.

From a macro perspective, we anticipate that the demand drivers for the automotive aftermarket industry will remain solid as the robust SAAR years beginning after the great recession, continue to roll into our more addressable market and miles driven continues to grow at a moderate pace, supported by continued record high levels of employment and stable gas prices.

Based on our team's ability to provide industry-leading customer service and gain market share and the impact of inflation, our inventory initiatives and the overall outlook for the aftermarket we are establishing our full year comparable stores guidance at -- store sales guidance at 3% to 5%, Our current business trends thus far in the first quarter continue to reflect solid growth in our core undercar and underhood categories. However, the lack of cold weather has been a significant drag on seasonal sales. So at this point in the quarter, we're behind where we would like to be. As a result, we are establishing our first quarter comparable sales guidance at 2% to 4%. For the fourth quarter, gross margin was 53.3% of sales which was lower than expected due to the acquisition of Mayasa and lower-than-expected sales of cold weather categories.

For the full year, gross margin came in at 53.1%, which was towards the top end of our guidance range. As we discussed on last quarter's conference call, our gross margin benefited from 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.

During the past month, several of our key categories have received partial tariff exceptions. This will reduce the level of benefit we had expected to see in the first half of the year as we sell through the own merchandise. However, the reduction of replenishment acquisition costs will benefit us throughout the year as we anticipate current higher selling prices will remain in effect as we and others in our industry maintain rational pricing in the face of continued SG&A pressures.

In aggregate, for 2020, we expect our gross margin to be in the range of 52.5% to 53%, with the year-over-year decrease due to dilution from Mayasa and less tailwind for merchandise purchase before the tariff-related acquisition cost increases.

Operating profit for the fourth quarter came in at 17.8% of sales, which is below expectations based on how we expected gross margins on a weak cold weather sales pressure on SG&A, which Jeff will discuss and dilution from Mayasa. For the full year, operating profit was 18.9%, which was slightly below the midpoint of our guidance due to the shortfall in the fourth quarter. For 2020, we expect operating profit to be in the range of 18.4% to 18.9%. The decline from prior year is due to lower gross margin, as I discussed, pressure on SG&A, which, again, Jeff will discuss and the dilution from Mayasa.

For the fourth quarter, earnings per share of $4.25 represented an increase of 14% as the shortfall in operating profit was more than offset by a lower tax rate, which Tom will cover in his comments. For the full year, earnings per share were $17.88, which represents an 11% increase over 2019. For the first quarter of 2020, we are establishing earnings per share guidance of $4.37 to $4.47, and for the year, our guidance is $19.03 to $19.13. Our quarterly and full year guidance includes an estimate for the excess benefit from stock options and the impact of shares repurchased through this call, but does not include any additional share repurchases.

Before I turn the call over to Jeff, I'd like to briefly discuss our recent leadership conference. Two weeks ago, in Dallas, we held our annual leadership conference attended by each of our store managers, sales team members, field management and distribution management, totaling over 7,000 O'Reilly team members in the hall. The theme of this year's conference was every customer counts. And we spent a lot of time talking about focusing on the fundamentals even more, rolling up our sleeves and outhustling and outservicing the competition. Team O'Reilly left Dallas extremely motivated, and I'm very confident in our team's ability to provide excellent customer service and gain market share in 2020 and beyond.

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

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

Thanks, Greg, and good morning, everyone. I'd also like to thank Team O'Reilly for delivering another record-breaking year. Your hard work and commitment to excellent customer service has always been the strength of our company and will continue to be our strength in the future.

As Greg mentioned earlier, our SG&A for the fourth quarter came in higher than expected, with average per store SG&A growing 4.7%. The primary driver of these unexpectedly high results were nickel cost with claims coming in much higher than expected. Also contributing to the above expected SG&A was store payroll where we continue to see ongoing pressure from near full employment and statutory increases to minimum wages.

