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PRESENTATION

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Good morning, everyone. It's Daniel Hofkin with William Blair. Thank you, everyone, for joining us.

This morning, we have with us the management of O'Reilly Automotive. With us today are Tom McFall, CFO; and Mark Merz and Eric Bird with Investor Relations and Financial Planning. Really thrilled to have you guys back at our conference once again, and this should be great.

I'm going to just turn it over quickly to Mark for some quick comments, and then we'll kick off the fireside chat.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

Fantastic. Thank you, Dan. We appreciate you having us today, and appreciate everybody taking some time to listen to us this morning.

Just wanted to give a quick minute or 2 about O'Reilly. I know this is more of a general conference, not specific automotive aftermarket. So just thought I'd give a quick couple of bullet points about the company, and then we'll turn it back over to Dan and he can kick off the questions for us.

So O'Reilly started in 1957. We had a single store here in Springfield, Missouri, and we grew to where we are today. We're a specialty retail of automotive aftermarket parts and supplies. So essentially, we sell parts to keep the 270 million registered vehicles here in the U.S. moving, getting people back and forth to work and to the doctor and to the grocery store every day.

As of March 31, we operated 50 -- 5,660 stores in 47 states here in the United States, and we also operate 22 stores in Mexico that came with our acquisition at the end of 2018 of Mayasa Auto Parts. It's been a great acquisition for us. We also operate 28 regional distribution centers, which are extremely important because we place our distribution centers close enough to our stores that we can replenish them.

Most of our stores -- almost all of our stores here in the U.S. -- in the Continental U.S. receive 5 night a week replenishment, which allows us to keep a larger breadth of inventory at the stores and not as much depth. So there's a greater chance that we can have the part in stock when the customer calls or walks into our stores every day.

We have over 77,000 team members across the country who execute and live our culture values every day. In my opinion, the most important culture value is excellent customer service. And that's what our team members do every day. They focus on providing industry-leading service to both our retail, do-it-yourself customers as well as our professional or mechanic service provider customers. And that is what we call our dual market strategy, which means we focus equally on both sides of the business. Anyone who needs a part in any way, we're out there taking care of them.

DIY customers are people like you and I. We work on our cars ourselves in our driveways when they're broken. Professional service provider customers or DIFM customers are the mechanics that some of us take our vehicles to when they break down. Our stores carry a very robust inventory; good, better, best on the value spectrum; every type of part from the entry-level part that, generally speaking, that DIY customer is looking for; to the better, best that -- and branded products that the professional service providers or mechanics look for.

We also augment this robust inventory that we have in our stores with same-day availability from our over 350 hub stores. And half of our stores in the U.S. have direct deliveries every day from the 28 distribution centers throughout the course of the day. So if a customer does come into the store and we don't have that hard-to-find part that we're looking for, we keep inventory close enough to the stores that we can give it to that customer on many times on a same-day basis, which is extremely important to help them get their lives back in order, which is ultimately what we do. We help them get their cars fixed so they can get their lives back in order.

So with that real quick overview, Dan, I'll turn it back over to you, and you can fire away with your questions.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Great. Thank you. That's very helpful.

QUESTIONS AND ANSWERS

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Just kicking off a couple of questions here. I guess maybe to begin with, what would you say enabled your 2 segments, your 2 businesses to perform so well in 2020 despite what was a sharp drop in miles driven? How should people think about the backdrop as we emerge from the pandemic with rising miles driven, also rising gas prices, other factors like vehicle age, et cetera? And how can O'Reilly continue to comp in each segment in the near term, would you say?

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

So 2020 was a crazy year by all standards. When we look at the specifics of the question you asked, so miles driven is an important statistic for our industry as cars are driven more and more cars are on the road, more parts need to be repaired. But ideally, the best step for us to be miles driven on cars outside of warranty. And because if it's in warranty, the dealer is going to repair most items outside of maintenance side.

