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ORLY.OQ - Q4 2020 O'Reilly Automotive Inc Earnings Call

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OVERVIEW:

Co. reported 4Q20 EPS of $5.40. Expects 2021 revenue to be $11.5-11.8b and EPS to be $22.70-22.90.

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Christopher James Bottiglieri *Exane BNP Paribas, Research Division - Research Analyst*

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

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

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

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

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

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

PRESENTATION

Operator

Welcome to the O'Reilly Automotive, Inc. Fourth Quarter and Full Year 2020 Earnings Conference Call. My name is Gigi, and I will be your operator for today's call. (Operator Instructions)

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

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

Thank you, Gigi. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our fourth quarter 2020 results and our outlook for 2021. 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, 2019 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. - CEO & Co-President*

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 on the call.

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To begin today's call, I would like to congratulate Team O'Reilly on delivering a truly remarkable year in 2020. At this time last year, when we first provided our outlook for 2020, we could never have anticipated the challenges we would face during the year. The COVID-19 pandemic has disrupted every facet of daily life in the United States and has required our teams to show tremendous flexibility in executing our business model and taking care of our customers. There simply aren't words to describe the selfless dedication, hard work and sacrifices our team members in our stores, distribution centers and offices demonstrated during 2020.

From the onset of the pandemic, we have closely monitored and quickly adapted to evolving information, recommendations and requirements issued by public health agencies and state and local governments, as we continually update our protocols and procedures to ensure best practices are followed. Our top priority continues to be the protection of health and safety of our team members and customers, while meeting the critical needs of our customers as an essential service provider.

Before I move on to the rest of our prepared comments today, I want to thank Team O'Reilly for your amazing dedication and performance during an incredibly challenging and successful 2020. The bedrock of our company's success sets our founding 63 years ago has been providing excellent customer service, and never has the value we provide to our customers been more evident than during the past year. Our team consistently stepped up to the plate to meet our customers' critical needs in the midst of extremely challenging circumstances and delivered record-breaking results in 2020, highlighted by full year comparable store sales growth of 10.9% and an annual operating profit of 26%.

2020 represents our 28th consecutive year of comparable store sales growth, record revenue and operating income, and none of the 27 preceding years was anything like 2020.

Now we will cover our fourth quarter results and the full year expectations supporting our 2021 guidance. Our comparable store sales for the fourth quarter grew at 11.2%. As we discussed on the last 2 quarters calls, we anticipated that sales would return to a level, which was closer to our expectations from the record-setting pace we saw in the middle of the year, but we remain very pleased at how steady and elevated our sales have been.

From a cadence perspective, after starting the quarter on a strong trend, as noted on our last conference call, we saw sales moderate somewhat in November but finished December with the strongest performance of the quarter, as we saw our robust underlying sales trend supplemented by a benefit from cold weather categories. The composition of our strong sales performance in the fourth quarter continue the trends we've experienced in the past 2 quarters, with our DIY business being the stronger contributor during the quarter, driven by robust increases in both ticket comp counts, ticket count comps and average ticket comps. However, our professional business also performed well and strengthened as we progressed through the quarter.

Our average ticket growth in the quarter and full year 2020 exceeded our expectations despite a limited benefit from inflation, indicating a continued ability and willingness of our customers to work on larger projects. From a category standpoint, we continue to see broad-based, robust sales trends across all categories with very strong performance in our DIY outfront categories and batteries. Even in an environment of pressure on total miles driven, as a result of the pandemic, we saw continued brisk sales in our undercar and Car Parc categories.

As we look forward to 2021, we remain very confident about the health of the automotive aftermarket, and we are monitoring several potential tailwinds and headwinds that affect our outlook for the coming year. While it is impossible to quantify the exact impact of the various factors that drove the surge in volume we experienced in 2020, we believe our industry benefited from several positive tailwinds that contributed to our extremely strong performance.

In the early stage of pandemic, government stimulus payments and enhanced unemployment benefits under the CARES Act provided immediate demand in our markets and have helped shore up the U.S. consumer even in the face of increased unemployment. However, the strength of demand in our industry has stayed very strong throughout 2020, and it is also clear that we benefited from an increased willingness by DIY consumers to invest in repairing and maintaining their vehicles for a number of reasons.

As we've seen repeatedly in previous economic cycles, the current economic uncertainty drives consumers to defer new car purchases and invest in keeping their existing vehicles on the road. The trend in 2020 for DIYers to take on larger jobs reflects this renewed focus on addressing

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underperformed maintenance. We also believe the strength we've seen in what have typically been more discretionary appearance and accessory categories reflects a shift in consumers allocating more of their time and spend to their vehicles and away from spending on other activities not possible during the pandemic.

As we evaluate the staying power of increased demand and we've seen on the DIY side of our business in 2020, we remain cautious, knowing that some of those tailwinds to automotive aftermarket demand may soften as we move further past the economic disruption brought on by the pandemic. However, we have been encouraged by how resilient the strong sales trends have been as we move past the injection of additional dollars into the economy and remain confident that consumers will continue to see value in repairing and maintaining their vehicle in a difficult economic environment as we've seen during similar periods in our history.

