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ORLY.OQ - Q3 2021 O'Reilly Automotive Inc Earnings Call

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## OVERVIEW:

Co. reported YTD 2021 EPS of \$23.45 and 3Q21 EPS of \$8.07. Expects full-year 2021 total revenues to be \$12.9-13.2b and EPS to be \$29.25-29.45.

## CORPORATE PARTICIPANTS

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

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

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

## CONFERENCE CALL PARTICIPANTS

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

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

## PRESENTATION

### Operator

Welcome to the O'Reilly Automotive, Inc. Third Quarter 2021 Earnings Conference Call. My name is Adrian, and I'll be your operator for today's call. (Operator Instructions) I'll now turn the call over to Tom McFall. Tom McFall, you may begin.

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

Thank you, Adrian. Good morning, everyone, and thank you for joining us. During today's conference call, we'll discuss our third quarter 2021 results and our updated outlook for the full year. 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 Third Quarter conference call. Participating on the call with me this morning are Brad Beckham, our Executive Vice President of Store Operations and Sales; and Tom McFall, our Chief Financial Officer; Greg Henslee, our Executive Chairman; David O'Reilly, our Executive Vice Chairman; and Jeff Shaw, our Chief Operating Officer and Co-President, are also present on the call. As we announced on last quarter's call, Brad will be providing prepared comments today -- on today's call in Jeff's normal spot as we anticipate and prepare for Jeff's upcoming retirement in early 2022 after more than 33 years of distinguished and dedicated service to the company.

It's my pleasure to congratulate Team O'Reilly on yet another incredible performance in the third quarter and to thank every member of our team for their unwavering commitment to our company and to our customers. The highlights of our third quarter results include a 6.7% increase in comparable store sales on top of an impressive 16.9% increase in the third quarter of last year and a 14% increase in diluted earnings per share, which is all the more impressive considering we grew EPS 39% in the third quarter last year. We'll walk through the details of our performance and our prepared comments today, but I don't want to miss an opportunity at the beginning of the call to express my sincere gratitude to our team for their relentless hard work and dedication as we continue to weather the pandemic.

Our team has been incredibly resilient to the challenges we faced over the last 1.5 years, and it would be very easy to take this for granted their ability to respond so well to this difficult environment. This is especially true since our team has been able to deliver quarter after quarter of record-breaking results. I can assure you it has been anything but easy. And our track record of consistency doesn't diminish the massive undertaking by Team O'Reilly to protect our customers and fellow team members while driving the highest sales and transaction volumes in the history of our company. So thank you, Team O'Reilly for your outstanding performance in the third quarter.

I'd now like to take a few minutes and provide some color around our sales performance for the quarter. Our comparable store sales performance has continued to track well ahead of our expectations, and we have been very pleased with both the consistency and broad-based nature of the strength of our top line.

From a cadence perspective, our sales results were fairly consistent throughout the quarter with solid positive comparable store sales growth each month. September was the strongest month of the quarter but the variability from month-to-month throughout the quarter was not significant on a 2- or 3-year stack basis. These very steady elevated sales levels continued to trend we drove in the second quarter despite not having a tailwind from government stimulus payments we saw in previous quarters. This top line sales strength has continued thus far in October and we continue to be pleased with the durable nature of the strong sales volumes we've been able to achieve.

The components of our comparable store sales growth in the third quarter are consistent with our second quarter results with strong growth on the professional side of our business, paired with solid growth from DIY. While our professional business faced easier comparisons from the prior year than the DIY business, we were still up against a challenging comparison and are very pleased with our team's ability to drive historically strong comparable store sales on a 1- and 2-year stack basis. We also continue to be very happy with the performance of our DIY business as this side drove the greater outperformance as compared to our expectations against extremely difficult comparison in the prior year.

Total ticket count comp for the third quarter were better than our expectations, but slightly negative as a result of pressure to DIY transaction counts due to the difficult comparisons and rising prices, which were partially offset by the growth in professional ticket counts. On last quarter's call, we commented that we expected to see incremental -- I'm sorry, we expected to see increased inflation in the back half of the year. However, third quarter inflation was even higher than our expectations.

