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PRESENTATION

Operator

Welcome to the O'Reilly Automotive, Inc. Second Quarter 2021 Earnings Conference Call. My name is Victor, and I'll 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, Victor. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our second 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.

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

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts Second 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. Greg Henslee, our Executive

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Chairman; and David O'Reilly, our Executive Vice Chairman, are also present on the call. I would also like to welcome Brad Beckham, our Executive Vice President of Store Operations and Sales, who is joining us for his first call.

I'd like to begin our call today by expressing my gratitude to Team O'Reilly for the hard work you've put into delivering yet another outstanding performance this quarter. We don't take for granted the exceptional results you generated in the second quarter nor the high level of execution required every day to produce these results. So thank you, Team O'Reilly for continuing to demonstrate why you are the best in the business.

Our second quarter results were headlined by a robust 9.9% increase in comparable store sales and a 17% increase in diluted earnings per share. These results are especially impressive as they were achieved on top of a 16.2% comparable store sales growth and 57% increase in diluted earnings per share we delivered in the second quarter of last year.

Over the past 5 quarters, since the onset of the pandemic, we have grown earnings per share an average of 44% per quarter, and this is truly remarkable performance. And this truly remarkable performance was achieved through our team's selfless dedication and focus on safety while at the same time providing excellent customer service. Congratulations Team O'Reilly on another exceptional quarter.

Before we dive into our results, I'd like to take a moment to extend my congratulations to Jeff Shaw, our Chief Operating Officer and Co-President, on his upcoming retirement. As we noted in yesterday's press release, Jeff has decided to retire in early 2022 after more than 33 years of dedicated service to the company and his fellow team members. Jeff is an incredible leader and mentor and passionate about providing consistent, excellent customer service. His career track is a prime example of our company's promote from within philosophy. Having begun his O'Reilly tenure as a parts specialist on the counter, he has grown his career by being a key contributor to our company's tremendous growth. Throughout his career progression to Chief Operating Officer and Co-President, he has consistently championed our promote from within philosophy and has served as a mentor to many of O'Reilly's current senior leadership team. Jeff has earned the gratitude of all of Team O'Reilly for his incredible contributions to our company's success, and we wish him a very happy and well-deserved retirement.

Thanks to Jeff's keen focus on succession planning, we're very pleased to announce Brad Beckham, O'Reilly's Executive Vice President of Operation -- Store Operations and Sales, will step into the Executive Vice President and Chief Operating Officer role upon Jeff's retirement. Brad has been an O'Reilly team member for over 24 years, and his career progression mirrors much of Jeff's having also started his O'Reilly career as a part specialist. Brad is an exceptional leader who shares Jeff's passion for providing excellent customer service and investing in our team members, and I'm confident he will continue to lead our company to success well into the future.

Now I'd like to address the quarter's results and start by providing some color on our exceptional sales performance. Our second quarter comparable store sales growth of 9.9% and our second quarter 2-year comparable store sales stack of 26.1% greatly surpassed our expectations for the quarter as we continue to maximize the benefits from the robust broad-based industry trends we've experienced over the last several quarters, coupled with a favorable weather environment and the benefit of government stimulus.

As noted on our first quarter call, the last round of government stimulus payments started to be distributed in mid-March, at which point the sales volumes accelerated meaningfully. This growth continued in April before moderating at the end of April to a level of consistently strong sales volumes that carried through May and June, which was well above our expectations. These volumes translated into positive comps every month of the quarter, which was impressive in light of the extremely strong compares we faced in May and June of 2020. These better-than-expected sales volumes have continued thus far in July, and we have been pleased with the durable nature of strong sales volumes we have been able to achieve.

Robust comparable store sales results we generated have been underpinned by significant contributions from both the DIY and professional business. We posted positive comps for DIY and professional in the quarter comprised of both ticket count comp and average ticket comp growth. The professional business was the larger contributor to the comparable store sales increase for the quarter, having faced softer comparisons on this side of the business resulting from a more gradual recovery last year from the initial pandemic impact.

We faced tougher comparisons on the DIY side, but we're very pleased with the performance in our DIY business as we calendar the exceptional sales volumes from last year. While both sides of our business exceeded our expectations for the quarter, our DIY business was responsible for producing the greater outperformance as compared to our expectations.

Same SKU inflation increased to slightly over 2% for the quarter, up from the 1.5% we experienced last quarter. We now anticipate we'll see additional larger increases in same SKU inflation as we progress through the year. But the ultimate extent of the impact will be determined by the duration of pressures to pricing levels from cost increases in wage rates, freight and raw materials. We anticipate the benefit to our top line sales results we partially offset as rising prices will likely cause some economically challenged customers to defer noncritical maintenance or trade down on the product value spectrum.