So when cars hit 5 years is when you start seeing more failures and repairs happening. And when you look at those miles driven, they didn't dip as much just because that statistic by itself isn't out there. But with the new car sales being down from just demand and lack of supply, more of the miles driven are around the cooler cars. So that was a positive for us.

When we look over a short period of time and we see big swings in our industry, they're primarily driven by 2 things: one is weather, and two is customer behavior. And I'd say weather was pretty normal last year. On the customer behavior, there's a huge amount of unperformed or underperformed maintenance on the vehicle fleet at any time. And customer sentiment about their vehicle and their economic health are drivers of whether that pool of unperformed or underperformed maintenance goes up and down. It's estimated to be $50 billion by our industry. And well, that's exactly the right number, hard to know, but it is a big number.

And what we see when we go in that kind of downturns and people get the expectation that they're going to keep their vehicle longer, they will pay that more and keep that more up to date. I think that's also something we saw last year where people were concerned about their economic health and wanted to maintain better the vehicles that they had.

And the last item was there was a lot of stimulus money out there with the people who had time to work on their cars. And because of that, we saw a bigger demand on the DIY side of the business, a bigger growth in the DIY side of the business. We had about 4 weeks between kind of the start of the pandemic when markets started to close down and for stimulus checks that were -- where businesses are up, we were down low double digits. And as soon as those stimulus checks hit, we saw business spike.

On the professional side of the business, a different dynamic there. So people were not traveling. Those customers tend to be more affluent, more likely to have a work-from-home job. And people are just concerned about having someone else in their vehicle. So the professional business was slower to return, and they had what we would say overall as an average year. They were down for longer and then rebounded in the third and fourth quarter, and that momentum has continued. So hard to parse all that out into the demand that we had. But those are, from our perspective, the major drivers in 2020.

When we look at 2021, what happens with gas prices is to be determined, whether they're temporarily up or going to be up. But as the academies have reopened and people got out and started to move around, we see miles driven increase, and that's a positive for us. How much increase in gas prices curtail people's driving is a pretty low bar by comparison. So we expect that in aggregate to be a tailwind.

We're also watching closely the new car sales. Used cars are at record high, which tends to indicate -- sorry, used car prices are at record highs, which tend to indicate that there's a shortage of vehicles. People are valuing their used vehicles more. They're going to do more repairs, which is a positive for us. But over the next couple of years, we will be watching the number of vehicles on the road to see if there's an increase as people potentially want to control more of their own transportation.

As we saw during the pandemic, public transit was not an option for most people. Ridesharing was a concern. People want to be prepared if there's another concern. And where do people live? And does that change miles driven along with some work-from-home arrangements? We'll see how that impacts miles driven. But ultimately, if there are more cars on the road driving more miles, that will be good for our industry.

On your question on how do you grow your professional side of the business and your DIY side of the business, it's great when there's more demand in our market. But on both sides of the business, we are a small portion of the overall industry. So it's the good old-fashioned go out and provide great customer service to every customer and go out and win customers and then gain share.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

All right. Can you talk about the near-term cost environment, things like labor, freight, et cetera, how you're managing through it? And then on the retail price and/or retail or DIFM price trend, what type of inflation you're seeing currently? And how do you expect that to play out over the remainder of 2021?

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

Well, we're seeing more inflation than we expected, and we talked about that on the first quarter call. As supply chains are constrained, we're seeing pressure on labor, although the unemployment numbers are not as low as they were. Participation is down, and it's hard to find good people who are interested in coming to work. So we would expect to see continued pressure on both sides.

The fuel costs are up. Transportation costs are up. So we're going to have to manage through that. And historically, when we've seen our acquisition cost of product go up as an industry, we've been pretty effective at passing those through to price. When the tariffs were put into effect in 2018 and 2019, you saw those come through to price on the street for both the professional and the DIY customer.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

I think you're muted, Dan.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Thanks. Thanks, Mark. Assuming that the -- some of the cost pressures, labor availability eases up later in the year, do you expect that to be an important factor in particular?