Our third quarter average ticket increase was aided by an increase in same SKU selling prices of approximately 5.5% as acquisition cost increases were passed along in selling price. As price levels have risen in the broader economy, demand in our industry has been resilient, and we continue to see strength in average ticket on a 1- and 2-year stack basis beyond the impact of same SKU inflation. However, we remain cautious in regard to our inflation outlook as we would expect some partial offsets same-SKU benefit as continued rising prices may cause more economically challenged customers to defer noncritical maintenance or trade down the product value spectrum.

Finally, we drove solid sales volumes across all of our product categories with especially strong performance in undercar hard part categories, offsetting some of the pressure in appearance and accessory categories, which are up against extremely strong comparisons after growing at historically high levels in 2020.

On a year-to-date basis, for the first 9 months of 2021, our comparable store sales growth of 12.9% and our 2-year stack comp of 23.6% were well above our expectations coming into this year. As the pandemic recovery has progressed, we remain cautious as to the lasting effect of demand tailwinds of our industry has experienced and candidly, had anticipated more moderation of the historically high growth rates we generated in 2020.

Each month, as we move further past the significant government stimulus and enhanced unemployment benefits, the stability of demand in our business is very encouraging and reflects the continued willingness for consumers to invest in repairing and maintaining their vehicles in the face of an overall shortage of new and used vehicles and continued economic uncertainty.

Similarly, we believe our strength of our professional business reflects the return to more daily commutes for many of the vehicle owners who professional customers serve. And we expect the gradual improvement in miles driven trends to continue and provide a benefit to the aftermarket as the recovery moves forward.

Beyond the macroeconomic tailwinds in our industry, it is also clear to us that we are taking share and capitalizing on the opportunities to meet our customer needs in a very challenging environment.

As we discussed in our earnings release yesterday, we are increasing our full year comparable store sales guidance to a range of 10% to 12% from our previous range of 5% to 7%. This increase reflects our year-to-date performance through our press release and also anticipate solid business trends through the end of the year. As I've already indicated, we've seen a high degree of consistency in our top line sales volume for several months now, and we feel it appropriate to revise our expectations as we near the completion of the fiscal year. However, the fourth quarter can be a volatile period, especially in light of possible further impacts from the pandemic, rising price levels, variability in winter weather and the holiday shopping season and potential economic shock from the higher gas prices.

Now I'd like to move on to the gross margin performance for the quarter. Our third quarter gross margin of [\$52.3 million] was a 13 basis point decrease from our third quarter 2020 gross margin and was in line with our expectations we discussed on the second quarter call. While the stronger performance of our professional business put mix pressure on the gross margin percentage, I want to spend a little time walking through 2 other dynamics that drove our gross margin results.

First, we have seen higher-than-normal broad-based increases in acquisition and input costs in our industry. One of the defining features of the automotive aftermarket throughout our history is the ability of the industry to leverage pricing power to pass through cost increases to end-user consumers with minimal impact to demand due to the essential nondiscretionary nature of the products we sell. The cost increases we've seen during the current inflationary environment represent broader-based inflation than we've seen for some time. However, we did see significant inflation during 2018 and 2019 on certain product lines caused by tariffs.

Consistent with the 2018-2019 time period, we've continued to see rational pricing in our industry and are very confident this will continue moving forward. Our pricing philosophy over time is to attempt to achieve consistent gross margin rates as a percentage of sales and higher gross profit dollars in line with the sales growth, which serves to offset similar cost pressures and SG&A expenses. However, as we've discussed in the past, similar to the 2018-2019 period of rising acquisition costs, we are currently benefiting from an enhanced gross margins as a result of increased pricing -- increased prices on the sell-through of products purchased prior to the cost increases.

The second gross margin dynamic I want to discuss today is the continued pressure we're seeing on distribution costs. As we discussed on last quarter's call, our distribution infrastructure is facing inefficiencies due to the massive sales spikes over the past 6 quarters, the difficult labor environment and global logistics challenges. We operate a high-service, high-touch distribution model, and we are fully committed to protecting and enhancing our competitive advantage in industry-leading parts availability.