We've also been pleased with our performance even in the face of declines in miles driven in the U.S., driven by decreased employment and increased work-from-home arrangements as well as a slower pace of economic activity. The performance of our professional business took longer to stabilize after the initial pandemic shutdowns due to the consumers' initial reluctance to take their vehicle to a professional installer shop for repairs and the demographics of the consumers on this side of the business, making them more likely to work from home and drive less. The professional business began to turn around in May and delivered solid above-plan results for the third and fourth quarter. However, for the full year, our professional business was below our expectations. While sustained pressure to miles driven as a long-term negative to our business, we're encouraged that we've performed well in the current environment and believe we will benefit as miles driven returns to historical norms postpandemic.

While it is evident that these positive tailwinds we have experienced have also benefited the entire automotive aftermarket, our extremely strong results in 2020 were also driven by significant share gains. We offer a compelling value proposition to our customers, providing excellent customer service through a well-equipped, technically proficient team of professional parts people leveraging industry-leading parts availability. The strength of this business model and our team who worked tirelessly to keep our stores open, stocked and supplied, wise and continues to be a huge advantage in an incredibly difficult environment and differentiates us from the experience offered by some of our competitors in big box stores. Each new customer is hard one, and our team remains committed to deliver on the promise of outstanding customer service in each store every day. We're confident the goodwill we've created for meeting our customers' essential needs during this crisis will drive customer loyalty and earn their repeat business.

As we have thought through the dynamics of demand in our industry and our performance over the last several quarters with a focus in looking forward to 2021, we remain confident in the strength of our industry and the ability for our team to continue to produce strong top line sales. However, we have experienced a tremendous surge in our business after the initial onset of the pandemic, and we remain cautious as we plan for the coming year in anticipation of continued significant uncertainty and the potential for volatility in our results.

On the professional side of our business, we expect solid performance throughout the year as we anticipate our current momentum to continue, as miles driven continues to rebound. However, on the DIY side of the business, we face extremely difficult comparisons beginning in April, as we lap the biggest surge in demand in a short period of time in our company's history.

As a result, we are guiding to a comparable store sales range of down 2% to flat versus comparable store sales growth of 10.9% in 2020, with the most significant pressure in that outlook expected for the second and third quarters, as we lap the record volumes. Thus far in 2021, we have been pleased with our results, as our strong sales trends have continued, and we benefited from additional government stimulus and favorable winter weather.

For 2021, we are reinstating our practice of providing selected annual guidance. As we move through 2021, we anticipate we'll face significant quarter-to-quarter uncertainty as the broader impact of recovery from the pandemic is difficult to predict. The potential volatility, coupled with dramatic different comparisons to the unique business trends we saw play out in 2020, makes it extremely difficult to project the timing and cadence of our business with a high degree of certainty. As a result, we are limiting our guidance to expectations for the full year of 2021 and not providing guidance for individual quarters.

As a final note on our outlook, our guidance doesn't incorporate any further benefits from additional government stimulus or unemployment benefits since the timing and ultimate impact of these measures is difficult to project. As we move through 2021, we will update our annual guidance

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as appropriate as we could see more significant volatility than we have historically as our industry and the U.S. economy charts a course out of this pandemic.

Moving on to gross margin. For the fourth quarter, our gross margin of 52% was a 131 basis point decrease from the fourth quarter of 2019 gross margin. The reduction from last year was driven by a reduced LIFO benefit from the impact of merchandise purchased in 2019 before tariff-related cost increases as well as the planned expected dilution from Mayasa. Both impacts are consistent with the pressure experienced in the third quarter and in line with our expectations.

As a reminder, on the tariff cost impact, through 2019, we received a gross margin benefit from the sell-through of on-hand inventory that was purchased prior to the tariff-driven acquisition price increases in 2018 and 2019, and we have experienced headwinds in the back half of 2020, as we compared against this 2019 benefit. We also experienced headwinds to gross margin in the fourth quarter related to the expiration of certain tariff exclusions we had received in the back half of 2019 that expired in 2020.

For the full year, gross margin came in at 52.4%. And for 2021, we expect our gross margin to be in the range of 52.2% to 52.7%. For the quarter, earnings per share of $5.40 represents an increase of 27% over $4.25 in the fourth quarter of 2019. For the full year, earnings per share were $23.53, which represents a 32% increase over 2019. For 2021, our guidance is $22.70 to $22.90, representing a decrease of 3% versus 2020 at the midpoint. However, on a 2-year compounded annual growth rate basis compared to 2019, our expected 2021 diluted earnings per share represents a forecasted annual increase of 12.9%. Our EPS guidance includes the impact of shares repurchased through this call but does not include any additional share repurchases.

To finish my comments, I want to, again, offer my appreciation to Team O'Reilly for an outstanding year. We truly have the best team in the country, and we couldn't be proud of your hard work and dedication to our customers in 2020.