Finally, on a category basis, we saw broad-based robust sales trends across all categories with especially strong performance in undercar hard part categories and weather-related categories.

As we disclosed in our earnings release yesterday, we are increasing our full year comparable store sales guidance to a range of 5% to 7% from our previous range of 1% to 3%. Included in this upward revision is our year-to-date performance as well as our continued strong performance to date in July. As we move into the back half of the year, we continue to face strong compares to the prior year. And while we have a constructive view of the demand -- sorry, a constructive view of the demand backdrop for our industry, we remain cautious as significant uncertainty remains surrounding the continued progression of the pandemic recovery as well as the expected end of additional federal unemployment benefits in all states.

Regardless of the uncertainties we face, we will continue to execute our proven business model and are extremely confident in our team's ability to drive further share gains moving forward. The tremendous rapid growth in our business has given us the opportunity to earn many new O'Reilly customers and the outstanding customer service they've received will be the key to earning the repeat business.

Turning to gross margin. For the second quarter, our gross margin of 52.7% was a 26 basis point decrease from the second quarter 2020 gross margin. This was in line with our expectations as we anticipated headwinds from DIY versus professional total sales mix and higher distribution costs compared to the second quarter of last year. For the full year 2021, we are maintaining our gross margin guidance of 52.2% to 52.7%. While we are above the midpoint of our full year guidance through the first half, we expect to see pressure from certain transitory distribution costs in the back half of the year.

Our distribution infrastructure is facing inefficiencies due to the massive sales spike over the last 5 quarters, the difficult labor environment and global logistics challenges. We continue to view our distribution network as a key competitive advantage that supports our industry-leading parts availability, and are steadfastly committed to protecting and enhancing this advantage. To this end, we have adjusted our near-term cost expectations to match the deliberate steps we are taking to ensure the highest possible distribution service levels and further deliver on our strategic inventory initiatives. Simply put, our dedicated supplier partners and extraordinarily hard-working distribution center team members have done an amazing job to support the surge in our sales volume and we remain committed to deliver excellent customer service as we navigate these transitory pressures.

Before handing the call off to Jeff, I'd like to highlight our second quarter earnings per share of 17% to $8.33 with a year-to-date increase of 39% to $15.39. Our second quarter earnings per share results represents a 36% 2-year compounded quarterly growth rate, and I'd once again like to congratulate and thank Team O'Reilly for delivering another quarter of exceptional performance. We are raising our full year earnings per share guidance to $26.80 to $27.00 an increase of $2.05, which at the midpoint now represents an increase of over 14% compared to 2020 and a 2-year compounded annual growth rate of 23%. This increase in full year guidance, driven by our strong year-to-date sales results combined with excellent operating profit flow-through, which Jeff will provide more details on here shortly. As a reminder, our EPS guidance includes the impact of shares repurchased through the call but does not include any additional share repurchases.

To conclude my comments, I want to express my confidence in the long-term strength of our industry as consumers continue to value investments in the care and maintenance of their vehicles and O'Reilly will be well positioned to meet those needs in the future. I also want to again extend my deepest thanks to our team for their commitment to our culture, fellow team members and our customers. Team O'Reilly, I'm proud of your continued outstanding performance, and I look forward to what we will accomplish on the road ahead.

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'd also like to extend my congratulations and express my sincere thanks to Team O'Reilly for their outstanding efforts and results this quarter.

Our team's ability to grow comparable store sales and operating profit dollars on top of second quarter 2020's record performance demonstrates just how deeply ingrained our culture is within Team O'Reilly. I couldn't be more proud to work with the team who, regardless of the past successes or challenges we faced, will remain driven to win the business by rolling up their sleeves and outhustling and outservicing our competition every day. We've had plenty of opportunities over the last year to show new customers that we are, in fact, the friendliest parts store in town, and I believe the continued strength in our results speaks volumes to our team's ability to provide that consistent top-notch customer service.

To begin my comments today, I'd like to provide some color on our SG&A expenses for the quarter and give some additional insight into the outstanding performance of our team. Our second quarter operating profit dollars increased by 8% as compared to last year. With our SG&A leverage at 29.7% of sales significantly outperforming our expectations as a result of our robust sales performance and solid expense control.