Our dedicated supplier partners, corporate supply chain team, an extraordinarily hard working distribution [set of] team members continue to do an amazing job navigating one of the most challenging supply chain environments we've seen in our careers. And we have taken specific targeted steps and incurred incremental expense to respond to the hurdles we're facing. Ultimately, we do believe these pressures will abate and conditions will normalize and be more conducive to driving appropriate leverage of our distribution cost. But we'll continue to prioritize inventory availability and take necessary steps to ensure excellent customer service, which is a fundamental driver of our long-term success.

As a result of these puts and takes, we are maintaining our gross margin guidance of 52.2% to 52.7% for the full year but we now anticipate finishing the year in the bottom half of that range. Before handing the call off to Brad, I'd like to highlight our third quarter earnings per share increase of 14% to \$8.07 with a year-to-date increase of 29% to \$23.45.

Our third quarter EPS growth comes on top of our growth of 39% in the third quarter of 2020, resulting in a 2-year compounded quarterly growth rate of 26%. We are raising our full year earnings per share guidance to \$29.25 to \$29.45, which at the midpoint now represents an increase of 25% compared to 2020 and a 2-year compounded annual growth rate of 28%. This increase in full year guidance is driven by our strong year-to-date results, updated sales expectations for the remainder of 2021 and excellent operating profit flow-through, which Brad will provide more detail on shortly. As a reminder, our EPS guidance includes the impact of shares repurchased through this call, but does not include any additional share repurchases.

To conclude my comments, I want to again thank Team O'Reilly for their tremendous hard work and dedication to delivering our culture and taking care of our customers every day.

I'll now turn the call over to Brad Beckham. Brad?

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

Thanks, Greg, and good morning, everyone. I'd like to begin today by echoing Greg's comments and congratulating Team O'Reilly on another outstanding quarter. As I stepped into Jeff's role on this call and provide commentary on our operating performance, I consider it a huge privilege to represent our team of over 80,000 dedicated professionals in our stores field operations, distribution centers and offices.

Team O'Reilly has established a tremendous history of consistently excellent performance, building on the foundation established by the O'Reilly family beginning in 1957 but the last year plus of record-breaking results has been truly amazing. The single biggest driving factor of these results is the quality of our team and our unrelenting commitment to excellent customer service.

As Greg previously discussed, our sales growth was very consistent throughout the quarter and solid on both sides of our business. Our team's commitment to our dual market strategy and our culture of excellent customer service has us well positioned to capitalize on the strong industry backdrop.

We have been able to leverage our competitive advantages to meet the challenges of our operating -- of operating in an extremely difficult environment and deliver an attractive value proposition to our customers, including many customers who are new to O'Reilly. As strong as our results have been, we know we still have significant opportunities to enhance the great service we provide to customers and gain additional market share, and our teams are dedicated to improving our business every day.

I'd now like to provide some color on our SG&A expenses and operating profit for the quarter. Operating profit dollars in the third quarter grew by 4% compared to the third quarter of 2020 and are up an incredible 41% above our operating profits we generated 2 years ago in 2019. Our SG&A dollar spend per store for the third quarter was up 8% over 2020, which is significantly higher than our typical growth in operating expenses. This is a result of the cost reduction measures we executed last year in response to the uncertainty around the pandemic as well as expenses incurred in 2021 in store payroll, incentive compensation and variable operating expenses to drive our sales growth. While our third quarter 2021 SG&A expense of 30.6% of sales represented a 78 basis point increase over 2020, it significantly outperformed our expectations as a result of our robust sales performance and solid expense control.

As a reminder, last year's third quarter SG&A expense levered 344 basis points and generated a level of profitability that was unique to the specific circumstances that we're facing -- we were facing at the point in the pandemic and was not sustainable nor appropriate for our long-term business. While this unusually difficult comparison created pressure on our year-over-year SG&A expense rate, we are very pleased with the improvement in our profitability on a 2-year stack. On this basis, our SG&A percentage is 266 basis points lower than our third quarter 2019 SG&A rate as our team was able to drive significantly higher top line sales growth than the rate of our SG&A increases.