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

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

Thanks, Greg, and good morning, everyone. I want to start by adding my congratulations and expressing my sincere appreciation to Team O'Reilly for another incredible quarter and an amazing full year performance in 2020. 2020 has presented wave after wave of changes, and our teams have consistently stepped up to the challenge to run our business and take care of our customers.

Challenges remain in 2021, and our team remain committed as ever to delivery an exceptional service and value to our customers. At this time of the year, we would normally be retiring from our leadership conference, which is a huge in-person gathering of all of store, field and DC leadership, where we enhanced our product knowledge and technical proficiency, showcase new tools and strategies to improve our customer service and take market share and to recognize outstanding achievement throughout our company.

Even though this year's event had to take on a new format as our first ever virtual conference, we had an extremely successful event, and no slogan could be more on target than our conference theme of O'Reilly Strong. That O'Reilly's strength was on full display throughout 2020, and we're especially proud of the daily sacrifices our team made to go the extra miles to take care of our customers' critical needs while also ensuring that the health and safety of our team members and customers remain the top priority.

Now I'd like to spend some time covering our SG&A and operating profit performance in 2020 and our outlook for 2021. For the fourth quarter, we generated an impressive increase in operating margin of 111 basis points and an operating profit dollar growth of 21%. For the full year, the improvements were 193 basis points and 26% of operating profit dollar growth, yielding a record 20.9% operating margin. This increase in operating profit results for 2020 was driven by the combination of a robust 10.9% comparable store sales growth and very limited per store SG&A growth of 1.2% after adjusting for Leap Day, resulting in leverage of SG&A of 263 basis points.

As we've discussed since our second quarter, 2020 was a very unique year in our industry as the onset and progression of the pandemic created extreme, short-term sales volatility in our business. Our corresponding actions to execute significant cost control measures to protect the company

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at the onset of the pandemic and our caution in adding back SG&A dollars created a situation where very strong sales generated levels of profitability that far exceeded historical performance and are not sustainable nor healthy for the long-term success of our business.

As we move through 2020, we've redeployed more SG&A dollars back in our stores to adjust to the current sales environment. We have continued to see sales outrun the growth of our SG&A and drive significant leverage. In establishing our operating margin guidance for 2021, we're projecting an increase in SG&A per store of approximately 2.5% after adjusting for Leap Day in 2020. This outlook reflects our plans to continue to actively manage our cost structure to provide excellent customer service to match the sales environment and ensure we're allocating sufficient resources to the image and appearance of our stores and the training and development of our team members. Even with the continued prudent outlook on managing SG&A, we'll face very challenging comparisons in the middle of 2021 to the deliberate significant cost reductions we executed in 2020.

As we've evaluated our forecast for 2021, we've looked in the rearview mirror to not only last year but 2019 as well. As compared to 2019, our current expectations per store SG&A growth drive solid incremental leverage, reflecting lessons learned as we've navigated through the high levels of sales and productivity gains in 2020, especially as we capitalize on the quality and experience of our team. As always, we don't manage our business for short-term results, but we'll invest the dollars necessary to provide the excellent customer service that drives our long-term success.

Our assumptions for operating costs include anticipated wage pressures, in line with existing minimum wage statutes currently scheduled but does not include potential further increases at a federal, state or local level, nor does it include any incremental top line inflation assumptions that we believe would result from new legislation.

Based on relatively flat gross margin and increasing operating expenses, we expect operating profit to decline between 150 and 200 basis points from 2020's phenomenal results. However, our operating profit guidance range of 19% to 19.5% of sales represents solid growth from the 18.9% operating profit that we achieved in 2019.

Our capital expenditures for 2020 were $466 million, which was lower than our typical capital expend and was below our original plan coming into 2020. At the onset of the pandemic, in the second quarter, we prioritized financial stability and flexibility. And as we move forward in a COVID-19 world, we reset our expectations for new store, DC and capital project development. Our #1 priority is to drive strong returns on our investments by ensuring our new stores start with a great store team to provide excellent customer service from day one, and our projects are completed successfully to enhance our service and drive efficiencies.

We resumed our capital deployment plan in the back half of 2020. And in line with our revised plans, we were successful in opening 156 net new stores in 2020, including our first greenfield new store opening in Mexico during the fourth quarter. We've been very pleased with our team's ability to successfully open great new store locations in a very difficult year, and our 2020 stores are off to a great start.

For 2021, we're setting our capital expenditure guidance at $550 million to $650 million. We've also established a target of 165 to 175 new store openings. Our new store target is higher than our new store openings in 2020, but is still restrained by expected delays in regards to design and permitting approvals. We feel confident that we can achieve our target and open another strong class in new stores, but will be dependent on local market conditions and municipal agencies for us to stay on our development schedule.