For the full year, per store SG&A increased 3.4%, which exceeded our beginning of the year guidance at 2.5% to 3%. The main drivers that took us above our guidance were wage pressures from near full employment, delays in new store openings earlier in the year, health benefit cost, cost of insurance, primarily auto-related, and a larger-than-expected charge for deferred compensation, although the offsetting benefit for that item shows up in [other] income.

Looking forward to 2020, we expect SG&A per store to grow in the range of 2.3% to 2.8%, which is above our historic run rate of 1.5% to 2%. We will be above our historic rate due to continued pressure on wages, continued pressure on the cost to cover our large vehicle fleet and ongoing technology investments, offset in part by the expectation that we will return to a more normal run rate for health benefit cost.

Our capital expenditures for the year were $628 million, which was at the bottom end of our full year guidance of $625 million to $675 million, but substantially higher than the previous 3 years, which averaged $480 million.

We had a very busy year in 2019, opening 200 net new stores, converting 20 acquired Bennett Auto Supply stores to O'Reilly stores, opening a new distribution center in Twinsburg, Ohio during the fourth quarter and developing our other DC projects, including substantial progress on our new Nashville DC, which will open early second quarter of 2020 and our Horn Lake DC, just south of Memphis, which will open in the fourth quarter of 2020. Also, during the fourth quarter, we were able to acquire existing distribution space contiguous to our Springfield, DC and corporate campus.

With fewer distribution projects and lower net store additions based on our target of 180 net new stores, we would normally expect our capital expenditures to come down. Now we are going to, again, set our capital expenditure guidance at $625 million to $675 million for 2020. A part of the reason for the elevated level are the 2019 projects that roll into 2020. However, the more exciting reasons are the projects we have slated for this year.

We have a large number of exciting projects and initiatives, but let me add some color to the more capital-intensive ones, which include: first, converting the hardware that runs our stores. Currently, our store systems run partially on a Linux server and partially on our IBM AS/400. Both pieces of equipment are a single point of failure for our stores. In 2020, we will convert all of our store systems to run on redundant Linux servers, which will eliminate the times the store computer system is down, and the store teams are forced to use paper catalogs and right manual sales tickets. This project also puts pressure on our SG&A as we must fully depreciate all of the store AS/400s by the end of the year.

Second, we will aggressively modernize our fleet of semitrucks in 2020. The enhanced safety features, improved fuel economy and maintenance savings on the project yields a great return on our investment. We're also planning to increase our spend on investments that drive energy savings in our stores. Over the past few years, we have steadily converted our store lighting to LED technology. We've been so pleased with the savings from lower electricity usage and maintenance, combined with the superior image in the stores that we're accelerating this project. Now one byproduct of this conversion is that the LEDs shine a bright light on some of the wear and tear in our high-volume more core stores. As a result, we will be remodeling more store interiors this year than is typical in our capital plan.

As I mentioned earlier, ensuring our substantial vehicle fleet continues to put pressure on our SG&A. We continue to have a very good accident rate. However, the cost of each accident continues to grow significantly for all large fleet operators. To better protect the safety of our team members and others while working to minimize our losses, we're testing a variety of crash equipments and monitoring tools to improve the accident rate of our store-based fleet, and those projects are included in our CapEx plan for 2020.

The last item I'll mention is our omnichannel efforts. We will continue to invest heavily in enhancing our omnichannel capabilities to meet our customers on their terms with solutions that meet their specific needs, whether they visit us to work, call or click. This initiative puts pressure on our expenses as well as our capital expenditures.

As Greg mentioned earlier, 2020 will be a learn and plan year as it relates to Mayasa. So we don't expect a meaningful capital spend this year, but that will change in future years. We have always geared our business model to generate long-term sustainable growth that is solidly profitable. We're very confident our SG&A spend, our additional inventory investment and our capital investments in 2020 will put us in a great position to continue our history of success. However, we're an extremely proactive and detail-orient company, and should situations change or additional opportunities arise, we will make changes to our investment strategy on a store-by-store, project-by-project basis.

As I conclude my comments, I'd like to again thank the entire O'Reilly team for a solid year in 2019. And as we preached at the conference and talk about every day, when we focus on the fundamentals of customer service and consistently execute our business model, Team O'Reilly truly makes every customer count. And I'm confident our team will do that again in 2020.