Based upon our results year-to-date and our expectations for the fourth quarter, we are now estimating our full year increase in SG&A per store to be approximately 8%, which is below our comparable store sales guidance despite the extremely difficult comparisons. We are also increasing our operating profit guidance by 50 basis points to a range of 21% to 21.4%. Expense control is a core value of our culture, and we manage operating

expenses on a store-by-store month-to-month basis. While all levels of SG&A growth and our improvements in operating profitability are larger than we've seen in recent history, our priorities for how we deploy operating expenses remain unchanged.

Our top priority is to ensure we are providing excellent customer service and ensuring we lead the industry in the value we provide to our customers. We have a very high standard for service, and we are relentless in developing long-term and loyal customer relationships through consistent daily execution of our business model. These relationships are the foundation of our business and the key to future growth. We also prudently manage our expenses to capitalize on opportunities to grow market share and operating profit dollars through enhancements to the customer service tools we provide our teams.

Next, I'd like to provide an update on our store growth during the quarter. During the third quarter, we opened 30 new stores, bringing our year-to-date total to 146 net new store openings across 40 states. This pace sets us up well to achieve our plan of 165 to 175 net new stores for 2021. Logistical supply and governmental challenges continue to make new store development difficult but our teams are diligently grinding away to open great new store locations with outstanding teams, and we continue to be pleased with our new store performance and our opportunities for future growth. For 2022, we expect to open between 175 and 185 net new stores in the U.S. and Mexico. And these store openings will again be in both new and existing markets as we have capacity to support profitable growth across our distribution footprint.

In addition to investments we're making to grow our business with expansion into new markets, we continue to reinvest in our existing stores and distribution infrastructure with a particular focus on supporting and enhancing our industry-leading inventory availability. Our ability to provide our customers all the parts they need to complete their repair faster than our competitors is critical to earning repeat business and gaining new market share. The vast number of different parts needed to service the U.S. light vehicle fleet means no store could ever stock enough parts to service any given trade area. Every store in our chain has a unique inventory tailored to that store specific trade area that we deploy to provide immediate access to those products with the highest demand.

To further enhance our availability, we are pursuing ongoing initiatives to aggressively add incremental dollars to our store level inventories above the typical annual investment for new stores and product updates. During the strong sales environment this year, rolling out the full scope of these initiatives had to take a backseat to the replenishment needs of our stores but we still see significant opportunities to increase our market share by beefing up the inventory that sets closest to our customers and will execute on a larger investment in 2022.

To support the demand for less requested parts, our stores receive overnight deliveries from 1 of our 28 regional distribution centers, supplemented by multiple deliveries per day, 7 days a week if the store is located in the market area of one of our DCs. For stores that aren't located in close proximity to a DC, including stores in a very large metro area with a longer drive time to the DC, we utilized a hub and spoke network with hub store stocking additional parts depth to support surrounding stores through multiple daily deliveries. Hub stores carry between 2 and 4x the SKU count of a normal store depending on the market area. We continue to aggressively enhance our hub network with not only upgrades but the addition of new hubs, which are typically of the larger variety. These large investments are critical to support our store team's ability to provide exceptional customer service.

Before I turn it over to Tom, I want to thank Team O'Reilly for their continued dedication to our company's success. With 1 quarter left in 2021, we've had an amazing year so far, but we will continue to stay focused on finishing the year strong. As always, the key to our success is providing unwavering customer service that surpasses expectations and continues to earn our customers' business, and I am confident in our team's ability to continue our tremendous success.

Now I'll turn the call over to Tom.

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

Thanks, Brad. 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 third quarter and year-to-date performance. Now we'll take a closer look at our third quarter results and add some additional color to our updated 2021 guidance.