After the successful opening of our newest distribution facility in 2020 in Lebanon, Tennessee, we have another major distribution project on the horizon for 2021, with the completion and opening of our new DC in Horn Lake, Mississippi, which is just south of Memphis, in the second quarter of this year. This new DC will be approximately 580,000 square feet, and our initial plan is to build out capacity to service 250 stores, servicing over 220 stores at start-up. The new DC will provide us with additional capacity for store growth in this region of the country and provide flexibility for the surrounding DCs while also accommodating a broader SKU capacity, increasing our breadth of hard-to-find parts and allowing us to provide an even higher level of service through the Memphis metropolitan area markets.

Our distribution teams are very experienced at planning, designing, building and opening our new DCs, and we're looking forward to another successful project in 2021. Outside of our new store and distribution growth, we've also identified several exciting projects and initiatives in 2021 to enhance the service we provide our customers and drive strong returns. Several of these projects were included in our 2020 plan but were delayed as we monitored our business to ensure a successful rollout while prioritizing the immediate needs of our customers during the pandemic.

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Finally, we 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 a store, call us or click.

As it relates to our operations in Mexico, our new store growth target includes 5 new stores that we have slated to open towards the end of 2021, but we're still in the early stages of our expansion plans and don't expect a meaningful capital spend in Mexico this year. Our collaboration with our Mayasa team members was excellent in 2020, and we continue to learn these new markets and lay a strong foundation for future growth.

Before I turn the call over to Tom, I want to once again thank Team O'Reilly for their dedication and hard work in 2020.

Now I'll turn the call over to Tom.

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

Thanks, Jeff. I would also like to thank all of Team O'Reilly for their continued commitment to our customers, which drove our record-setting performance in the fourth quarter and full year of 2020.

Now we'll take a closer look at our quarterly results and our guidance for 2021. For the quarter, sales increased $346 million, comprised of a $273 million increase in comp store sales, a $51 million increase in noncomp store sales, a $25 million increase in noncomp nonstore sales and a $3 million decrease from permanently closed stores. For 2021, we expect our total revenues to be between $11.5 billion and $11.8 billion.

As Greg previously mentioned, gross margin for the fourth quarter decreased 131 basis points to 52%, which was driven by the year-over-year comparison to significant gross margin benefits we captured in the fourth quarter of 2019 related to sell-through of pre-tariff on-hand inventory and tariff exclusions on certain product lines as well as dilution from the acquisition of Mayasa. Looking at the fourth quarter stand-alone, we had a positive impact from LIFO of $6 million, down from $23 million in 2019.

Included within our guidance for 2021 is the larger anticipated positive impact from LIFO, which will offset pressure to our POS margins from the expiration of tariff exclusions we benefited from in the first half of 2020. We received a very minor benefit from same SKU inflation in the fourth quarter 2020, in line with our expectations, and our outlook for 2021 for sales and gross margin includes a muted expectation for same SKU inflation of 1%. The pricing environment remains rational, and we expect that to continue.

Our fourth quarter effective tax rate was 21.4% of pretax income, comprised of a base rate of 21.8%, reduced by a 0.4% benefit from share-based compensation. This compares to the fourth quarter of 2019 rate of 20.6% of pretax income, which was comprised of a base rate of 23.8%, reduced by a 3.2% benefit for share-based compensation. The fourth quarter of 2020 base rate, as compared to 2019, benefited from renewable energy tax credits, in line with our expectations.

For the full year, our effective tax rate was 22.7% of pretax income comprised of a base rate of 23.4%, reduced by 0.7% benefit for share-based compensation. For the full year of 2021, we expect an effective tax rate of 23%, comprised of a base rate of 23.4%, reduced by a benefit of 0.4% for share-based compensation. We expect the fourth quarter rate to be lower than the other 3 quarters due to the expected timing of benefits from renewable energy tax credits and tolling of certain tax periods in the fourth quarter. These expectations assume no significant changes to existing tax codes. Also, variations in the tax benefit for share-based compensation can create fluctuations in our quarterly tax rate.

Now we'll move on to free cash flow and the components that drove our results and our expectations for 2021. Free cash flow for 2020 was $2.2 billion versus $1 billion in 2019. The significant increase of $1.2 billion or 115% was driven by an increase in operating income, a reduction in net inventory and deferral of tax payments under the CARES Act and a reduction in CapEx. In 2021, we expect free cash flow to be in the range of $1 billion to $1.3 billion with the year-over-year decrease due to increased net inventory investment, lower operating profit and slower sales growth and a more normal SG&A spend, increased CapEx, as Jeff previously outlined and an increase in cash payroll taxes paid, as half of the taxes deferred in the 2020 CARES Act will be paid at the end of 2021.

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Inventory per store at the end of the quarter was $650,000, which was up 2.8% from the end of last year. I want to touch briefly on our per store inventory growth in 2020 and our plans for 2021. We came into 2020 and have developed a plan to further enhance our store-level inventory position and build on our industry-leading parts availability and had targeted of per store inventory growth of 5%. This increase was driven by just over $100 million of additional inventory in our store and hub network, above and beyond our normal new store and typical product additions. As we move through 2020, we needed to refocus our priorities to support the extremely sound sales volumes and replenishment needs of our stores and had to delay some of the inventory initiatives we have planned and finished the year below our original plan at an inventory increase of 2.8%. For 2021, we plan to complete our 2020 inventory expansion plan and expect per store inventory to increase approximately 4%.

