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ORLY.OQ - Q1 2021 O'Reilly Automotive Inc Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to the O'Reilly Automotive First Quarter 2021 Earnings Call. (Operator Instructions)

Thank you. Now I'd like to hand the conference over to Tom McFall. Mr. McFall, please go ahead.

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

Thank you, Jack. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our first quarter 2021 results and our updated outlook for the full year of 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, 2020, and other recent SEC filings. The company assumes no obligation to update any forward-looking statements made during this call.

At this time, I'd like to introduce Greg Johnson.

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

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

I'd like to begin our call today by thanking Team O'Reilly on another outstanding record-breaking quarter. While our expectations were for a strong first quarter based on business trends and comparisons, to say the results of the first quarter were record-breaking just doesn't do real justice to the incredible performance of our team, highlighted by a 24.8% increase in comparable store sales, a 526 basis point increase in operating margin and an impressive 78% increase in diluted earnings per share.

The last year plus since the onset of the pandemic has been one of the most challenging periods in the history of our company, and we are especially pleased our team was able to once again rise to the occasion and deliver these outstanding results while adhering to strict safety protocols. Simply put, Team O'Reilly has responded in an amazing fashion to provide excellent customer service, and I am profoundly grateful for the hard work and sacrifice of each member of our team.

As we highlighted in our press release yesterday, our first quarter comps benefited from a continuation of the robust broad-based sales trend we've experienced for several quarters now as well as a favorable weather environment for most of the quarter. As a result of these factors, we're very pleased with our comp performance through the first 2.5 months of the quarter. In mid-March, the most recent round of government stimulus payments hit, at which point we saw ourselves grow -- our sales growth accelerate meaningfully.

From a cadence perspective, our quarter played out with very strong results in January, aided by beneficial weather and additional government stimulus. February followed a similar trend, with some offsetting pressure from inclement weather in the middle of the month that significantly impacted many of our Southern U.S. markets that are not accustomed to this type of winter weather. This headwind temporarily cut into our professional business as customers held off on risking the roads to bring their vehicles in for service, but we still finished February above our expectations.

March was easily our highest comp of the quarter against the soft prior year comparisons, driven by continued strong underlying trends, favorable timing of spring weather and the stimulus benefit. In total, our first quarter comparable store sales growth of 24.8% and our 2-year comparable store sales stack of 22.9% strongly exceeded our expectations.

As you would expect, we are also pleased with the composition of our sales results in the first quarter as we saw strength in all areas of our business. Both our DIY and professional businesses contributed strongly to our sales results for the quarter, with our DIY business being the bigger contributor, similar to what we've experienced in recent quarters, driven by strong ticket comp -- ticket count comps as well as continued robust increases in average ticket comps.

Additionally, our professional business also performed extremely well, with the brief inclement weather pressure in February I just discussed. On that side of the business, we also saw an acceleration in ticket count comps and strong growth in average ticket. Average ticket on both sides of our business was healthy despite a limited benefit of approximately 1.5% from same SKU inflation, indicated a continued ability and willingness of our customers to invest in their vehicles and work on larger projects.

From a category standpoint, we continue to see broad-based, robust sales trends across categories, with strong performance in our DIY out-front categories and batteries. During the first quarter, we also benefited from strong demand in weather-related categories as well as under car hard part categories. The harsh winter weather this year and the associated wear and tear it inflicts on vehicles is a positive development after the last 2 mild winters in our industry and should support demand in under car categories as we move through the next 2 quarters.

Now I'd like to discuss the update to our full year comparable store sales guidance and our outlook for the remainder of the year. As we announced in our earnings release yesterday, we are increasing our full year comparable store sales guidance to a range of 1% to 3% from our previous range of down 2% to flat. This increase in our expectations is based on the strength of our first quarter results and our continued robust performance quarter-to-date in April.

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This is an exception to our normal practice, where we historically have not factored into our guidance revisions any business trends subsequent to the end of the quarter we are reporting because of the extreme volatility we can see over such a short time frame. However, the continued extremely strong sales momentum we saw at the end of March, aided by the latest round of stimulus, has continued into April, and we feel it appropriate to reflect this outperformance in our annual guidance update.

As we look forward to the rest of 2021, we remain confident in the positive underlying fundamentals of consumer demand in our industry. Even before we started to see the impact of the most recent rounds of stimulus at the end of the first quarter, we were capitalizing on strong demand from DIY consumers willing to take on larger jobs and invest in repairing and maintaining their vehicles. We've also been encouraged by the improving trends on the professional side of our business, even as we remain in an environment of decreased employment, increased work-from-home arrangements and lower miles driven in the U.S.