For the quarter, sales increased \$272 million comprised of a \$210 million increase in comp store sales, a \$58 million increase in noncomp store sales, a \$4 million increase in noncomp nonstore sales. For the full year of 2021, we now expect our total revenue to be between \$12.9 billion and \$13.2 billion, up from our previous guidance of \$12.3 billion to \$12.6 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 want to provide additional details on our positive LIFO impact. For the third quarter, the LIFO impact was \$43 million compared to no material benefit in the prior year. As a reminder, the positive LIFO impact is a byproduct of the reversal of our historic LIFO debit. Since 2013, due to negotiated acquisition price decreases, our calculated LIFO inventory balances exceeded the value of our inventory at replacement cost. And we elected the conservative approach to not write up inventory value beyond our replacement cost.

As a result of this accounting, we've seen a benefit from rising cost and price levels via the sell-through of lower-cost inventory purchased prior to the recent cost increases. However, during the third quarter of 2021, our LIFO reserve flipped back to a credit balance as a result of inflation and acquisition costs. And moving forward, we expect to be back to typical LIFO accounting and no longer valuing inventory at a lower replacement cost. As a result, we anticipate a benefit from the final sell-through of the remaining lower cost inventory will hit primarily in the fourth quarter of 2021 and will no longer be a tailwind beyond that. We will provide gross margin guidance for 2022 on our fourth quarter earnings call, but I wanted to outline this switch back to a LIFO credit since it will have the impact of being a declining benefit moving forward, which we anticipate will in part be offset by expected future normalization and distribution costs.

Our third quarter effective tax rate was 22.5% of pretax income comprised of a base rate of 24.2%, reduced by a 1.7% benefit for share-based compensation. This compares to the third quarter of 2020 rate of 23.2% of pretax income, which was comprised of a base tax rate of 24.4%, reduced by a 1.2% benefit for share-based compensation. The third quarter of 2021 base rate was in line with our expectations. And for 2021 full year, we continue to expect to see a lower fourth quarter base tax rate due to the expected tolling of certain tax periods and realizing benefits from 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 existing tax codes. Also, variations in the tax benefit from share-based compensation can create fluctuations in our 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 9 months of 2021 was \$2.2 billion, up from \$1.9 billion for the first 9 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 investment in solar projects, partially offset by a reduced benefit from accrued tax withholdings resulting from the ability to defer certain payroll tax payments in 2020 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 \$2 billion to \$2.3 billion, up \$500 million at the midpoint from our previous guidance based on our strong year-to-date operating profit and cash flow performance and our net inventory performance. Inventory per store at the end of the third quarter was \$633,000, which was down 3% from the beginning of the year but up 1% from this time last year, driven by the extremely strong sales volumes and supply chain constraints. Our AP to inventory ratio at the end of the third quarter was 126%, which matched the all-time high our company set at the end of the second quarter and was heavily influenced by the extremely strong sales volumes and inventory turns over the last year.

We now anticipate our year-end AP to inventory ratio to finish near a similar level. However, over time, as we increase inventory levels, we expect to see moderation in this ratio.

Capital expenditures for the first 9 months of 2021 were \$341 million, which was down \$23 million from the same period of 2020, primarily driven by the timing of expenditures for new store and DC development activities and strategic initiatives. As we look to the remainder of the year, we still see tremendous opportunity to deploy capital to enhance our service offerings and capitalize on growth opportunities. But we would now expect for some of those investments to be pushed into 2022. As a result, we're revising our CapEx forecast to come in between \$450 million and \$550 million for the year.

Moving on to debt. We finished the third quarter with an adjusted debt-to-EBITDA ratio of 1.75x as compared to our end of 2020 ratio of 20.3x. With the reduction driven by a decrease in adjusted debt, including the redemption of \$300 million of senior notes in the second quarter as well as substantial growth in our trailing 12-month 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 third quarter, we repurchased 1.6 million shares at an average share price of \$595.96 for a total investment of \$943 million. Year-to-date, through our press release yesterday, we repurchased 4.1 million shares at an average price of \$534.60 for a total investment of \$2.2 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 our shareholders.

Before I open up our call to your questions, I'd like to thank the O'Reilly team for their dedication to our customers and our company. Your hard work and commitment to excellent customer service continues to drive our outstanding performance.

This concludes our prepared comments. At this time, I'd like to ask Adrian to ask -- I'm sorry, I'd like to ask Adrian, the operator, to turn to the line, and we'll be happy to answer your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And our first question comes from Brian Nagel from Oppenheimer.