Our AP to inventory ratio at the end of the quarter was 114.5%, which was significantly higher than our normal ratio and heavily influenced by the extremely strong sales volumes and inventory turns in the last 9 months of the year. We anticipate our AP to inventory ratio to come back off of these historic highs as we complete our inventory initiatives and our sales growth moderates. Our current expectation is to finish 2021 at a ratio of approximately 109%.

Moving on to debt. We finished the fourth quarter with an adjusted debt-to-EBITDA ratio of 2.03x as compared to the end of 2019 of 2.34x, with the reduction driven by the significant growth in our EBITDA during 2020. We continue to be below our leverage target of 2.5x, and we will approach that number when appropriate.

After a brief pause at the onset of the pandemic, we have continued to execute our share repurchase program. And for 2020, based on the strength of our business, we were able to repurchase 4.8 million shares at an average share price of $431.93 for a total investment of $2.1 billion. Subsequent to the end of the year and through the date of our press release, we repurchased 0.7 million shares at an average share price of $447.40. We remain very confident that the average repurchase price is supported by expected future discounted cash flows of our business, and we continue to view our buyback program as an effective means of returning excess capital to shareholders. As we evaluate our liquidity, leverage, use of capital and share repurchase program moving forward, we'll continue to prioritize maintaining our strong financial position, including the investment-grade rating on our public debt. We have a long history of conservatively managing our balance sheet, and we'll continue to take prudent steps to ensure the long-term health and stability of our company.

Before I open up our call to your questions, I'd like to congratulate the O'Reilly team on a great 2020 and thank them for their continued dedication to our company and our customers.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Simeon Gutman from Morgan Stanley.

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

My first question is on the sales line. Can you talk about in the outlook the minus 2% to 0% comp? Can you talk about your assumption for industry growth versus market share? And if there's any commentary you can provide looking backwards on the 11% comp that you did in 2020.

And I know -- I think Greg Johnson mentioned in his prepared remarks that undercar was doing well in -- despite miles driven being down. Can -- does that -- should that make us more tempered about how the industry should recover as miles driven resumes starts to grow again?

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

Tom, do you want to take that one off?

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

Okay. So on the guidance for the comps of negative 2% to flat, we break that into two pieces. We didn't see the incredible upside on the professional side of the business that we saw on the DIY side of the business. And consumers have more time on their hands, they had government money in their pocket book. And as we talked about tick on larger projects, some of which are very atypical for economic downturns where they were working on projects and making sure their vehicles were maintained.

So when we look at the professional side of the business, we continue to see growth on that side of the business. On the DIY side of the business, much more cyclical. And after the huge gains in 2020, we'd expect them to be pressured in 2021.

On the miles driven, it kind of feeds off of that same comment. We would expect as miles driven to increase, that our business will see a positive impact from that with the caveat that we saw a lot of DIY projects during the year. Ultimately, for our business to be up that much, consumers were being more proactive in maintaining their vehicles, and the amount underperformed or unperformed maintenance decreased.

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

Yes. To add to that, Simeon, on the category question, we were pleased with our performance across the board. I did call out undercar. Really, the only categories that underperformed were weather and miles driven-related. Things like lighting and wipers were softer than what we would have liked to have seen. But one of the shifts that we saw during the quarter, and I also called this out, is the willingness and ability of the DIY customer to take on larger jobs than perhaps they would have historically.

And for example, some of our undercar lines, like brakes, really performed well and better than expected on the DIY side of the business that were typically that would be a stronger category for the DIFM side.

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

Okay. My follow-up is on incremental margins, and I guess maybe more for Tom. If you look back pre-COVID, and you mentioned some '19 -- 2019 stats, your incrementals were closer to 20%. I don't know when we'll get to a new normal, and I appreciate we're not going to give '22 guidance at this time. But is there any reason why we can't get back to that level when the business can grow again? Is the leverage point of the business higher? Or is -- or can we look back at '19 and '18 levels of incremental margin and use that as a normal level going forward?

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

I don't think that the incremental leverage points for our business have changed. 2020 was such a dramatic year with sales being softer at the beginning of the year and then down significantly at the onset of the pandemic that protect the health of the business. We made dramatic cuts in our expenses, and then mid-April sales turned directly north. So it was a very unusual circumstance. We weren't sure how long that was going to last, and we're very prudent on adding back SG&A. And obviously, sales continue to be exceptionally strong. So comparison to the 2020 metrics is very difficult. That said, I don't think that the core underlying economics of our business have changed, and I think that we will go back to continuing to execute the very similar business model.

Operator

Our next question comes from the line of Michael Lasser from UBS.

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

How have you thought about using this period of remarkable comp strike to take a look at your pricing and make any investments in your pricing that might be necessary to ensure you're competitive with both your traditional and online competitors? Because you did not call out pricing as an impact to your gross margin during the period. And one might think that given some of the competitive factors out there, especially with one of your large competitors talking about price investments that, that would have been the case.