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

When we look at our cost structure, we have a relatively high cost structure as a multi-unit specialty retailer. And we've always been very stringent in how we manage our costs. When we look back at 2020 on the onset of the pandemic, no one knew how long it was going to last or how severe it was going to be. And we, along with others, adjusted our staff to what we thought the business would be, and then the business turned around and we ended up really being understaffed for the year and running 2/10 of payroll. And we kind of kept waiting for the stimulus to wear off or the additional unemployment benefits to stop and for business to slow down, and we don't want to be overstaffed for that. So we were slow to add staff back. And today, we tell you, we're still running to lean on payroll. But we try to manage our expense structure over the long term. So we will run a little bit leaner now. And if those abate, if business slows, we'll be in a position to manage our cost structure.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Okay. And then in terms of -- you talked about -- or I believe a couple of competitors have talked about making some investments in price, particularly on the DIFM side of the business. Can you talk about what you're seeing specifically in that segment?

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

Some interesting comments out there and specific categories that are very strategic to drive increasing gross margin dollars that aren't quite -- are made not in relation to our direct mainline competitors, I think, is the tagline. The commercial business has always been very competitive, and people run different deals whether they're big players or small players. We try to be very thoughtful about our pricing, and we are never going to run a price that we can't continue to sustain. If you try to go out and buy the business, it's hard to keep it right at a reasonable cost. So we've always focused on service first and a reasonable price second.

That said, we are competitive. We're not going to lose business because someone is going to take price way down. Typically, that involves the supplier and a chain of negotiations and discussions there. But it also depends on what price you started from. If you were too high to begin with and you got down to where market is, you're investing in price and potentially taking some share but maybe not setting a new lower market price. So we would tell you that we will always be competitive on the street, whether it's professional or DIY.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

And Dan, for us, we always have in our history and always will lead with service. I talked in the beginning about the robust distribution infrastructure, the types of parts that we carry, the replenishment that we have with our stores, the same-day availability from the hub stores networks directly from the distribution centers. At the end of the day, it's all about service. Like Tom said, we're going to be price competitive, but we're not going to lead with price. We're going to lead with service. That's our culture.

And on the professional side of the business, specific to your question, and Tom mentioned it when he answered the first question, this industry is very fragmented, especially on the commercial side. There's 37,000 parts stores out there, and the top 10 chains only have about half of those locations, with the top 4 having a big piece of that. So there's lots and lots and lots of opportunity out there to gain market share. And the way you gain and keep a customer is providing consistently excellent service every day. If you have the competitive price and you're head and shoulders ahead with service, that's how you keep and maintain business and grow those gross profit dollars and operating profit dollars over the long term. And that's what we focus on as a company.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Right. Can you talk about beyond this year? What are your thoughts about the industry backdrop over the next few years in terms of some of the main variables that you watch? And how you think about O'Reilly's opportunity to continue to gain share, grow comps, grow the domestic store base, where you see that getting to and also operating margins?

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

Okay, lots of questions in there. We would expect employment to continue to improve over the next few years. As we talked about, we'll be watching the number of new vehicles and vehicles on the road, and we expect that to be a tailwind. Oil prices and weather can be a wildcard in there for our -- if gas prices spike, we'll see people work to not drive. They're temporarily up now, maybe it's permanent. We shall see.

But as I talked about, there is a lot of share out there that is controlled by companies that aren't O'Reilly, and our job is to go out and continue to provide great customer service and win customers. And that's what we've done for our career. So we expect to continue to do that. We still see a lot of great growth opportunities and how many stores we open each year. We backed off the last few years and built and spent harder during COVID to get all the work done and people staffed and inspectors out there to approve buildings. So lower number this year. We're still looking to see how the development goes for next year.