We can't be certain regarding the pace of improvements in these factors given the uncertain nature of how the economy will exit the pandemic, but we remain confident we will benefit as miles driven return to historical norms. However, we remain cautious in our outlook as we move forward through the rest of 2021 and still anticipate potentially significant quarter-to-date variability due to fading tailwinds from the government stimulus and the potential that some demand has been pulled forward as a result of the favorable weather backdrop and extremely soft -- strong demand in the first quarter.

As a reminder, we faced extremely difficult prior year comparisons in the -- for the remainder of the year, especially on the DIY side of the business, with the most significant pressure in that outlook expected for the second and third quarters. While it remains impossible to predict how the remainder of the year will play out for our industry or the broader economy, we know that a significant driver of our success is completely within our control, and we fully expect to continue to leverage the strength of our business model and industry-leading team to build out strong share gains in 2021.

Moving on to gross margin. For the quarter, our gross margin of 53.1% was a 76 basis point increase from the first quarter 2020 gross margin. The improvement was above our expectations built into our guidance range and benefited from the outperformance of a higher-margin DIY business as well as good leverage of distribution costs on the strong sales volume. For the full year of 2021, we continue to expect our gross margin to be in the range of 52.2% to 52.7%. Our guidance continues to include a muted expectation for any gross margin benefit from inflation. To the extent that we see more inflationary pressures than expected, we anticipate pricing in our industry will remain rational.

For the first quarter, our earnings per share of $7.06 represents an increase of 78% over $3.97 in the first quarter of 2020 and a compounded 2-year growth rate of over 30% compared to the first quarter of 2019. And I want to again congratulate Team O'Reilly on this outstanding performance.

For 2021, we are raising our full year guidance to $24.75 to $24.95, an increase of $2.05 from our previous guidance, driven by the strong year-to-date sales results and the excellent operating profit flow-through, which Jeff will discuss in more detail in a moment. The midpoint of our revised guidance now represents an increase of 6% versus 2020 and a 2-year compounded annual growth rate of 18% compared to 2019. Our EPS guidance includes the impact of shares repurchased through this call but does not include any additional share repurchases.

Before I turn the call over to Jeff, I want to spend a few minutes discussing our inventory position and the status of our supply chain. The strength of our supply chain, including our strong relationships with our supplier base, and the historical investments we've made to build out our industry-leading distribution network and inventory availability has long been a strategic competitive strength for our company. This competitive advantage has really shined through the past year and been a key factor in our strong sales performance, but our supply chain has definitely been pressured as we've experienced elevated sales volumes.

We've been pleased with the strong performance of the majority of our supplier base and, overall, our supply chain has held up very well. But we do have room for improvement with a small number of suppliers who have underperformed due to pandemic impacts, raw material shortages or shipping delays.

We have also faced pressures in our distribution centers as our dedicated DC teams have been processing record levels of inbound and outbound shipments. Just like in our stores, our DC teams have been working extremely hard to take care of our customers and support the extremely strong

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sales, even as the current levels of volume have created stress on normal operating capacity of our facilities. We remain very committed to maintaining and growing our competitive advantage and inventory availability and view the current pressures we're facing in the short term.

To finish my comments, I want to again express my gratitude to our team for their continued selfless dedication to our company and to our customers. Our first quarter performance was truly incredible and is a testament to the hard work and commitment of our team. 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 today by echoing Greg's comments and thanking Team O'Reilly for the remarkable results in the first quarter. Our team has certainly proved over the course of time that they are steadfastly committed to our customers and able to overcome whatever challenges they encounter in running our business. That dedication has certainly been on display in the past year as our team has responded selflessly to the extreme demands and safety protocols during the pandemic.

Our results in the first quarter are just another indication of the degree to which our customers rely on us for excellent customer service, industry-leading parts availability and a seasoned, dedicated, knowledgeable team of professional parts people. Our first quarter of 2021 was truly a record-setting performance. But even as strong as our results were, I think it's actually impossible to fully appreciate the level of hard work and long hours required for our team to produce these results.

Our team's response to the extreme weather conditions they faced in the middle of the quarter is just another picture of their relentless commitment to going to the extra mile for their customers. Many of our markets faced severe impacts from the extreme weather conditions, but our store teams went above and beyond to keep our stores open. And our distribution teams match that effort by ensuring access to the parts our stores needed, enabling us to meet the critical needs of our customers. Challenges in our stores, such as treacherous road conditions, pause of electricity and broken water pipes are nothing new for our team, who has proven their resilience in response to countless challenges over the years, whether it be severe winter weather, natural disasters or a global pandemic.