As we discussed last quarter, the strong sales trends continue to produce historically high levels of profitability. Greg has already mentioned the extremely tough comp store sales comparisons we were up against in the second quarter. And we also faced our toughest SG&A leverage and operating margin comparison against the second quarter of last year. As a reminder, last year's second quarter results were driven in part by cost adjustments we made to our business in response to the initial impact of the pandemic, which generated a level of profitability that was unique to those specific circumstances and not sustainable or beneficial to our long-term business.

While this unusually difficult comparison created pressure on our year-over-year operating margin rate, which declined 87 basis points, we're very pleased with the improvement in our profitability on a 2-year stack. On this basis, our operating margin percent of 23% is a 372 basis point improvement over our second quarter 2019 operating margin performance as our team was able to drive compounded top line growth at almost twice the rate of our SG&A increases.

SG&A per store grew 11.5% in the second quarter, which represents annual per store growth of 5.1% on a 2-year basis. Well below the 13% average comparable store sales growth we achieved over the same period. Per store SG&A dollar growth was above our expectations for the second quarter as we spend additional dollars in store payroll, variable operating expenses and incentive compensation in support of the much better-than-expected sales dollars.

Expense control remains an integral part of our culture, and we will always carefully manage every dollar we spend while also ensuring our stores and store team members are well equipped to deliver the service levels our customers know and expect. Based on our results year-to-date, we're now estimating our full year increase in SG&A per store to be approximately 5%. Due to the SG&A leverage above our expectations on the strong sales performance through the date of this call, we're increasing the midpoint of our operating profit guidance by 55 basis points to a range of 20.5% to 20.9%.

Next, I'd like to provide an update on our store growth during the quarter. During the second quarter, we opened 50 new stores across 25 states bringing our year-to-date total to 116 net new stores. This pace sets us up well to achieve our plan of 165 to 175 net new stores for 2021. And we continue to be pleased with our new store performance, which is driven by a solid team of professional parts people in each of our new stores. We're also pleased with the performance and results from our team in Mexico and look forward to the growth ahead of us in that market.

As I wrap up my prepared comments, I'd like to again thank our team members throughout our stores, DCs and offices for their steadfast commitment to our business and customers. You've shown us not a single challenge or obstacle that will stand in the way of your team's success. Finally, I also want to thank Greg Johnson, Greg Henslee, David O'Reilly and all of Team O'Reilly for the kind words in regard to my retirement announcement, as well as the opportunities that I've had over the years to be a part of a truly first-class team and to play a role in Team O'Reilly's tremendous success story. Looking forward, I'm extremely excited for the future of our company and the deep bench of solid leaders that we have who will drive the continued success of our company.

As for my specific succession plan, as Greg mentioned, Brad is a tremendous example of our promoting within philosophy, working his way up through the ranks based on outstanding performance and a deep knowledge of what drives our business. He's an experienced and well-respected leader in our company who is fully prepared to step into the role of Chief Operating Officer, and I know he will do an outstanding job.

And since this will be my last quarter, we all participate in the prepared comments, I'm especially pleased to transition this responsibility over to him. And just because my time as an O'Reilly team member will soon be coming to an end, as retiree, I'll continue to be a long-term shareholder and will be cheering Team O'Reilly on from the sidelines in the future.

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 hard work and commitment to excellent customer service, which drove our tremendous second quarter and year-to-date performance. In addition, I'd also like to take this opportunity to congratulate Jeff on his upcoming retirement and thank him for his many years of top-notch leadership.

Now we'll take a closer look at our second quarter results and add some additional color to our updated 2021 guidance. For the quarter, sales increased $374 million comprised of $298 million increase in comp store sales, a $57 million increase in noncomp store sales and a $19 million increase in noncomp, nonstore sales. For the full year of 2021, we now expect our total revenue to be between $12.3 billion and $12.6 billion, up from our previous guidance of $11.8 billion to $12.1 billion based on our strong year-to-date top line performance and our continued confidence in our team.

Greg covered our gross margin performance earlier, but I do want to provide details on our positive LIFO impact, which was $19 million in the second quarter and above our previous expectations. As a reminder, in the second quarter of 2020, we recorded a headwind in LIFO with a charge of $4 million. When we set our full year gross margin guidance earlier this year, we were anticipating a larger positive impact from LIFO in the first half of 2021 versus the back half. However, as we continue to experience inflationary input cost increases and depending on the persistence of inflation, we may see similar or more LIFO benefits in the back half of the year, which is expected to partially offset pressure on our higher-than-planned distribution costs that Greg discussed earlier.

While some of the components driving our overall gross margin outlook have changed from our original expectations at the beginning of the year, we still expect to finish the full year within our original stated gross margin range of 52.2% to 52.7%.