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

Another nice quarter. So the first question I want to ask. Just you commented -- it was commented in the prepared remarks about pricing and the impact upon demand. And I'm recognizing that there's some conservatism as you look forward. But I guess the question I have is, are you seeing indications now that as prices have risen, the consumers are either shifting away from products or there's some hesitation to buy certain items in your stores?

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

Yes, Brian. What I would tell you is we have not seen any significant movement thus far. We called that out as a possibility going forward if fuel prices continue to rise and continue to be challenges within the general economy. But so far, we haven't. What might happen or what has happened historically during times where consumer spending drops off to a degree as consumers may defer things like oil changes out beyond their normal oil change intervals or trade down the value spectrum. We really haven't seen that. We have -- over the last several quarters, we have really done a nice job of promoting some of our proprietary branded products. And we've seen a shift to some of those proprietary brands like, for example, SYNTEC motor oil. And what we've seen is those shifts are more related to us promoting those products than a shift downward in buying habits. Those are really planned shifts. But I would say unpredicted shifts or surprises, we have not seen those thus far.

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

That's really helpful. And the second or the follow-up question I have, a separate different topic, but with maybe kind of bigger picture in nature. But with regard to sales, I mean, clearly, the business is performing extraordinarily well here and continuing to perform well from a sales perspective, as we move past, like you said, past the benefits of stimulus, past while COVID still a factor maybe past some of the disruptions or even benefits of COVID. So as you look at your business and then compare it now to say, prepandemic levels, what's really -- what do you think is really driving it? I mean, is there certain factors you can point to that are just kind of underpinning this continued better than prepandemic sales levels?



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

Yes. I'll start that, and I'll see if Brad might have something to add. Brian, there are several things that are going on right now in the economy that short term are probably impacting that. And a couple of those things I called out is the availability of new cars and the availability and extended pricing on used cars today. It's just -- it's not cost-effective. People are paying as much for a 2-year-old used car as what sticker prices on a new car because new cars are not available. And I think that's driving more people to maintain their existing vehicles more so than perhaps they did pre-pandemic. Also, I think during the pandemic, we saw a trend of more traditional white collar employees and employers and people in general doing some of the things themselves that historically they may not have done. So that trend may be extending as well, which would support the DIY side of our business. So I think those things in combination are drivers that are positively impacting our sales volume as of recent and throughout the pandemic.

Brad, did you want to add anything to that?

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

The only other thing I'd add to what Greg said, it's just what I mentioned earlier, just about new customers. When I'm out in the field, and I have been quite a bit here lately seeing our teams and had them on the back and talking to customers on both sides of the business. We're seeing a lot of new customers, Brian. And again, on both sides of the business. And back to your original question, what we're seeing is a huge need. While prices are higher, we're seeing a huge need for value. And as you well know, with the nondiscretionary nature of our business, like Greg mentioned, with us totally focused on our supply chain, executing better than anybody else out there. Our delivery times and turning those base for the customers and all the value that we know we can create on that front counter with our professional parts people highly focused on retention right now. And we just see our teams doing a great job winning those new customers. And then when we win them over, we impress them with our service levels.

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

And Brian, one more additional thing. I think part of the growth we're seeing is we're taking some market share. I said that in our prepared comments and you look at industry reporting on our performance across the board against the remainder of market, we continue to outperform in most categories. And I think that we are taking market share. And I think as challenged as our supply chain has been, as large of a company as we are in the buying power that we represent, I have to think that some of these smaller companies are having more supply chain challenges perhaps than we are, which is supporting our market share gains.

**Operator**

And our next question comes from Zach Fadem from Wells Fargo.

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

So first one for Tom. Your ex-LIFO gross margin was about 51% in Q3, which is about 100 basis point step down versus Q2, if I'm calculating that right. So first question is, how much would you view the step down as transitory due to the supply chain factors today? And then as we look to '22, is it fair to expect the core ex-LIFO gross margin to hover around this 51% level? Or is a return to the 52% level the right way to think about it?