Now I'd like to spend some time reviewing the extremely strong operating profit performance and SG&A leverage in the first quarter and our updated outlook for 2021. For the first quarter, we generated an astounding increase in operating margin of 526 basis points and operating profit dollar growth of 63%. As we've discussed since the second quarter of last year, the surge in sales in a short time frame has generated historically high levels of profitability, and those sales gains have continued to outpace our rate of SG&A growth even as we redeployed more SG&A dollars back into our stores to adjust to the sales environment.

Our first quarter of 2021 was an almost perfect case of this trend. The quarter saw us increase SG&A per store by 7%, which is well above our historical trends and yet far short of the 24.8% comparable store sales increase that we generated, resulting in an incredible improvement in SG&A leverage of 450 basis points.

The SG&A per store growth, which is adjusted for Leap Day in 2020, was driven by additional store payroll hours and associated benefits and other variable operating expenses to meet the strong sales demand as well as higher-than-normal incentive compensation at all levels of the company. As we've said for the last few quarters now, we know this level of SG&A expense leverage isn't the right long-term answer for our business, and we continue to plan to actively manage our cost structure to provide excellent customer service to match the sales environment and ensure that we're allocating sufficient resources through the image appearance of our stores as well as the training and development of our team members.

We now estimate that our full year increase in SG&A per store will be approximately 3.5%. This target is up from our original expectation based on our results so far in 2021 and matches the revised comp guidance range that Greg walked through earlier. Based on strong leverage on the robust sales through the date of this call, we now expect operating profit to range between 19.9% to 20.4%, an increase of 90 basis points from our previous guidance.

On the expansion front, I'm extremely pleased to announce that this month, we successfully opened our newest DC in Horn Lake, Mississippi, which is just south of Memphis. This new facility took well over a year to plan, design and build, made even more challenging by external delays caused

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by the onset of the pandemic. But our teams were able to stock the DC with an industry-leading inventory set. And day 1, we began shipping larger-than-expected orders to support strong sales growth in our stores in the Memphis and surrounding markets.

Over the next several weeks, we will fully ramp up this 580,000-square foot facility to support over 220 stores, with additional capacity for store growth in the middle of the country. Our DC teams remain committed to enhancing our top-notch inventory availability, and we'll continue to develop our distribution network to support strong growth and set the bar for inventory availability in the industry.

Finally, before turning the call over to Tom, I'd like to provide a brief update on our store expansion during the quarter. In the first quarter, we opened 66 net new stores spread across 30 states. This progress is in line with our plan for total new store openings of 165 to 175 net new stores for 2021. And we continue to be pleased with our team's ability to successfully open great new store locations, but could still see some delays in design and permitting approvals dependent on local market conditions and municipal agencies.

To conclude my comments, I want to once again thank Team O'Reilly for their outstanding performance in the first quarter. Now I'll turn the call over to Tom.

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

Thanks, Jeff. I'd also like to thank all of Team O'Reilly for their continued commitment to our customers, which drove our tremendous first quarter performance.

Now we'll take a closer look at our quarterly results and additional updates to our guidance for 2021. For the quarter, sales increased $614 million, comprised of a $589 million increase in comp store sales, a $53 million increase in noncomp store sales, a $10 million increase in noncomp nonstore sales, a $35 million decrease from Leap Day 2020 and a $3 million decrease from permanently closed stores. For 2021, we now expect our total revenues to be between $11.8 billion and $12.1 billion.

Greg previously covered our gross margin performance for the first quarter, but I want to provide details on our positive LIFO impact, which was $9 million in the first quarter, in line with our expectations and the prior year. As we discussed when we set our full year gross margin guidance, we are anticipating a larger positive impact from LIFO in the first half of 2021, which will partially offset pressure to our POS margins from the tariff exclusions that have expired.

Our first quarter effective tax rate was 23.5% of pretax income, comprised of a base rate of 24.4% and reduced by a 0.9% benefit for share-based compensation. This compares to the first quarter of 2020 rate of 20.9% of pretax income, which was comprised of a base tax rate of 21.8%, reduced by a 0.9% benefit for share-based compensation. The first quarter of 2021 base rate was in line with our expectations. The lower 2020 tax rate was the result of the timing of renewable energy tax credits realized in the first quarter of last year. For 2021, we expect to realize benefits from renewable energy tax credits in the fourth quarter.

For the full year of 2021, we continue to 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. 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 rates.