Our second quarter effective tax rate was 23.1% of pretax income, comprised of a base rate of 24.4%, reduced by a 1.3% benefit for share-based compensation. This compares to the second quarter of 2020 rate of 24.1% of pretax income, which was comprised of a base rate of 24.5%, reduced by a 0.4% benefit for share-based compensation. The second quarter of 2021 base rate was in line with our expectations. And for 2021, we continue to expect to have a lower fourth quarter base rate based on the expected tolling of certain tax periods and realizing benefits from a renewable energy tax credits.

For the full year of 2021, we continue to expect an effective tax rate of approximately 23%. These expectations assume no significant changes to the existing tax code. Also, variations in the tax benefit from 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 as well as our updated expectations for 2021. Free cash flow for the first 6 months of 2021 was $1.5 billion, up from $1.2 billion for the first 6 months of 2020, with the improvement driven by an increase in net income, a larger benefit from our net inventory investment and a larger prior year investment in solar projects, partially offset by decreases in income taxes payable and tax withholdings, both resulting from the ability to defer certain income tax and payroll tax payments in the prior year under the provisions of the CARES Act. We do anticipate additional investments in solar projects in the fourth quarter of 2021.

For the full year of 2021, we now expect free cash flow to be in the range of $1.5 billion to $1.8 billion, up $400 million at the midpoint from our previous guidance based on our strong year-to-date operating profit and cash flow performance and strong net inventory performance.

Inventory per store at the end of the second quarter was $636,000, which was down 2% from the beginning of the year but up 1% from this time last year driven by the extremely strong sales volumes and corresponding improvement in inventory terms. During prior quarter's earnings call, we discussed our plan for 2021 initiative 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. While we are still making progress on this plan, which when fully executed, will result in an approximately 4% increase in average per store inventory. Our strong year-to-date sales volumes and the resulting replenishment needs of our stores continue to be the priority. As a result, we could see some further delays in our inventory growth initiatives if we are able to maintain our high level of sales growth.

Our AP to inventory ratio at the end of the second quarter was 126%, which was another all-time high for our company and was heavily influenced by the extremely strong sales volumes and inventory turns over last year. We anticipate our AP to inventory ratio to decrease from this historic high as we continue to execute on our additional inventory investments as well as our sales growth moderating. Our updated expectation is to finish 2021, at an AP to inventory ratio of approximately 115%.

Capital expenditures for the first 6 months of 2021 were $223 million, which was down $22 million from the same period of 2020, primarily driven by the timing of expenditures for new distribution and development activities. 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-EBITDAR ratio of 1.76x as compared to our year-end 2020 ratio of 2.03x, with the reduction driven by a decrease in adjusted debt as well as growth in our trailing 12-month EBITDAR. During the second quarter, we used available cash on hand to redeem $300 million of our senior notes, which were scheduled to mature in 2021 and carried a coupon rate of 4.625%. We continue to be below our leverage target of 2.5x, and we'll approach that number when appropriate.

During the second quarter, we also successfully upsized our revolving credit facility, which was scheduled to expire early next year. The new 5-year facility has an aggregate capacity of $1.8 billion up from the $1.2 billion on the old revolver, which provides us with additional financial flexibility moving forward.

We continue to execute our share repurchase program. And during the second quarter, we repurchased 0.7 million shares at an average price of $537.25 for a total investment of $400 million. Year-to-date, through our press release yesterday, we repurchased 2.4 million shares at an average price of $488.59 for a total investment of $1.2 billion. 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 shareholders.

Before I open up our call to your questions, I'd like to once again thank the O'Reilly team for all their dedication and continued hard work. Your contributions continue to drive our record-breaking results.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) phone. Our first question on the come from the line of Simeon Gutman from Morgan Stanley.

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

Jeff, congratulations, Brad, congratulations to you. My first question is on, I guess, short-term question on the commentary around July. Is there any way we could assume that your comments around demand holding up means that the 2-year or 3-year stacks are holding? And if that's fair, obviously, we're looking at the second half guidance, implying negative. Is there anything else that we should be aware of besides just tough compares, but you've already gotten through your worst of it in July. Is it just prudence in your second half guidance?

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

So we continue to be very happy with our daily performance in July, and it's carried through from those volumes in May and June. We've rolled that into our comp guidance for the full year. There remains a lot of uncertainty in relation to the recovery in the pandemic and the variants that are out there. We still have tough compares in August and September and put up a great comp in the third quarter of last year. So we feel like it's prudent to give the guidance that we gave for the full year.