Now I'll turn the call [over to Tom].

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

Thanks, Jeff. Now we'll take a closer look at our quarterly results and our guidance for 2020. For the quarter, sales increased to $168 million, comprised of $100 million increase in comp store sales, a $58 million increase in noncomp store sales and a $10 million increase in noncomp, nonstore sales. For 2020, we expect our total revenues to be between $10.7 billion and $11 billion.

Our fourth quarter effective tax rate was 20.6% of pretax income, which was lower than expected based on a larger-than-expected benefit from share-based compensation, and was comprised of a base rate of 23.8%, reduced by a 3.2% benefit for share-based compensation. This compares to the fourth quarter of 2018 rate of 23.6% of pretax income, which was comprised of a base tax rate of 24%, reduced by 0.4% benefit for share-based compensation.

For the full year, our effective tax rate was 22.3% of pretax income, comprised of a base rate of 23.8%, reduced by 1.5% benefit for share-based compensation. For the full year of 2020, we expect an effective tax rate of 23.2%, comprised of a base rate of 23.6% reduced by a benefit of 0.4% for share-based compensation. We expect the first and fourth quarter rates to be lower than the second and third due to solar tax credits in the first and tolling of certain tax periods in the fourth. Also, variations in the tax benefit from share-based compensation will create fluctuations in our quarterly tax rate as a percent of pretax income.

Now let me add some color to our free cash flow and the components that drove our results for the year and our expectations for 2020. Free cash flow for 2019 was $1 billion, which was $170 million decrease from the prior year. The decrease was driven by higher net inventory investment, cash taxes and capital expenditures, offset in part by increased operating profit. In 2020, we expect free cash flow to be in the range of $1.1 billion to $1.2 billion, with the year-over-year increase due to increased operating profit and lower cash taxes, offset in part by higher investments in capital expenditures.

Inventory per store for the U.S. stores only at the end of the quarter was $631,000, which was a 3.1% increase from the end of 2018. The increase above our expected range of 2% to 2.5% was due to acquisition price increases and slow December sales. As Greg mentioned earlier, we're going to make additional inventory investments in 2020 and expect our per store inventory to grow 5%. Our AP-to-inventory ratio for our U.S.-based business at the end of the fourth quarter was 104.6%, which was below our expectations and below the 105.7% where we ended 2018. For 2020, we expect slightly more and finish the year at 104% based on the inventory initiatives Greg discussed.

Moving on to debt. We finished the fourth quarter with an adjusted debt-to-EBITDA ratio of 2.34x 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 continue to execute our share repurchase program, and for 2019, we repurchased 3.9 million shares at an average share price of $369.55 for a total investment of $1.4 billion. Subsequent to the end of the year during the date of our press release, we repurchased 0.2 million shares at an average price of $428.29. We remain very confident that the average repurchase price is supported by expected discounted future cash flows of our business, and we continue to view our buyback program as an effective means of returning excess capital to our shareholders.

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

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mike Baker from Nomura.

Michael Allen Baker - *Nomura Securities Co. Ltd., Research Division - Research Analyst*

I just wanted to ask a follow-up on the gross margin outlook. You said one of the reasons why it won't be as strong is due to some tariff relief, which I guess means that, that won't lead to as good of gross margin because you don't expect to be able to increase retail prices as much. Is that right?

And then as part of that, you go on to say that you still expect a benefit from lower acquisition costs throughout the year. So I'm just trying to square those 2. Is it that you expect the benefit, but it just might not be as big of a benefit as you had previously thought? I'll start there.

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

Sure. Mike, this is Tom. So 2 pieces to that question. So first, we expect to see a LIFO benefit mainly in the first half of the year. Our LIFO calculation is a total pool. So as these cost of acquisitions come in, they immediately reduce the total pool. So that's the first part of the question.

The second is, these lower acquisition costs on these specific product lines is as the sale prices remain high will generate more gross margin. So we'll gain that initial charge back over the turn of the good, which is why we'll see in the second half of the year, more benefit than less benefit in the first half.