Now I'll move on to free cash flow and the components that drove our results and our revised expectations for 2021. Free cash flow for the first quarter of 2021 was $790 million versus $227 million in the first quarter of 2020, with the significant increase driven by increased operating income, decreased net inventory, an increase in accounts -- excuse me, an increase in income tax payable and the comparisons to the 2020 investments and renewable energy projects as a result of the timing of these projects and associated cash tax benefits last year.

For 2021, we now expect free cash flow to be in the range of $1.1 billion to $1.4 billion versus our previous guidance of $1 billion to $1.3 billion based on our strong first quarter operating profit and cash flow performance, offset by our expectation that some of the benefit we saw in the first quarter for the reduction in net inventory and taxes payable will reverse as we move through the year.

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Inventory per store at the end of the quarter was $637,000, which was down 2% from the beginning of the year and down 0.8% from this time last year, driven by the extremely strong sales volumes, particularly at the end of the quarter. As we discussed on last quarter's call, when we outlined our full year expectations for inventory per store, our plan for 2021 to carry over from 2020 is to add just over $100 million of additional inventory in our store and hub network, above and beyond our normal new store and typical product additions. And we still expect to complete this plan and grow inventory at approximately 4% per store in 2021. However, the timing of these incremental inventory additions will be impacted by the more immediate need of supporting the replenishment needs of our stores. And we could see some further delays to these initiatives if sales trends remain at historic highs.

Our AP-to-inventory ratio at the end of the first quarter was 119%, which was an all-time high for our company and heavily influenced by the extremely strong sales volumes and inventory turns over the last year. We anticipate that our AP-to-inventory ratio will gradually moderate from this historic high as we complete our additional inventory investments and when our sales growth moderates. Our current expectation is to finish 2021 at a ratio of approximately 109%.

Capital expenditures for the first quarter were $95 million, which was down $38 million from the same period of 2020, driven by the timing of expenditures for new stores and DC development activity. We continue to forecast CapEx to come in between $550 million and $650 million for the full year.

Moving on to debt. We finished the first quarter with an adjusted debt-to-EBITDA ratio of 1.88x as compared to the end of 2020 ratio of 2.03x, with the reduction driven by the significant growth in first quarter EBITDAR. We continue to be below our leverage target of 2.5x, and we'll approach that number when appropriate.

We continue to execute our share repurchase program. And during the first quarter, we repurchased 1.5 million shares at an average price per share of $450.65 for a total investment of $665 million. We remain very confident that the average repurchase price is supported by the 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 our shareholders.

Before I open up the call to answer your questions, I'd like to again thank the O'Reilly team for all their contributions to our company's outstanding results. This concludes our prepared comments. And at this time, I'd like to ask Jack, the operator to turn to your line, and we'll be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Greg Melich with Evercore ISI, your line is open.

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

Tremendous quarter. I guess I'd love to follow up on the trends between the DIY and the do-it-for-me side of the business. You said that both were strong. I'm just wondering if the gap between them is gone except for that February period when you said weather really impacted the commercial side.

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

Yes. Greg, this is Greg. So we were very pleased with both sides of the business. We're very pleased with the positive results we had, both in traffic and ticket average on both sides of the business.

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Similar to what we saw last year when government stimulus was introduced, the DIY side of our business typically benefits more quickly and more favorably than the DIFM side. With the benefit that we saw in March and, to a lesser degree, I guess, in January, that really impacted the DIY side of the business and broadened that spread over what we saw in the past couple of quarters, more similar to what we saw when the last incentive was in place, I guess, was the second or third quarter last year.

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

Got it. So both strong, but there's still DIY, as long as that stimulus is there, that the gap really isn't narrowing, right?

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

Right.

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

Got it. And then I guess the follow-up would be on Mayasa. I'm just curious how the business there has gone, both from an integration standpoint and just actual demand.

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

Jeff, do you want to take that one?

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

Yes. Greg, obviously, the pandemic really impacted our ability to get down and work with the team last year. I mean we basically had to handle everything we've done via Zoom calls.

But integration is going well. The team performed strong. They had a really good year last year. They were impacted by the pandemic in Mexico, somewhat like we were. Probably not as drastically and it was a little bit later, but business picked back up strong, and they finished the year strong. And everything is going good.

Hopefully, as the pandemic eases we can get back down there and work with the team and continue the integration. But we're really excited about Mexico and the team and what they've accomplished.

Operator

Bret Jordan with Jefferies, your line is open.

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

Could you talk a little bit about the contribution of share gains to your results and maybe the -- sort of the magnitude of share gains in the DIFM versus the DIY business?

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

Yes. It's a great question, and I wish I had a great answer for it. It's -- we know that the share gains are a contributor for the quarter. But we also know that stimulus is a contributor for the quarter, and weather is a contributor for the quarter. So it's hard to differentiate how much of the benefit in the quarter was from share gain.