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

Okay. Fair enough. Can I ask Greg or Tom, thinking about how much of the demand this year in '21, if there's any framework you're thinking about what's pent-up versus pull forward. Does the current year become a base from which we grow or does the industry or your business have to digest some of this? I know it's early to guide in the out year, but anything that you're -- that you can share of sort of the puts and takes to think about future growth?

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

Yes, Simeon, we're obviously not guiding into 2022 or beyond at this point. But as we said in our prepared comments, we're pleased with the performance during the second quarter. We're pleased with virtually every category, both the DIY and DIFM side of the business. Quite frankly, the business outperformed our expectations. And as Tom said, there's a lot of unknowns as we move into the back half of the year and into 2022 and beyond as it relates to pandemic, supply chains, things like that. So we're hopeful that sales trends continue, but we're not guiding anything beyond this year. Tom, do you have anything to add to that?

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

What I'd add to that is last year and on the call today, both Greg and Jeff have discussed that we've seen dramatic increases in customer traffic, and we see new customers and the onus was on us to earn those customers repeat business by providing them great customer service. If you look at our guide at the beginning of this year, the expectation was we were going to get some of that business back from last year. So having -- sitting where we are at the comp level that we're sitting at this year, I think, speaks to, as Jeff said in his prepared comments, our ability to earn more customers repeat business. So we are very pleased with the business, and we've clearly stepped up the base what we've determine to be the base business.

Operator

Our next question come from the line of Bret Jordan from Jefferies.

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

On the sales exceeding expectations, I guess, could you sort of parse out what might be underlying sort of broad strength in demand versus share gains trends? I mean it seems like you guys have been outperforming the underlying market. But are your share gains exceeding expectations or just the general trend in the market?

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

It's really, Bret, as you know, it's really hard to differentiate the difference between what is share gains and what may be pent-up demand or what have you coming off of a very strong year in 2021 and having a stronger year as we've had thus far this quarter, we're confident that we're taking market share. We're confident we're taking market share on both sides of the business.

As far as parsing out how much of that is market share gain versus just pure demand, it would be just purely a guess to try to differentiate the two. But I mean, in summary, we're confident, Bret, that we are taking market share today.

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

Okay. Great. And then a quick question on supply chain. I mean the cadence of availability or obviously a lot of supply disruption. Could you talk maybe as to -- is the trend improving? Or are we bumping along the bottom as far as access and cost of a product?

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

Sure, sure. So you break the supply chain down into various areas. Our -- as we said, our distribution centers have been pressured by the volume. And as most companies across the U.S. have seen, we've had difficulty with the labor market and keeping those DC staffed and caught up. So that's been a hurdle that we've challenged throughout the year this year. Things are starting to improve in several markets, and we're optimistic that through the balance of the year, our DCs will continue to get caught up and perform better.

From a supplier perspective, the last couple of quarters I've commented that we had a handful of domestic suppliers that were facing challenges in fill rate. And really, while it may be a couple of differences, it's pretty much the same suppliers. Their challenges are somewhat higher. Some of it's raw materials, a lot of it's carryover from COVID and labor, just having enough people to build, manufacture and distribute the product. So we're working very, very closely with those suppliers. Each of those suppliers, our supply chain team is meeting with at the highest levels on a weekly basis now to try to find creative ways to help them get caught up.

And then the elephant in the room, which everybody knows is container shortage with product coming from overseas. We're all facing those challenges. And we're doing everything we can do to keep our product flowing. I would say that overall, Bret, even with all those challenges, we continue to be pleased with our business and our performance of our stores. We've always talked to some of the strengths of our supply chain being the fact that we have especially in our major categories, we have multiple suppliers in those categories, and that's really helped us through this period where you may have different countries of origin for some of those manufacturers where you have multiple suppliers per category and also our good, better, best offering.

So while we may not have the exact product every consumer wants on the shelf, we've got a product that fits their application. And I think consumers today, like it or not, no matter what store they walk into whether it's a grocery store or hardware store, an auto part store, the shelves are not as stocked as they typically would be. And I think the consumer has a little bit more of a willingness to trade up or trade down as necessary.

Brad, did you have anything you want to add to that?

Brad W. Beckham - *O'Reilly Automotive, Inc. - EVP of Store Operations & Sales*

No, I think that's pretty well said.

Operator

Our next question will come from the line of Michael Lasser from UBS.

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

And congratulations to everyone on their new roles and Jeff on your retirement. My question is on the DIY...

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

Michael, can I for second, we're having a little bit of a hard time understanding, you're not coming through clear.

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

Is that better?

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

It's much better.