Michael Allen Baker - *Nomura Securities Co. Ltd., Research Division - Research Analyst*

Okay. And 1 quick follow-up. Would the -- if not for the Mayasa acquisition, would the gross margins still be down? I guess we're trying to figure out how much of an impact that is. You said -- I think you said slight. So just trying to figure, I guess, how slight?

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

So we discussed this on last quarter's conference call that the lower benefit from products purchased before the tariffs would abate during 2020, and we'll see that in the second half. We didn't quantify the amount that that's the main driver that are -- that combined with Mayasa are the drivers for a lower gross margin.

Operator

Our next question comes from Greg Badishkanian from Citi.

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

David Bellinger on for Greg. So I just want to follow-up on the improving traffic of late. Can you give us some more color in terms of -- on the DIY side of the business, was that still negative in Q4 in terms of traffic? What are the underlying drivers here? As you mentioned some improvement baked into the 2020 guidance in terms of traffic. Are you expecting that to build throughout the year? And should we think of -- or should we see from you any type of competitive pricing actions on your part to try to help drive that improvement?

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

Yes. So the first part of your question, what was the makeup of traffic. What I would tell you is that traffic for the second quarter in a row, overall was positive. The cash traffic was slightly negative, which was more than offset by the charge traffic. Tom, do you want to take the...

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

Yes. The second -- our expectation for 2020 is that as we anniversary the pressure on DIY ticket count, which those customers are more susceptible to rising prices, as we annualize those price increases and annualize the pressure on the ticket count that we will see growth in that ticket count.

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

Got it. Okay.

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

So apparently negative swinging to slightly positive. And your answer is, yes, it should improve over the years, we anniversary more of the tariff-related price increases.

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

Understood. And then my follow-up, a bit more nearer term in nature for Q1 the guidance there, you're up against your easiest comparison of the year, we're still looking for comps in that 2% to 4% range. So is that all weather related? Are you currently within that range now? Or is there some acceleration embedded in the back half of the quarter?

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

What I would tell you is, obviously, first quarter is always a volatile quarter for us that can be significantly impacted by weather. We're very early in the quarter. There's a lot of the quarter remaining. The primary -- the drivers, the fundamental drivers of the categories are performing well. When you look at the undercar, underhood categories, we're pleased with how we're performing there. We're really missing on the weather-related categories because of the atypical weather that we've had thus far in the quarter.

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

The thing that I would add to that is as we move through the quarter, and it starts to warm up, south to north, those drivers of our business, historically, the weather-related categories become less of a portion of our total sales. And January is a low volume month for us, more than 2/3 of the quarter are still in front of us.

Operator

Our next question comes from Liz Suzuki from BoA.

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

I was just curious why you think you won't be able to leverage SG&A on a 3% to 5% same-store sales growth number? It just seems like the operating margin outlook is a bit lighter than what we were modeling. And I get that there's going to be some dilution from Mayasa, although it seems like it's such a small business that I -- maybe I'm surprised that it's been called out as such a margin headwind. And then we would have expected that some of your previous investments are starting to lap, and there should be an opportunity to drive more dollars to the bottom line. So I was just hoping you could break out some of that operating margin pressure.

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

Let me -- this is Tom, let me start, and I'll turn it over to Jeff. When we look at our SG&A, we're continuing to see benefits as we lap these inflationary price increases. But our -- as a small unit, especially retail, our #1 expense is payroll. And that continues to be an area where both low unemployment and statutory rates continue to push that number up. So in Jeff's comments, we talked about the fact that SG&A would be above our historic norms. We do continue to see efficiencies, but it's being offset by those pressures, and we continue to invest heavily in our technology, and that continues to pressure SG&A as it has over the last few years.

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

Well, I would just add that we always -- you have to pay what the market bears. And there's a lot of pressure on wages and has been for a couple of years, also with the statutory minimum wage increases. But we always do our best to leverage that by trying to increase team member productivity through additional team member training, additional technology, which is why we're investing in the technology initiatives.