And I'll tell you, if you talk to our stores up and down the streets, they'll tell you that we are, without a doubt, taking share. They're seeing repeat customers. We're focused on making sure we're providing a high level of service to all those customers. And we still feel like we're hanging on to some of that share gain, both from big box and from some of the smaller 2-steppers. I just don't really have a good way to quantify how much of the sales improvement was from -- specifically from share gain.

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

Okay. And then maybe just give us a little color on the regional spread and performance. And maybe what were the standout regions and maybe the gap between the weakest and the strongest areas?

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

Sure. Jeff, do you want that one?

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

Yes. With over 5,600 stores out there all across the country, there's always going to be markets that we just know that we can do better in. And that's what our sales and ops team are out there focused on every day. But honestly, we're pretty pleased with our performance across all our markets in the first quarter, really exceeding our expectations on both sides of the business since May of last year. And that trend really continued into the first quarter of 2021 as well.

Now our newer markets in the Northeast and the Southeast continue to ramp up strongly, just as you expect they would, based on the maturity of that group of stores. But as Greg mentioned in his prepared comments there, February was a little softer for us, especially in our Southern markets. And that was really due to the -- just the severe winter weather they experienced that they're just not accustomed to.

But we always do everything in our power to make sure that we're there for our customers when these type of weather events occur. Whether it's extreme weather -- winter weather like we just experienced or a flood or wildfires out West or hurricane, we always do our best to be the local store, the last store to close and the first store to open during these catastrophic events.

We just know how important it is to be there for our customers that are living through these type of disasters and need parts. And this commitment is top-notch customer service, just really, it occurs at store level, one customer and one store at a time. And I just can't say enough about how proud we are of our store and DC teams as well as our support teams there in the offices.

Operator

Chris Horvers with JPMorgan, your line is open.

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

So I want to follow up on the April commentary. Obviously, it's -- last year, April was a bit of tale of 2 halves. You have the, sort of, impact of shelter in place and the drop in miles driven early. But you talked about -- and your peers have talked about a big pickup when stimulus hit, sort of, mid-

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to late month in April last year. But you also raised -- so I know we're parsing out a shorter period of time. But can you talk about what you've seen as you've lapsed stimulus last year in the business, whether it's on a 1- or 2-year basis or DIY versus do-it-for-me?

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

Chris, this is Tom. So it's unusual for us to include the quarter that we're in and provide updates to our guidance and include that. So when the stimulus hit this year, business accelerated beyond our expectations. And as Greg talked about, especially on the DIY side of the business -- so we've included that in our guide and talked about it being strong because of that driver.

To parse out the individual weeks is something that we're not going to do. But I would tell you that throughout April, we've been very pleased with our performance, and it's been above expectation.

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

Got it. And then on the gross margin, I see the -- relative to 4Q, I see the LIFO delta versus 4Q. And I know that mix was probably an easier mix comparison on the DIY front last year in the first quarter.

The other piece seems to be the supply chain. It seems like you got a lot more leverage this quarter relative to the fourth quarter. So trying to parse out what changed there. Was there some higher incentives perhaps you paid to supply chain workers in the fourth quarter? Or what was the change? And any thoughts on where you might end up in the range for the year would be helpful.

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

Chris, as you know, we don't talk about our actual distribution costs as a percent of sales. Our comments are in relation to the first quarter of last year, though significant leverage this year helped our gross margin improvement. In relation to the fourth quarter, we continue to work hard to push a lot of volume through our boxes more than was really ever designed. So our teams, as Greg said, have done an outstanding job of making that happen.

But whenever we see these high volumes, we're going to have more leverage than we normally would, offset by inefficiencies just created by how, [gosh, stern] high, the volume that are going through the DCs is.

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

Right. So is the -- a 25 versus the 11 is the essential big difference?

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

Our comments are versus last year's negative 1, the 2.

Operator

Scot Ciccarelli with RBC Capital Markets, your line is open.

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

Scot Ciccarelli. So on your updated outlook, and Tom, you obviously just kind of referenced what you're experiencing so far in April, is there any change to your prior back half expectations? Or is the increase in guidance really just reflective of the 1Q upside and some increase in 2Q due to the April start?

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

Yes. Scot, this is Greg. It's the latter. Early in the year on our fourth quarter call, we talked about the uncertainty and all the unknowns that we would face in 2021, including government subsidies and weather and miles driven and vaccine availability and all those things. So our updated guide is based solely on performance to date through this point in April. We've made the same assumptions that we made first part of the year on the back half of the year. And there's just so many unknowns that we didn't make any adjustments for the back half.