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

Right. My question is on DIY retail. Presumably, it was strong in the quarter. It remains strong today, banking contracts to some other at-home DIY categories, right?

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

Michael, I apologize. You went from clear to back very hard to understand.

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

Let's try this for last time. Better?

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

We'll give it another shot.

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

Okay. Last one. So the question is, why is DIY retail so strong? Is it simply a function of people are driving more, despite the tough comparison, the increase of vehicle miles driven continues to drive that business and should continue to drive that business even as we rebase that off of a higher level into the spring and beyond?

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

Okay. Mike, we're going to answer the question of why this DIY remains so strong. The rest of the question was difficult to answer. I'll start and turn it over to Greg. We continue to see an environment where people are somewhat concerned about their economics and are taking on more challenging jobs by themselves. Some people continue to work from home. That's a benefit for us. Used car prices -- new cars are hard to find and used car prices are very high. So those items continue to be a positive for us, and we continue to think that now that we're taking share within the DIY marketplace.

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

Yes. The only thing I would add to that, Michael, is your comment is probably accurate about miles driven. I think consumers -- a lot of consumers did not take vacations last year. Perhaps where they are this year and are doing more maintenance-type things as well as perhaps more weather-related repairs. We had a normal winter last year for the first time in a couple of years. And that's really impacted some of our mild undercar categories where consumers are able to replace shocks, brakes, things like that, that may have been damaged during the winter.

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

That's very helpful. My quick follow-up question is on what was the contribution from like-for-like price increases or inflation in the period? And how much visibility do you have for the contribution from inflation over the next few quarters? And how is this going to impact the gross margin you already alluded to similar like for changes. But can you give us a more explicit impact on gross margin as well?

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

Okay. So for the quarter, I think we've talked to it in our prepared comments. Our LIFO number was -- I'm going to have to look it up again now, it was...

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

I guess, I was more interested in the inflation impact, Tom?

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

I'm sorry. Okay. So inflation was slightly over 2%, as Greg talked about. We've got visibility of what our pricing is doing right now and expect that we're going to continue to see more inflation in the short term. As Greg talked about on many of our categories, freight is a big component, raw materials and labor. Especially for freight and raw materials, we tend to price those separately and adjust the price base on those markets. So to the extent that these pressures continue through the full quarter, we'd expect to see a higher inflation in the third quarter and the fourth quarter. To the extent that they start to abate, we'd expect to see those costs come back down. So it will be dependent.

Operator

Our next question will come from the line of Chris Horvers from JPMorgan.

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

Congratulations to all. So a couple of follow-up questions. I guess, first, in terms of the gross margin outlook, can you maybe just resummarize what the changes are relative to your original expectations? And what are you expecting from a LIFO perspective in the third and fourth quarters?

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

We're expecting to see more benefit from LIFO in the third and fourth quarter as our costs have increased and we reduced our LIFO debit. We expect that to be offset by transitory distribution costs as we focus on getting into an even better inventory position and starting to work on our inventory initiatives, and that will have some short-term cost impacts on our distribution, which flow into gross margin.

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

Got it. So that, that catch-up on the inventory side is going to sort of also offset the fact that you are implying less volumes year-over-year in the back half of the year given the comp guide?

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

Yes. To some extent, our distribution centers to keep up with the volume that we're doing right now, as Greg talked about in his prepared comments, are running inefficiently. So running a lower volume would actually yield a better distribution percentage at this point. But mainly, we're talking about just challenges on the labor side and how we get focused on getting a better inventory position.

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

Understood. And then as a follow-up, just to parse out the volume commentary on May and June. When you talk about comps similar in May and June? Or is that relative to your expectations of volumes? Or is that a commentary that May and June comps were the same, basically?

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

Our comments relate to our expectations. Obviously, we have a lot different comp cadence from last year that we compare to. So our focus is really on what were our expected volumes and what we achieved versus those expected volumes. And we were way above those in the beginning of April, as we talked about on the first quarter call, due to the stimulus that went out, but that base underlying trend of over expectations that we saw at the end of April continued in May and June. And we're focused on generating sales levels as opposed to the math from what was last year.

Operator

Our next question come from the line of Greg Melich from Evercore ISI.

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

My question was on the -- looking at sales versus 2019. So I guess they were up 26%, a little acceleration from the first quarter. Could you break down that comparison to 2019 for DIY and do it for me? Knowing how s(expletive) up the comparisons over last year?

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

Yes, Greg, we're not going to quantify that. But as we said in our prepared comments, DIFM was a larger contributor than DIY for the quarter.