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

Okay. Great. And just on Mayasa, I mean, is there perhaps some conservatism in these estimates, just accounting for unknown factors, given that this is your first venture abroad and maybe you're trying to bake in a certain level of conservatism there just to account for the fact that it's a new venture for you.

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

So when we look at Mayasa, it's relatively small in comparison. And when we look at this acquisition, it's really about developing a footprint that we can expand. So we will be in there working on buying synergies and cost synergies that you would expect. But we'll also be investing to build the team and the processes to build a much larger organization. So we're going to add expenses to accelerate our ability to grow out there.

Operator

Our next question comes from Bret Jordan from Jefferies.

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

Talk a little bit more about the tariff exceptions you mentioned in some key categories. I guess is that something that you could expect to receive rebates from past tariffs paid?

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

Yes. So Brett, we really got 3 primary categories that we've seen some exception in, and it's not across the board. For example, rotors has an exception, but the exception is only on a certain diameter or circumference rotor. So the larger rotors didn't get the exception, the smaller rotors did. Most of the exceptions that have been granted are retroactive, and we would expect to get the tariffs paid to date back as well.

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

Okay. Any sort of sizing of those?

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

No. We really don't have anything we want to disclose there, Bret.

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

All right. And then a question on the inventory expansion adding $100 million plus. Is that existing coverage of the inventory you currently carry? Or are you going to be expanding branded or private label SKUs to sort of new pieces of the parts mix?

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

Yes. So it's -- here's kind of what we're doing. We've been successful for years with our inventory deployment strategy and the strength of our supply chain is one of our greatest strengths. Markets continue to change. The marketplace continues to change, and we're trying to make sure that we're adapting accordingly. We're not changing anything related to depth or breadth of inventory in our distribution centers. What we're looking at is, as the consumer, especially the professional customer, as their expectations continue to increase on prompt delivery time, in-stock position from all of our stores, even though we replenish our stores daily and they get multiple deliveries in markets where we have a distribution center or through our hub store network where we don't, we're trying to push more individual SKUs down to the spoke store level and the hub store level.

So what we're doing is adding not depth but more so breadth of SKUs at our hub-and-spoke stores, and it's not specific to private label or national brands. It's just trying to get more inventory out there available to drive sales.

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

Bret, this is Tom. I'd like to add something to the first question on tariff exceptions. I'd highlight that yourself and others on the call that we work very hard at making sure that we didn't take the full tariff increases through -- looking at the currency through other sourcing, through sharing those increases with our suppliers. So we, the aggregate price increases were quite a bit less than the actual headline tariff number.

Operator

Our next question is from Daniel Imbro from Stephens.

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

Wanted to start on the comp outlook. Understanding you guys have talked about a few initiatives today, and obviously, traffic getting better through the year seems to be implied. But the full year guide seems to imply an acceleration on the 2-year stack as we move through the year as comparisons get tougher. Could you just maybe help us think through the buckets in more detail? Is that an assumed sales uplift from remodels? Is that just the traffic getting better? Can you talk about what gives you confidence that the 2-year stack should improve as we move through the year?

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

Yes. I'll start that, and then let Tom add on. I think it's a combination of everything you said there. I mean I think the appearance will help, the store appearance package changes will help. I think the inventory availability initiatives we have underway will help. I think all the things that we're talking about from a CapEx perspective that would help drive sales is going to help our comps for the year in our 2-year stack.

As I said earlier, we're not overly disappointed with how we're performing in our key categories undercar, underhood categories that you expect to sell throughout the year. The softness in the first quarter is primarily related to those seasonal items. It's the batteries, it's the wiper blades, it's the categories, antifreeze and washer fluids, the things that you sell during the winter when you have extremely cold weather that causes breakage in wear and tear. And we just haven't seen that thus far in the year. Again, it's very early in the year. And then there's still an opportunity to have a lot of cold weather in the remaining weeks of February, and we certainly hope we do, and sales for those categories pick up. But we're optimistic about the categories that drive our business day in and day out from an underhood, undercar perspective.