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

Yes, Michael, this is Greg. Really, 2020 was no different than any other year. We have competitors out there, both on the professional side of the business and the retail side of the business that there's price movement based on cost inputs, there's price input based on commodities. They go into the product. There's price inputs based on trying to grow sales, changing suppliers. It's an ongoing battle, and it's something that we face year-over-year. And really, we work hard, both on the professional side of the business and the retail side of the business to make sure we're priced competitively. And frankly, I don't see 2020 as being any different than any other year in that respect. We did the same things. We passed along cost increases where we could, as we always do, and we closely monitored our competitor pricing trends. So really, I don't think we did anything any different in 2020 than we would do any other year.

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

And just to confirm, there were no price investments that were a significant contributor to your gross margin being down more in the fourth quarter than it was in the third quarter.

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

When we look at our fourth quarter gross margin versus our third quarter, it was pretty consistent except for on the distribution side. We have lower volumes, so we have less leverage on our distribution costs. And quite frankly, our distribution centers have worked tirelessly all year. And some of the normal maintenance and inventory maintenance had to be put aside as we work to fulfill record volumes, and we had some catching up to do on our distribution side and had to spend additional payroll there.

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

Okay. My follow-up question is as you look out to 2021, if sales are weaker than you expect because there's more demand that was pulled forward than what you anticipated, how would you manage your SG&A in response to that? Will it still be up 2.5%? Otherwise, might you have underinvested in operating expenses in 2021 and need to catch up this year, which might limit some of your flexibility?

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

Jeff, do you want to start that off? And maybe Tom will add to it.

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

Yes. Michael, I'd just say that we always have managed our SG&A to our business, and we manage our payroll store-by-store and really adjust to the sales demand in the market. And if sales are a little softer, we adjust accordingly. Maybe it's less hours, it's less over time. Maybe less headcount and vice versa, like we've seen last year. It's the most dramatic swing we'd ever seen in having to ramp down in a period we would normally ramp up going into season and then had to immediately try to ramp back up the best we could to meet the incredible sales demand. So it's always fluid. Last year was incredibly volatile, but we adjust accordingly for the long-term health of our business and what's best for our customer service.

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

Michael, what I'd add to that is as a multiunit retailer, we have a relatively high fixed cost to operate the stores. But what I think you saw in 2020 is that if we had the expectation, we're going to have a significant downturn in volumes that we can and will take very active steps to address our SG&A.

Operator

Our next question comes from the line of Chris Horvers from JPMorgan.

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

Tom, can you talk about that the LIFO benefit of $6 million here in the fourth quarter on an absolute basis? Is that a fair base assumption as you look into 2021 on a quarterly basis? Or are you expecting that to rise as there are some parts inflation -- price inflation coming through? And then more broadly, can you provide some color on sort of gross margin cadence over the year?

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

So from a LIFO standpoint, $6 million in the fourth quarter, we'd expect to be around that number, maybe just a little bit higher, looking at the price increases. We're aware of currently in our expectation from moderate inflation rate of 1% throughout the year. So hopefully, that covers our LIFO number. It obviously was significantly different and lower in 2020 than it was 2019 after the 2018 and 2019 tariff price increases. That could change based on the tariffs. But as you know, we plan to continue to exist in the current tariff tax world. And as those change, we make the appropriate changes within our business. When we look at gross margin for next year, I'd tell you that absent any of those significant shifts, we would expect to be relatively flat throughout the year.

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

Okay. Got it. Okay. Understood. And then I guess more broadly on the balance sheet and share repurchases, you seem to be sticking to this very consistent buyback, which has always been the hallmark of O'Reilly. But at the same time, you are below your long-term leverage target, and your valuation has dislocated relative to history. As you think about that and think about the opportunity to maybe add some debt to the balance sheet to fuel some extra buyback, do you want to see what happens in the middle part of the year as you lap through these tremendous stimulus fuel DIY comps? Is there some prudence there that you're just trying to play out given that uncertainty?

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

So when we look at our leverage and we look at our plan in 2021 with the lower EBITDA rate, we will have some fluctuations, and our rate will go up as some of those quarters roll off.

In relation to the buyback, we evaluate where we think the stock is trading in relation to our discounted cash flows, and we're going to continually buy back shares. And when we feel that there's that dislocation you talked about, we're going to buy back more shares.

When we look at 2020, we suspended our buyback at the onset of the pandemic for an abundance of caution and to make sure that liquidity is king in those situations. And I think our results show that in good times and bad, our model generates significant cash. And to the extent that we can't deploy that in a way within the business that creates the right ROI, we'll consistently buy back shares and try to buy back more when we think the market isn't perceiving the value of the stock right.

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Operator

Our next question comes from the line of Scot Ciccarelli from RBC Capital.