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

On a year-over-year basis, is that...

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

Compared to prior year.

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

Right. If we look back to '19, is DIY still more of the growth versus '19 than do within Pro? Or did that also...

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

We look at aggregate sales in dollars. I think we covered this in the call is that when we look at the second quarter, we know that DIY far surpassed professional business in the second quarter of last year due to the timing of stimulus, the work-from-home arrangements and hesitation for people to turn their car over to shops to have them work on it, and it recovered more slowly. So our comment that the second quarter DIY was above our expectation more strongly than the professional business indicates that on a 2-year basis, the DIY is the bigger contributor.

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

Got it. Okay. And then the second question is, I think in your prepared comments, you mentioned that as some of this inflation flows into the back half that you're expecting some potential trade down. Have you actually seen that already in some markets or some products? Or is that just an anticipation given on what's happened in the past?

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

Yes, Greg, we just called that out as a possibility if inflation continues. Historically, we've seen when prices increase, when gas prices increase, things like that, that the economically challenged consumer has less discretionary cash to spend. Sometimes they will defer maintenance and sometimes they'll trade down the value spectrum. So that's why we called that out.

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

Okay. So it's more of an expectation of things that happened in the past? Not about anything you're seeing today?

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

That's correct.

Operator

And our next question will come from the line of Daniel Imbro from Stephens.

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

Greg, I wanted to talk about the supply chain a little bit. And obviously, ocean freight is an issue, but some of your peers are talking more about direct sourcing, maybe trying to go find cheaper labor, cheaper manufacturing to lower cost of goods. I'm curious maybe what the strategic outlook would be for O'Reilly along that? Or maybe what are the benefits of using more full-service suppliers like you guys do domestically to keep your service levels up?

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

Yes. As I spoke before, we don't do a great deal of direct importing. We -- a lot of our import suppliers, we require to keep inventory on hand here in the States. They're the owner of that freight until it hits the port. That has worked well for us. Unfortunately, we've gone through some of that inventory over the past few months. So today, it's probably not working as well for us as it normally would because all that product inevitably has to come from overseas. We continue, Daniel, to evaluate where it makes sense to bring product in from a direct import perspective versus through the suppliers 3PL or warehouse here domestically. And it's really a matter for us of -- it's an economic calculation of is there enough demand and enough flow-through of the product to justify bringing it in direct versus bringing it in through their distribution centers here in the U.S. So we have a combination. We have SKUs. We've after some of these suppliers direct into our third-party 3PL facilities. And then -- but the bulk of what we bring in from overseas would flow through their -- the manufacturing facilities here domestically.

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

Got it. That is helpful. And then, Tom, sorry to beat dead horse, I just want to make sure we understand the inflation side a little bit. So the guidance you've given assumes what Greg mentioned earlier, that inflation does accelerate? Or are you assuming the benefit to LIFO assuming inflation flatlined with 2Q? I just want to make sure we understand what's embedded in that outlook you provided?

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

So from a sales perspective, we anticipate that we will have some tailwinds from increased inflation offset by deferrals and trade down. So it hasn't really impacted our total sales expectations.

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

And what about on the gross margin side?

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

On the gross margin side, being in the LIFO debit, as the prices go up, their last bias, below LIFO who are making more money on those products than we normally would, so that will be a benefit. And that benefit will be offset by additional distribution costs as we strategically look to improve our inventory and get further ahead on our inventory initiatives.

Operator

Our next question come from the line of Seth Basham from Wedbush.

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

Congrats to Jeff. I actually have a question that Jeff may be able to answer. If we look at the team member count, it remains below pre-pandemic levels. How do you view this now? Do you think that you can operate your stores with less labor? Or is there an expectation to continue to ramp back up?

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

Well, Seth, we've been throughout the last, really, 1.5 years, I mean, since the pandemic hit, we had the downturn. I mean, we really just kind of block down on payroll, not knowing what the future held. And really dialed in our headcount and our payroll to what our business was doing and then we just had the explosive growth in volume there mid-April on. And we just really didn't know how long that was going to last. We were kind of playing it by year, really week to week, month to month and being very cautious in staffing back up. And as we've seen the volume hold there in the third and fourth quarter, we cautiously started ramping back up headcount to match the sales demand. And that's really carried into the first quarter and second quarter of this year as very cautiously ramping headcount back up as well as just the seasonal ramp-up in the business. We continue to focus on our full-time initiative as well and replace maybe part time with more full-time headcount, knowing that we provide better service levels with more tenured experienced team members. So that has part of it. And obviously, this is Brad's wheelhouse, so I might let him speak to that if he's got any additional comments.