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

To add to Greg's comments, we finished 2019 with a 7.8% 2-year stack. And at the midpoint of our guidance, at the end of 2020, we would get 8%. So what we would say is that we expect the underlying dynamics of the automotive aftermarket and our execution of our business model will remain robust and will be consistent. Now we expect to see some improvement in traffic, less inflation, but a different composition of our average ticket. So we would view our outlook for 2020 to continue to be solid based on those trends.

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

That's helpful. And then as a follow-up to an earlier question. On the expense side, I think we get that payroll is a pressure, but I thought your commentary in the prepared remarks was that the industry was remaining rational and that you were passing through some of that SG&A pressure through higher prices. Are you just seeing an inability to pass-through that level of inflation to offset the SG&A pressure? Or can you help us understand the moving pieces there a little bit more?

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

So we do continue to pass on prices. Although we would tell you right now our view for 2020 is they'll remain static and the benefit will be from pre-anniversary of price increases that went on. When we look at those SG&A pressures, our opportunity, I think, is less on the pricing side, more on returning to normal growth in our base average ticket and improving customer counts. But we, as Jeff talked about, need to make sure that we're staffing our stores appropriately at market rates. And we have a very technical workforce that makes all the difference at the store level.

Operator

Our next question comes from Zac Fadem from Wells Fargo.

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

With the warmer start to January, we're hearing a lot of comparisons to 2017. Hoping you can walk us through some of the differences today versus 3 years ago. Why you think the setup this time around could be different, particularly from a non-weather perspective?

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

Yes. Zac, if you think back to 2017, some of the things that we called out in 2017 are not applicable or less applicable today than they were then. 2017, we called out not only weather, but we also called out where we were with the SAAR years of vehicle, vehicle populations that were entering our market, the aftermarket post warranty, and we talked about Hispanic hibernation, post election, some of those things. And when you look back at the average age of vehicles today that are coming out of the great recession, you're well into the years that are better for our industry even than they were 2 years ago. So I would say that those are some of the differences.

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

Got it. That's helpful. And then could we -- just to put the Mexico P&L impact to rest, could you walk through your expectation for top line impact? And then just to confirm the margin pressure, sounds like it's roughly half Mexico, half core business. Could you just confirm that that's right? And maybe walk us through the moving parts there?

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

As we have with other smaller acquisitions, we're not going to break out the economics of that acquisition. I think the key thing to know about the Mexican business is that the vast majority of their business, they are only run at 21 stores, and most of their business is independent jobber business and that has a different operating metric profile than company-owned stores. What you're going to see is you're going to share the gross margin with the independent jobber store you're selling to, so significantly lower gross margin, but you're also not bearing the expenses at the store level, so a lower SG&A.

Operator

Our next question comes from Kate McShane from Goldman Sachs.

Chandni Luthra - *Goldman Sachs Group Inc., Research Division - Associate*

This is Chandni Luthra on behalf of Kate McShane. I guess my first question is, so you guys gave a 1% same SKU inflation expectation for 2020. But how does that vary from 1Q where you've guided a 2% to 4% comp versus say, into 3% and 5% regime into the back half of the year? Just trying to assess where the same SKU inflation more in the first half of the year? And -- or how does that vary?

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

Definitely more in the first half of the year, very little or much less in the third quarter and virtually none in the fourth quarter. In the fourth quarter of this year, most of the -- we were slightly higher than we expected, and that was on base commodities.

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

And I would say the guide was more so based on weather-related demand and the impact of inflation between the first quarter and the remaining 3 quarters.

Chandni Luthra - *Goldman Sachs Group Inc., Research Division - Associate*

Got it. That's very helpful. And if I could get a follow-up question on your supply chain. So obviously, a lot of retailers have been talking about coronavirus. Just trying to assess, are you seeing any impact on your supply chain from that part of the world?