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

Scot Ciccarelli. Okay, I think we all recognize that e-commerce historically hasn't been a very big part of your business. But just given the broader acceleration that we've seen in e-com penetration this year, even across sectors where it's never really been prevalent, can you update us on the size of your e-commerce business today? And how much of that is focus versus ship to home?

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

Scot, here's what I would tell you. Our sales overall grew at an incredible pace this year, and our e-com sales grew at an incredible pace this year. But the end result is that e-commerce is still a very, very small percentage of our overall sales number. When you break it down by buy online, pick up in-store or ship to store versus ship -- purchase in store, our growth was substantially higher, pick up in store, ship to store, just demonstrating that the consumer, again, sees tremendous value and coming to our brick-and-mortar business, whether it's curbside pickup or they actually come into our stores in lieu of buy online, ship to home where they actually get additional discounts. So we're very pleased with our e-com results. Although, again, it's a very, very small percentage of our total overall sales.

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

Got it. Very helpful. And then just a second quick question here. We are still hearing about product shortages in the category. Can you help us start to understand how you guys are thinking about product availability and whether you think that your ability to obtain product has potentially played a role in some of the share gains you referenced today?

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

Yes. I mean, Scot, the strength of our supply chain, I think, really has been one of our competitive strengths forever, and I think it really shined through in 2020 and just demonstrated that true strength. We -- one of the things that we elected to do years ago was to require our international suppliers to keep products stateside here in the U.S., and that helped us early in the pandemic, and we were very aggressive with our ordering on the onset because we could see as sales began to trend upward.

That said, our supply chain was definitely pressured in 2020, and we did have supply -- some suppliers that underperformed. We still have a handful of suppliers that are not performing at the level that we would like for them to, and we're working very aggressively to ensure that they get back up to speed. Some of that -- much of that is related to the pandemic, whether domestic or international. We have one domestic supplier that has challenges with COVID right now, and the market that they're doing their manufacturing and distribution is really being hit hard right now. But that's a short-term pain.

And then there's a couple of suppliers that we're having issues with. It's more of an industry-wide event where we lost a supplier in the category early on this year. But what I would tell you generally is things have improved from a supply standpoint, and we feel good about the very few suppliers that we have that are not performing well.

Operator

Our next question comes from the line of Chris Bottiglieri from Exane BNP Paribas.

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Christopher James Bottiglieri - *Exane BNP Paribas, Research Division - Research Analyst*

So I guess the first one, I wanted to do is just kind of clerical thing to go through gross margins. So if I heard you right, it sounds like relative to Q3, the gross margin have to Q4 or the LIFO compared with similar. The DC pressure was in totality worse than Q3. Tariff was something new. My ask is something similar. I guess is there anything else in that gross margin headwind, like ocean freight? Was that an impact? And then how about tariffs? Is that just a onetime event? Or is this something we'll see throughout '21 as well until you anniversary it? The tariff exclusion I'm referring to.

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

The tariff items are ongoing and have more to do with them being consistent with last year as comparing to 2019 when they were at new items. The tariff exclusions, I think we talked to occurred in end of 2019 and 2020 and produce premium margins when those prices went -- when the acquisition price went down but the selling prices didn't go down. So hopefully, that addresses that laundry list of questions.

On the ocean freight, I don't think that we have seen -- I think we've all read that, that is an area of pinch point right now, and prices are going up. I don't think that we've seen at this point, a meaningful impact of that. But obviously, we're keeping a close eye on that. To the extent that, that rises within our industry, we tend to all acquire the similar parts from similar areas, and we view that as an input cost that should hit all of the retailers and wholesalers.

Christopher James Bottiglieri - *Exane BNP Paribas, Research Division - Research Analyst*

Got you. That makes sense. Okay. Then just kind of one bigger picture question. Obviously, it's been a tremendous year for the industry in terms of a behavioral shift from your customer base in terms of the projects they're tackling, in terms of the channels that they're shopping at. Do you say this -- like you see this being kind of -- once the economy reopens, do you think any of this can stick? Like are people going to continue to tackle some of these hobbies? Do you think there's a chance they want to continue staying at auto part stores rather than the big box? But I guess anything that O'Reilly specifically is doing proactively to kind of retain those sales would be helpful.

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

Yes, Chris, as we talked about, there are several levers, several tailwinds that benefited us in 2020. And we certainly hope some of those dynamics carry over into 2021, obviously, not the pandemic itself, but some of the other trends.

When you look at where we feel like we made the most progress from a share gain perspective in 2020, we feel like it was some of the smaller WD players out there that maybe don't have the supply chain strength we did and have the product availability that we had. I think that shift, assuming that our stores did a good job servicing those customers, which we all know they did, we hope that some of that is sticky business, and we're in a relationship business. And hopefully, some of those customers on both sides, both professional on the retail side, continue to come into our stores.

The other area where we feel like we took some share is a big box retailers. And when you think about what you experience when you walk into a big box store, today, there's a little more apprehension with a lot of consumers about going into that environment for fear of contracting disease, you're masked and obviously all of those things. I think some of the consumers rather than walk to the back of the store to pick up a battery or wiper blades or what have you, fight the crowd, take that risk and then go home and install those products themselves, they came to O'Reilly. And they saw is, hey, we've got quality products. We've got competitive pricing, and guess what, we'll install those products for you there in the parking lot. So those customers that experienced that shift in 2020, we certainly hope a lot of that carries over 2021 and beyond.