Brad W. Beckham - *O'Reilly Automotive, Inc. - EVP of Store Operations & Sales*

Yes, Seth, I think directly to your question, I think it's a combination of both. I think this last year, like a lot of companies, I'm sure we've learned a lot about ourselves. When we're looking at last spring in the worst-case scenario, we had to make decisions on our head count. We did that very surgically based upon team member productivity and learned a lot in that first quarter to go through the pandemic. And then to Jeff's point, as we've gone on here, it's been kind of a short to mid term outlook in terms of what we thought the business was going to do. We always run our business like we always say, for the long term when it comes to staffing and our service levels, while at the same time, being able to back ourselves out if we have points that business changes the other direction from a store count -- from a headcount and from an hour standpoint. But we've been working this last year a lot on full time. We see some productivity increases from that. And we also have other initiatives on the productivity front that we're working on right now, and we're pleased with those.

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

That's very helpful. Just one related follow-up. Are you seeing a big increase in our mix of sales that are through the online channel? Is that helping you operate more efficiently with labor? How do you expect the online channel to develop over the next year or so?

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

Seth, I'll take that one. We have seen significant growth in our online channel. As we've said in previous quarters, most of that growth ends up in the stores. Last quarter, about 3/4 of our online sales were pick up in store or ship to store. Some of that would -- could be curbside. But we -- but most of that -- the increases that we've seen as opposed to taking the discount that they are offered for ship to home have ended up in our stores. And that just goes back to our thesis from forever that those consumers, they need help. They want to make sure they getting the right parts, they need it timely. And so Brad, do you want to add to that?

Brad W. Beckham - *O'Reilly Automotive, Inc. - EVP of Store Operations & Sales*

Yes. Seth, the other thing I would add is that a lot of times when we talk about online digital business, we talked about oreillyauto.com and we talk about B2C. But what I would say is it reminds you of our B2B business with our first call online and all our shop management systems where we directly integrate with so much of our professional business. Obviously, to your question, that's the other side of it. It's been a huge productivity improvement incrementally at that for us and for our shops. And so not only do we have everything that Greg talked about with oreillyauto.com, buy online, pick up instore, ship to home. But one of our biggest initiatives with professional being our bread and butter is continuing to grow that digital business on the professional side in turn, get the incremental gains in productivity on our side and with our shops.

Operator

And our next question will come from the line of Bobby Griffin from Raymond James.

Mitchell James Ingles - *Raymond James Ltd., Research Division - Research Analyst*

This is Mitch Ingles filling in for Bobby. Congrats on a great quarter. Yes, so to start, any color on the performance by region would be helpful. And to that theme, are you seeing any slowdown at day -- on daily sales for areas that have recently ramped up COVID-related restrictions?

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

Brad, do you want to take that one?

Brad W. Beckham - *O'Reilly Automotive, Inc. - EVP of Store Operations & Sales*

Sure. Well, we're very pleased with all regions and really the consistency of our business across the U.S. in the second quarter also on both sides of the business like we discussed on the DIY and professional side. Our -- it might be little bit tough to talk about regional just because our time and energy really focus less on the macro trends like weather, but it was fairly favorable across our regions, like Greg mentioned, when he talked about the categories. But instead, 100% fundamental execution of our business model that adds up to share gains, really which to me is our culture being alive and well in every single market, promoting proven performers from within and being the friendliest most professional parts store in every single market we operate in.

So -- and then on your last question, I don't think from a COVID standpoint where we've seen ramp-ups here recently, we have not seen that affect our business thus far.

Mitchell James Ingles - *Raymond James Ltd., Research Division - Research Analyst*

Great. And as a quick follow-up, is it fair to categorize the weather turns year-to-date as the most favorable the industry has seen over the past few years. So for instance, June is on record as being the hottest in at least 127 years. So it's probably difficult to parse out a stimulus in [BMD] recovery. But any read as to what the benefit of weather could have done in 2Q and year-to-date would be very helpful.

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

So what I would tell you is that the last couple of years have been not as favorable weather. So in comparison, it's much better, I'd tell you over a long period of time, it's slightly above average. When we talk about performance improvements, we're having a better AC year. We're having a better under car years as the roads got tore up more this winter. A lot of batteries that were stressed in the winter got replaced in the summer. But to go -- we're not going to go through an attempt to quantify on this call the seasonal benefits. But what we'd tell you is that we got back to a slightly better than normal as compared to poor the last few years.

Operator

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

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

Thank you, Victor. 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 third quarter results in October. Thank you.

Operator

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