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

Not yet. We -- one of the differences in us and a lot of our competitors in the industry is we all bring a lot of product in from China. That's no secret. The timing of this coronavirus kind of correlated with Chinese New Year. So we had already all product in advance, planning for the shutdown from Chinese New Year. One of the advantages that we have is there's not a lot of product that has a demand cycle that warrants bringing it from China directly into our individual DCs. So rather we negotiate with our suppliers to keep a number of days of inventory on hand in their distribution facilities within the U.S. So we've got built up inventory within the U.S. that will keep us for probably 2 to 3 months that before we would see the impact from product coming from China.

Operator

Our next question comes from Chris Leary (sic) [Chris Bottiglieri] from Wolfe Research.

Jacob Nelson Moser - *Wolfe Research, LLC - Analyst*

This is Jake Moser on for Chris. So first, could you just talk a little bit more about the health benefit expense in the quarter? I think you said it would normalize as the year goes on. So is this like a onetime true-up? Or if not, like what drove such a large onetime expense?

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

So we're fully self-insured for health benefits. And they have not a very long time from initial claim to when you know the full extent of the claim, particularly about 6 months. So what we saw was our third quarter mature in a way that was much higher than we thought, and fourth quarter come in a lot higher, but health benefits have a fluctuation, and we've had good years and good quarters and we've had rougher years and rougher quarters, and it really -- some of it is just statistics and odds. What we looked at was a few really big claims and more medium to larger claims than we'd expect. Impossible to predict fully, but we would expect this to be more of an outlier and expect 2020 to follow more historical medical trends for our population.

Jacob Nelson Moser - *Wolfe Research, LLC - Analyst*

Got you. And then secondly, can you just talk about the timing of the 2020 DC openings? And is there anything we should be thinking about in terms of cost pressures or comp lift as these are built out and opened?

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

Jeff, do you want to take that?

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

As far as timing, the 11 in DC will roll in the second quarter. And then the Horn Lake or Memphis DC will roll in, in the last quarter of the year. From a cost perspective, we would expect to feel some cost pressures. Distribution is included in our gross margin, but it's not a huge number, which is why we didn't call it out separately.

Operator

Our next question comes from Michael Lasser from UBS.

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

In the past, the aftermarket has seen a prolonged impact from the lack of cold weather and -- in particularly in the spring from the lack of corrosive material that's put on the road and from path holes. It seems like looking at your guidance, you're assuming that, that won't be the case this year. Why would this year be different?

And as part of that question, as you do look at your full year comp guidance, do you see more risk in the front half of the year from the weather or in the back half of the year from the lack of tariff-related inflation?

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

Yes. Mike, I'll take the first part of that, and then let Tom talk about the first half versus back half of the year. As I said earlier, our softness has been more in weather-related categories. And the fact that our sales have remained strong on those typical wear and tear categories, such as undercar steering, chassis, things like that. Through the first few weeks of the year and the tail end of 2019, that gives us confidence that those repairs and those hard part categories will still perform well for us.

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

So to take out the rest of the question, Michael. As we get near the end of the season, people will defer true seasonal purchases whether that's air conditioning season or in this case, cold weather. We'd expect the rest of the winter to be normal. Precipitation is really what creates the rough road. So we'd expect that to be normal, and that hasn't been as different. If you remember last year, we had the polar vortex, which that cold weather really drives the seasonal. So between that and a better vehicle dynamic as opposed to 2017, where we were going to get the harder vehicle dynamic gives us confidence. And as Greg said, our underlying core categories have been good.

As far as the risk to comps throughout the year, what we would tell you is that we're not in an underserved market. We need to continue to go out and execute better than our competitors and grow our market share every day, whether it's the first quarter or the fourth quarter, and it will be the same next year. When we look at our comps, and we continue to perform very consistently. A lot of it driven by the vehicle dynamics by reasonable gas prices by high levels of employment, and we expect that to continue throughout the year. So our expectations for comps will be relatively consistent in the second, third and fourth quarter, first quarter or by January lack of cold weather categories.

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

And your gross margin guidance for this year has caused a lot of conversation and debate. Should we expect that once you get past this inventory accounting dynamic that your gross margin should be stable to growing over the long term?