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

Perfect. And then, Greg, if I could follow up on one of your other comments regarding the acceleration you saw in the back half of March. Obviously, you had the stimulus benefit this year, but it also coincided with the big drop in sales last year. If you were to look at, let's call it, a 2-year stack, would the back half of March still be a significant outlier on the upside? Or would it start to look a little bit more like the rest of the quarter?

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

Scot, this is Tom. I'll answer that question. So our discussion of performance was versus our expectations. Obviously, our expectations for the end of March were raised comp because of the soft performance last year. Same thing for the beginning of April. So versus our expectations, we have a higher level of expectation. We outperformed that as we've outperformed our expectations all quarter long through the date of this call.

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

Okay. But no commentary on in terms of what that actual line might look like, Tom? The 2 year?

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

Correct.

Operator

Brian Nagel with Oppenheimer, your line is open.

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

Great quarter. Congratulations. So my first one, I apologize, I know a number of questions are focused on stimulus, but I'd want to dive a little deeper into this as well. So clearly, you've called out the stimulus as a benefit to your sales here lately. So I guess my questions are one, I mean, realizing we've had -- there's been a number of stimulus events, so to say, through the pandemic, how do you -- how would you think about the kind of sustainability of that?

And then the demand that it's driving, I know this is difficult to answer. But is it more incremental in nature? Or is there a pull forward aspect to it?

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

Great questions and a lot of unknowns around those questions, Brian. We did benefit in March and into April. We feel like a significant part of that, that was from stimulus. Unfortunately, we don't know how long that trend will continue. Historically, that's not lasted much beyond a quarter or a few weeks into the following quarter. It has carried on over into April this time, but we just don't know how long that trend will last nor do we know if there'll be additional government stimulus. It seems less likely that there'll be future stimulus this time. But we just really don't know what that will be.

Tom, do you want to take the second half?

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

Yes. So in our prepared comments, we did discuss that our -- one of the items that we're thinking about through the remainder of the quarter is when -- was there some pull forward in this big rush of business at the end of March through April. For those of you who followed our industry for a while, you know that there can be some movement between the first and second quarter based on the timing of spring when customers get out and do their spring cleanup. Within this acceleration of business, we're assuming that some of that was pull-forward, and that's inherent within our guidance for the year.

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

Got it. And then my follow-up, if I could, also with regard to sales. But -- so you and others in your industry talked about one of the -- one factor that really helped to drive outsized sales growth through the pandemic last year was this hobbyist customer, someone that maybe got more aggressive through the pandemic. As we now start to approach these more difficult comparisons, how are you seeing that portion of your business track?

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

Yes. Brian, some days, I wish I wouldn't have even called that out. Because we called it out more of an anomaly, that car care -- I'm sorry, washes, waxes, a lot of performance products, we just saw more growth than we typically see last year.

Now when you compare that to batteries and a lot of other hard part categories, sales were much stronger in those categories last year than they were in these, what you call, hobby categories. But we called it out last year because there was some sort of an anomaly.

When you look at 2021 performance in the first quarter, we did sell a lot of car care products, and performance was still -- performed very well. As a matter of fact, all of our categories performed well. But when you look at those categories, those unusual categories that spike, performance -- there's an enthusiast out there that buys performance parts day in and day out, but your average consumer doesn't buy a lot of performance parts. They buy OE replacement parts.

So we have seen that trend continue, but probably to a lesser degree than what we saw last year. But again, that's really not a significant driver to the comp. The more significant driver for our core categories, battery, brakes, under car, things like that, which also have performed very well this year.

Operator

Michael Lasser with UBS, your line is open.

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

Recognizing that there is a lot of uncertainty and you're very early in the second quarter, if we assume that you comp up mid-single digits in Q2 to get to the high end of your 1% to 3% comp guidance for the full year, it would imply that you'll do mid- to high single-digit comp decline in the back half of the year. In that case, your compound annual growth rate for sales would be a couple of hundred basis points below where you've been running on compound annual growth rate for a long time.

Should we assume that's what you have embedded in your guidance for demand being pulled forward? I know there's a lot in that question, trying to frame this all out.

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

Okay. Michael, I'm going to try to answer your question. You were breaking up a little bit. I'm not sure the premise of your question that you started with is accurate. We're obviously not providing quarterly guidance this year as we've done in the past.