Operator

Our next question comes from the line of Daniel Imbro from Stephens, Inc.

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

Greg, I want to start on a longer-term question. Obviously, another outcome of the pandemic has been a bit of deurbanization, maybe increased used vehicle ownership. We've seen a lot of headlines around that from the dealers and the other auto names. Should that become a tailwind to your business as we think through '21 and longer-term into '22 and '23 as there's more older vehicles on the road? Or how should that impact your business in the coming years?

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

Yes, it should definitely be favorable to our business. For every consumer that buys a used vehicle as opposed to a new vehicle, which would be under warranty and the first few years of repairs may go back to the dealer. When those consumers elect to buy a used vehicle rather than a new vehicle, typically, those are out of the warranty cycle, which brings more of that volume into our stores sooner.

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

To add to Greg's comments, we'll have to see how it plays out long term. Obviously, the new vehicle sales were down due to the economic concerns and production concerns and then have bounced back. To the extent that consumers move more to the suburbs and rural and drive more miles, that's good for our business long term. To the extent that people decide they want to control more of their own transportation and the vehicle count per household goes up, that's another good item for us from a long-term perspective. Early in that cycle, we'll see how it trends out.

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

Got it. That's helpful. And then just as a quick follow-up to your last answer on the big box market share. Is there anything you're seeing from those mass merchant or big box customers that's different from your core customer? Are they more price-sensitive? Are they using loyalty rewards or discounts more frequently? And do you think you've done enough during the pandemic to make that customer market share sticky as big box maybe reopen some of their online or auto offering that they took off-line during the pandemic?

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

Yes. Daniel, although that we've looked at it from a loyalty perspective. I don't know that when a customer walks in our store if we really know if they were previously a big box shopper or not. So from a loyalty perspective, a lot of the demographic that shops in the big box stores, you would think would be loyalty customers. They're definitely price-sensitive customers that were coming -- that came into our store. As far as sticky transactions, it was a challenging year for us, as Jeff said in his prepared comments. And store team members just did a heck of a job working long hours to take care of customers, meeting them in the parking lot, doing curbside delivery. We upped our service level in 2020, and we certainly hope that, that pays off from a relationship standpoint to maintain a lot of that volume in 2021 and beyond.

Operator

Our next question comes from the line of 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 the quarter-to-date performance. You mentioned December was the strongest of Q4 and that January had remained strong. I assume the implication here is that Q1 is tracking ahead of that 11% in Q4. But if you could give us a little bit more on that.

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And then weather was talked about a little bit. You alluded to some favorability. Are you seeing extreme conditions that beyond just the short term can provide some sort of tailwind looking out over the next few quarters?

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

So the -- Seth, the first part of your question, I think you can infer what you said from our data points that we gave. On the second part of the question, cold weather is good for us. Cold weather brakes cars. To the extent that we have very cold weather, especially on the electrical and battery system, it will weaken those faster and should provide support in the middle of the year when it gets really hot, those weaker batteries will fail at a higher rate.

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

Got it. Okay. And then just a follow-up on the gross margin, we had a few questions on this. It has come down modestly in recent years. You're basically saying it's stabilizing in '21. Fully appreciating your focus on gross profit dollars. But just wondering, is this the right run rate to be thinking about long term for gross margin rate? Or are there incremental gross margin initiatives. And I'm talking about gross margin rate initiatives that should help long term. Like how should we be thinking about the long-term outlook?

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

I think if you look back to our comments, especially in 2019, we were pretty direct that we were making premium margin on many products because of the shifts in the tariffs and the LIFO impact of having bought product before the tariffs but having raised prices when the tariffs kicked in and then having premium pricing on items where the tariffs came off from an exclusion but the selling prices didn't change. I think we were pretty clear that 2019 was an abnormally high year.

So if we take that year out, I think if you look over time, our goal is to incrementally improve margins 10 to 20 basis points through better buying and through more efficient distribution. Obviously, and Greg talked about it earlier, pricing is very dynamic in our market. And to the extent that we have a lot of acquisition price changes, creates the opportunity for better or worse margin. But as we've been in the last 10 years outside of -- end of 2018 to 2019, a pretty consistent acquisition cost, very low same SKU inflation, gives you a more consistent margin. So I guess in short, what I'd tell you is that end of 2018, 2019 presented some opportunities to charge a premium margin in our industry those who have run their course. And I think we're back to an appropriate margin with incremental increases at a small level over time.

Operator

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

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

Thank you, Gigi. We would like to conclude our call today by thanking the entire O'Reilly team once again for their continued selfless dedication to our customers and for their incredible performance in 2020. We look forward to another strong year in 2021. I'd like to thank everyone for joining our call today, and we look forward to reporting our 2021 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.

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