On operating margins, I know that most of the people on this call use a lot of percentages in their models, and there's been a lot of discussion of percentages here over the last 2, 3 quarters. Our job and our company goal is to continue to profitably grow our business, and that means improving our operating profit dollars year-over-year. And we've been very successful in that, and that's what we will focus on continuing to do.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

I think you did again, Dan.

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

First meeting of the day.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Yes, yes. No, just -- I wanted to make sure there's no background noise here. Thanks for the heads-up. Can you talk a little bit about electric vehicles over time? How those will factor in, in terms of the industry dynamics and also O'Reilly specifically? And any other sort of longer-term curveballs or concerns that you might have?

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

Sure. So electric vehicles are somewhat of a wildcard. They make up a very small segment of the new car sales each year and a very small segment of the population. And they continue to evolve. The technology continues to change. Different companies continue to pop up and make different versions of electric companies. Obviously, Tesla is the main provider of electric vehicles today or all electric vehicles. But there's a lot of limitations to those as far as cost. They're expensive in aggregate, although they have some models that they doubt as being low priced. I think I read somewhere that the average Tesla rolled off the assembly line last year sold for $69,000. So that's pretty high for the general usage. Continues to be a lot of discussion about the weight to energy ratio of batteries and how to increase that over time and increase mileage to make the vehicles more acceptable in more applications.

So it continues to evolve. Even if we had the right electric vehicle solution tomorrow, we won't have the electrical grid infrastructure to support that many cars being charged. So it's going to evolve over time. Right now, hybrids are a much better solution or much more sales and more uses. For us, that's good. They have electric parts and gas parts. But when we look at the core of what we do, we are here to provide a service to our professional installers who exist because there are not enough bays -- service bays at the dealerships to service the entire fleet. And the OE dealers are not as cost competitive as other options. And that's why the professional business exists, and we're here to support those businesses and their parts and equipment and technology and training needs.

On the DIY side of the business, people are fixing their own cars because they can't afford to have somebody else fix their cars. And although it would be great to have everybody be that affluent, that does not look like it's going to happen anytime soon. So the real drivers for why our company exists will continue no matter what powertrain exists in the vehicles. And we get a lot of questions about what's our content for electric vehicle. Well, it's hard to know because we don't really know what the Model T looks like for an electric vehicle.

In the meantime, we continue to work with our major suppliers who are also OE suppliers and working a lot of these technologies to come up with new solutions and how our DIY and professional customers can continue to work on advanced technology. But this will be a change that happens over a long period of time. Cars that roll off the assembly line right now are going to be on the road for 19 or 20 years. So the population changes. It changes very slowly, but we continue to adapt to the new technologies that are coming out in vehicles to provide those professional customers what they need to have their businesses be successful and for DIY folks to keep their cars on the road in an economical cost.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

And you may have mentioned this briefly, but any concerns about within electric vehicles that the OEM dealers will -- or the manufacturers themselves will want to do more of the servicing themselves to the degree that there are replacement parts as part of electric vehicles?

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

The OE dealers definitely want to service the vehicle fleet. The issue is there's just not enough bays. And the last major move in dealerships was to reduce the number of dealerships, and Tesla runs a totally different program. So they will continue to be a competitor, and we have to provide a great value to our customers to turn their business.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

And Dan, the reason the aftermarket exists today is years ago, there were too many vehicles for the dealerships to service. So independent mechanics, many of them who were mechanics for the OE dealerships went out and started their own shops, their own business. They became entrepreneurs, wanted to control their destiny. Today, their -- the size of the vehicle fleet compared to the size of the dealership network is absolutely upside down, and that's why all the independent mechanics exist out there. That's why the automotive aftermarket exists out there.

And companies like us not only provide the parts to those mechanics who work on those vehicles, but we also provide training into the aftermarket. We do thousands of training classes a year, evenings and weekends, where mechanics will bring in supplier reps and they'll teach the mechanics the new changing technology on the vehicles. So we play an important role in ensuring that, and some of our competitors as well, ensuring that the aftermarket can work on whatever the changing technology is on the vehicle fleet, electric vehicles, hybrid vehicles, synthetic fuel, internal combustion, whatever it is.