But what I'd like to remind everyone is that when we discussed the second quarter last year in quite a bit of detail, after 2 or 3 weeks in April, on the onset of the pandemic that were very difficult and then we saw stimulus come in and the business reverse, that carried through May and June. And May and June are our toughest compares of the year. So I'm uncertain that the premise you laid out at the beginning is how we're thinking about the business when we look at 2-year stacks and performance on a monthly basis for the full year.

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

Yes. Michael, if you look at the dollars as opposed to the percentages on a 2-year basis, I think our projections are still pretty aggressive.

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

Understood. That's very helpful. My second question is, over the last few months, what's been the internal conversation about taking some of this remarkable sales strength and using it to reinvest back into operating expenses in the business? Inevitably, labor -- the labor market is going to get tighter, wage growth is going to increase. Would it -- does it better prepare you for the long run if you take some of this short-term strength and reinvest it back in the business?

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

Okay. I'll answer that question. We've always had a very long-term view on payroll. And when business is not as good as we'd like it to be, that doesn't mean, especially on the professional side of the business, the customer experience expectations go down. Customer service requirements actually go up.

When the business is really good like it is now, it's hard, as Jeff talked about in his prepared comments, to add enough staff to keep up with that. And what we don't want to do is add more staff than we're going to need in the foreseeable future.

Our focus, and then I'll turn it over to Jeff, has been on more full-time people, and we want to make sure that we're planning appropriately for the long term. Jeff, would you like to add to that?

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

Well, you pretty well covered it, Tom. But there again, I mean, we've always taken a long-term view on staffing and doing what's right for our business kind of store by store and really making sure that we staff to grow the -- provide excellent customer service and grow our business, and that varies by store.

We've definitely -- we skewed to hiring back more full-time team members. And it's just a full-time team member provides -- those are more tenured. They're more experienced, and they provide just a higher level of service. And one of our -- I guess, our weaknesses for a long time that we're really focused on is just improving our service levels on our nights and weekends and really trying to shore up there. And that's been a big initiative for several years now, and we feel we're making pretty good headway on that.

Operator

David Bellinger with Wolfe Research, your line is open.

David Leonard Bellinger - *Wolfe Research, LLC - Research Analyst*

Great quarter. So my first question here is just on parts inflation. I think last quarter, you indicated a 1 percentage point increase was embedded in your full year forecast. And I think you called out 1.5% in Q1 alone.

So how high could same SKU inflation go over the balance of the year? Can you talk about the magnitude of some of the price increases you're seeing now? And was that a factor in raising full year sales guidance at all?

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

Wow, that's a tough question. There have been pressures on supply chains within our industry and in the economy in general and shipping pressures. So how soon those ease and how we come out of the pandemic will determine that. We hear the word transitory a lot from economists. To the extent that they persist, we could see higher inflation than we had projected. We saw a little bit higher than expected here in the first quarter, although we expected that to ease in the back half of the year. To the extent it doesn't, we are going to remain rational in our pricing, and we would expect the industry to also remain rational.

David Leonard Bellinger - *Wolfe Research, LLC - Research Analyst*

Got it. Okay. And maybe just a follow-up on that. Is there potentially something (inaudible)

(technical difficulty)

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

I'm sorry, we're having a hard time hearing your question.

David Leonard Bellinger - *Wolfe Research, LLC - Research Analyst*

Sorry. Just to follow up on that last one. Is there anything different about the inflationary backdrop now? Can some of those price increases that are normally passed through, can those be used as a competitive lever to keep these new and reacquired customers in your system?

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

When we look at pricing, for the vast majority of the things we sell, they're need based. We are -- we want to be competitive in price, but we really want to win on service. So when we look at what's the appropriate pricing, we manage that on a SKU-by-SKU, store-by-store market basis. But we expect to continue to follow the pricing strategy that we've used for a long time that's made us successful.

Operator

Kate McShane with Goldman Sachs, your line is open.

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

I just wanted to follow-up on the inflation question but -- when it comes to gross margins. So if there is more inflation that comes down the pipe, would there be a quarter or 2 delay of when you would see that in the gross margin? And as DIFM does come back here as hopefully, miles driven resume and gas demand goes up, how does that come into play with your gross margin guidance for the year?

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

Okay. So when we see price inflation, we want to react in a timely basis. Part of that depends on what -- how much inventory we have, what the competitiveness of the market is. But our expectation is that if we're going to have acquisition price increases, we're going to attempt to maintain a gross margin percentage. And those additional dollars that come with rising prices will help offset SG&A rising prices because they go hand in hand.

On the professional side of the business, our guidance for the year was that we were going to have very tough compares on the DIY side of the business and the professional is going to continue to grow. And professional carries a lower gross margin because those customers are buying with volume discounts. So that was inherent within our guide for the year, that we would have stronger growth on the professional side of the business. And as Greg called out in our first quarter, part of the gross margin growth above our expectation was due to DIY growing faster.