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

Well, what we would tell you is that our focus is on comp gross margin dollars. And as we saw this year with same SKU inflation, we're able to generate more comp gross margin dollars at a similar rate. So we always try to improve our acquisition costs and the efficiency of our distribution and squeeze out those costs to drive better gross margins. So our expectation is that it will be stable to slightly growing.

Operator

Our next question comes from Simeon Gutman for Morgan Stanley.

Joshua Kamboj - *Morgan Stanley, Research Division - Research Associate*

This is Josh Kamboj for Simeon. It sounds like a larger than usual number of store and technology projects are coming to fruition this year. Combined with the increase in the DC openings in the recent Mayasa acquisition, it looks like there is a greater sense of urgency around investing than in the recent past. Is that a fair assumption? And if so, can you talk about what might be driving that and potential areas of mis-execution that you might be monitoring especially closely?

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

Yes. I mean, there's -- you can break it down by categories and some categories, there's a greater sense of urgency, some have just been ongoing initiatives. An example of a greater sense of urgency would be the replacement of our store point-of-sale systems. Over the past year, we've been working on making our systems more stable in our stores, and that entails both making sure our communication networks are redundant and dependable as well as making sure the systems themselves have high availability. And when you look at a dated platform, like the AS/400, when those machines fail, it takes some time to comeback up. Jeff's comments in his prepared statements, that creates downtime for the stores and creates manual processes, which doesn't result in a very favorable customer experience.

So that's a big spend for us. It's a big lift. It's something we've been working on for a few months now, and we fully expect to roll those out by the end of the year. Some of the other investments are just -- they just have the right return, and there are things we need to do. We've seen savings in our utility expense in 2019 as a result of the LED lighting initiatives in our stores and our DCs, and we're extending that, both from an appearance standpoint, which should help with sales as well as the financial return.

Another example of an initiative with a high ROI is our delivery fleet, our DOT fleet. We -- that's going to do several things for us. Our fleet is an aging fleet. We always depreciated our trucks over an extended period of time. And over the years, those trucks have become much more efficient. So by replacing a significant portion of our trucks this year, it does several things for us. One, it reduces our maintenance costs because it's new equipment. Two, it should help with our driver hiring and retention because it's new equipment, drivers like to drive new equipment. There are many drivers out there that are not certified to drive trucks with manual transmissions. All of our new trucks will have automatic transmissions, which opens up the applicant pool significantly and also that allows us to have more collision avoidance on our trucks and more technology in our trucks.

So it's a combination of all the above. Some of it, it's based on ROI, some of it's based on driving sales. And some of it, it's just out of necessity like the computer system replacements in our stores.

Joshua Kamboj - *Morgan Stanley, Research Division - Research Associate*

And then your Q4 comps were obviously pretty healthy and better than many were expecting. Did you see evidence that you gained significant share in the quarter, perhaps? Or was it more a function of maybe your store footprint?

And then just related to that, can you talk about some specific factors you might have assessed and embedded in your 2020 guide, for example, the extra day because of the leap year, potential sales risks in 2H around the election, anything like that to be aware of?

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

Joe (sic) [Josh], on the comp question on for leap day, we don't include that in our comps. So that day just becomes a noncomp day. When we look at around the election, our expectation is that we won't see significant disruption around the election.

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

As far as the Q4 comps, I mean, we came out of Q3 pretty strong and that carried into Q4. Just as Greg mentioned in his prepared comments, it's often pretty widespread in December. As far as taking market share, I mean, it's always our goal to be the dominant supplier in every market we operate in. And that's what we focus on fundamentally in all of our stores across the country everyday is just the fundamental execution and top-notch customer service, trying to build relationships with all the customers in the market, both retail and professional.

Operator

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

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

Thank you, Zenara. We'd like to conclude our call today by thanking the entire O'Reilly team for our solid fourth quarter and full year 2019 results. We look forward to a strong year in 2020, and I'd like to thank everyone for joining our call today. And we look forward to reporting our 2020 first quarter results in April. Thank you.

Operator

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