It's -- like Tom said, it's a very, very slow turn. So the vehicles that are rolling off the line today aren't our core customer today. When they fall off of warranty 5, 6, 7 years down the road and things begin to fail is when they become a larger customer for us. We certainly sell parts to vehicles that are under warranty, but they're more maintenance-type items. When those parts begin to break, which warranty is when they become our core customers. So we will see whatever the changing technology is, just like we saw it back in the '80s when the first computer modules were on vehicles, the aftermarket adapted. Because of the long runway, we'll have plenty of time to prepare for whatever the vehicle technology is to make sure we have the parts that both our DIY and DIFM customers need to service that.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Can you give us maybe a little bit of an update on the Mayasa acquisition in Mexico, how you're thinking about the Mexican market in the near term and also as a longer-term growth platform for O'Reilly?

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

Eric handles a lot of the Mayasa financials, so it sounds like a great question for Eric.

Eric Bird - *O'Reilly Automotive, Inc. - Manager of External Reporting & Planning*

Well, we've been very pleased with how they performed all along. That was intended to be a good platform, good learning opportunity for us to come down and partner with a management team that shared our culture and our values, and they're very much that. So while COVID has certainly hindered our ability to get down there and have our teams go down and travel and partner with them, we've still been making great progress on the acquisition and have big plans for Mexico and remain very optimistic about opportunities down there.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Any thoughts on how that market is similar and/or different than the U.S. market and also more broadly other potential non-U.S. markets over time?

Eric Bird - *O'Reilly Automotive, Inc. - Manager of External Reporting & Planning*

There is some big similarities within the vehicle fleet, which is one of the reasons that pushed us to primarily look down to Mexico for our first international expansion opportunity. But yes, and overall similar, a lot of DIY, DIFM. There is a little bit of differences between how we think about some of our DIFM customers down there. The Mayasa business currently runs a very large jobber business, which is something that was very prevalent here in the U.S. and since we've acquired a lot of jobber customers and consolidated that side of the business. So probably a little bit of a step behind from that perspective, but certainly continues to be opportunity on both DIY and DIFM down there.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Great. I think final question that we'll probably have time for is something that we're asking of all our companies. Can you just kind of review your efforts on the whole ESG front?

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

Sure. Well, we're very, very happy that we're working on our third annual sustainability report. From an ESG standpoint, I know that term has come up in recent years from O'Reilly that's -- those items have always been a part of our culture, focusing on the environment, focusing on our team, which is our most important asset and having fantastic governance. So we've always executed an ESG platform. Just in the last several years, there's been more focus on reporting around it. So again, we issued our initial ESG sustainability report. In 2019, we issued our second one. In November of 2020, we're currently working on our third one, which we hope to issue this fall.

The first report was more focused on the E in ESG, the environment, because our engagement with our stakeholders and shareholders that year was more focused on environment. The second year, it was more focused on diversity and inclusion because that was the engagement that we had, talked about our training programs, our development opportunities, promote from within our organization. And this year's report will likely be -- continue to be more focused on diversity and inclusion. We've got some exciting new information that we'll have in that report. I can't disclose what all of it is now, but it will be more focused on the diversity and inclusion side of the ESG spectrum when that report is released.

Daniel Harry Hofkin - *William Blair & Company L.L.C., Research Division - Analyst*

Great. Well, folks, thank you, Tom, Mark and Eric for joining us and taking time out of your schedules to meet with our investors. And thank you to everyone else joining this conference call, and we will let you guys get on to the next set of meetings. Best of luck, and thanks, everyone. Have a good conference.

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

Thank you, Dan.

Mark Merz - *O'Reilly Automotive, Inc. - VP of IR, Reporting & Planning*

Thanks, Dan. We appreciate you hosting us.

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

Thanks, everyone.