Operator

Liz Suzuki with Bank of America, your line is open.

Elizabeth Lane Suzuki - *BofA Securities, Research Division - VP*

Just a question on the competitive environment. Are you seeing any changes in promotional behavior on pricing to pros in particular as that segment recovers? I guess in other words, is there a grab for market share in what's now the faster-growing channel that could result in some gross margin pressure going forward?

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

Yes. Jeff, do you want to take that one?

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

Sure. I'd say overall pricing remains pretty rational. I mean you see certain regional players maybe that run certain deal certain times of the year. But all in all, across the board, pricing is pretty rational. We obviously stay on top of it and react accordingly to make sure that our price is always competitive in the marketplace and then really focus on winning with availability, service and relationship.

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Elizabeth Lane Suzuki - *BofA Securities, Research Division - VP*

Great. And just a follow-up on the competitive landscape. So I mean, last year was clearly a very disruptive environment for the auto aftermarket, but a lot of small businesses also received support from PPP loans, so we didn't see maybe as much M&A as we might have expected in that kind of environment. So how does the pipeline for potential acquisition targets look today?

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

Yes. Liz, I would say that our industry actually performed pretty well. There are some small players that we're having conversations with that may be an opportunity for us to acquire. We're looking -- we're always looking at acquisition targets. We're always looking for strategic acquisition targets that are a bargain or a competitive advantage or a market that we need to move into, and we value those acquisitions accordingly based on the value to -- that it brings to the company.

There's just not a lot of bigger acquisition targets, larger chains left out there that are in markets that we don't already have exposure to. So really, what we're focused on is the smaller acquisitions. And when I say smaller acquisitions, I mean, 1, 2, 3, maybe 5, 10 store chains, just whatever comes down the pipe. We would absolutely be open to some companies the size of a bond or a [vintage] that may have 20, 30, 40 stores, should those come available. We also continue to look for acquisition opportunities outside of the U.S. as well.

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

What I would add to that is our history shows that we're a willing participant to consolidate the industry. When we look at the players that are still out there that would be a target for us, the players that are left are strong performers. And those performers tend to come up for sale when there's a change in ownership or it's a family-run business, and they're not going to pass it on to the next generation. So that acquisition pipeline is more determined by individual events at different chains than macroeconomic circumstances.

Operator

Zach Fadem with Wells Fargo, your line is open.

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

I have a longer-term question on the DIY business. Obviously, having a great moment right now and plenty of one-off drivers. But considering the rising population of older vehicles on the road, curious how you think about the DIY industry structurally and whether you think the long-term run rate could be higher versus prepandemic.

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

Yes. It's a great question, Zach. The fact that new car sales are softer and used car sales have been pretty strong, a lot of that's based on supply and demand, that's good for our industry. That's good for our industry for a couple of reasons. One is, as you allude to, the DIY channel, a lot more of those maintenance repairs and maintenance cycles can be performed in the DIY channel. And also, most of the time or a significant portion of the time, I should say, those vehicles are probably out of warranty.

So they're out of the warranty period. The consumer has 2 options: option A is to go to their independent garage, one of our professional customers; or two, do the repairs themselves. Or take it back to the dealer, which most consumers probably would not choose because of the cost factor of making those repairs.

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I think we've seen over the past year a willingness of the DIY consumer to do more repairs and maintenance on their vehicles than we have historically seen. Is that going to be -- is that going to continue into the future? It's hard to say. I sure hope it does. As I've said in the past, I think that there's some traditions involved here. I remember changing the oil in my car with my dad when I was younger. And hopefully, some of these traditions where you had a father showing their children how to change the oil and maybe change suspension or breaks, the easy repairs, hopefully, a lot of that sticks and stays in the DIY channel.

But either way, whether it's the DIY channel or the DIFM channel, the strength in used car sales should benefit our industry and the aftermarket.

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

That makes sense. And my follow-up for Tom, last quarter, you suggested your gross margin rate on an ex LIFO basis would be fairly consistent through fiscal '21. But given the Q1 outperformance and changes in same SKU inflation, I'm curious if you could update us on your latest thinking here.

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

Well, I'll have to look back at the transcript. I think that I said our -- we expect our gross margin to be pretty similar, all in. Obviously, we had a little better performance than we thought during the first quarter, not enough to make us want to change our range.

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, Jack. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued hard work in delivering a record-setting quarter. I'd like to thank everyone for joining our call today, and we look forward to reporting our second quarter results in July. 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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