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

Well, Zach, there's a lot of moving pieces in margin right now as prices have gone up dramatically in a short period of time. To answer your first question, ex-LIFO would that have been the margin. I think that because we have product that we purchased at a lower cost, it allows us to maybe

be a little more prudent in the timing of raising prices and doing that in a smart way with our customers to make sure that we don't have a shock value. So I'm not sure that I would say that, that's how -- absent that ability to leverage that benefit that we may have run prices through a little bit different, not saying we're not going to eventually run all the prices through.

The second I might tell you is that when we look at our gross margin, we had a big LIFO benefit, but we also had a similar headwind from distribution. So over time, we will balance those. We feel like we've been pretty consistent in the gross margin percentage we've run over time. Obviously, since over the last 10 years since we purchased CSK and worked on a lot of outsourcing -- I'm sorry, sourcing to the most economical countries in private label, we've increased our gross margin substantially over that period. But over the last couple of years, it's been pretty consistent. And although we're not going to guidance on this call for next year, we wouldn't anticipate dramatic changes in our overall gross margin.

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

Got it. So in terms of the broader laundry list of supply chain inflationary pressures across all retail. You've called out product and DC costs. We're also dealing with higher freight and port delays and labor and product availability issues. So when you think about all these pinch points impacting your business today, could you talk about which ones are most front and center for you? Which aspects have been more manageable? And would you say we've reached peak pressure? Or do you still think there's incremental headwinds from here in the upcoming months?

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

Yes. Zach, this is Greg. I'll take this one. I don't think we're near the end of this, unfortunately. Obviously, the backlog -- you watch the news, the backlog of ships in China, at port in the U.S., various ports in the U.S. and on the water continues to be pressured and challenged. When you talk about our supply chain, you have to think about it sequentially. And really, it started -- the pressure started in the DC just based on the sheer volumes that they've experienced over the past several quarters. And to compound that, those volumes came at a time where the supply and demand of human capital was way out of balance. And it's very, very difficult, as everyone knows, to hire in the environment that we've been in the last several months or past few quarters.

Now we have seen some improvement since some of the government stimulus and unemployment benefits have subsided but we're still having some challenges staffing up in some of our DCs. The good news is, from a DC perspective, we're showing continued improvement, and our DCs are getting caught up and we're working hard to make sure we're positioned to be prepared for future growth in 2022 and make sure that our staffing levels are adequate and we're working on continued productivity gains and get our distribution costs more in line with where they were. So that was really the initial component of the supply chain crisis, but then you compound that with increased freight charges, I think most everyone has heard the variation in container shipping cost from as low as \$3,000 in 2021 up to recently as high as \$18,000 to \$20,000 per container equivalent. And that has been a challenge. And then just everything that we face seems to compound. Now there's rationing of electricity in China. So all these things have compounded the issues and the timing has been a challenge the way these things have layered on.

What I will tell you is that we, from a distribution perspective, we're in much better shape than we were this time last quarter as recently as then. From a supply chain perspective, we continue to work on -- our strategy is to have multiple suppliers for most of our major product categories to mitigate any risk, and we're leveraging current suppliers and additional suppliers in order to try to get product. And we're seeing improvement on product flow, but it's still a lot longer tail from order to delivery than what it typically is.

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**Operator**

And we have a question coming from Greg Melich from Evercore.

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

Really 2 questions. One, first on the pricing. You mentioned that you came in stronger than you thought for all the cost reasons. And Tom, it would be fair to say that, that 5.5%, if that's what was realized in the third quarter, it should actually be more than that year-over-year as we look into the fourth quarter and beyond, just given the way pricing flows through?

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

Well, we would expect it to be a strong number again in the fourth quarter. Optimistic that some of the supply chain items will write themselves, but we will have more view on that on our fourth quarter call for next year.

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

Got it. And then I think you mentioned that your second quarter EBIT margin was unsustainable and really not good for the long-term health of the company or something like that. So [here] ends up at 21%, 21.5%. I guess that's a new range. Is that a good healthy level to grow from?

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

Greg, just for clarification. The prepared comments on were related to the third quarter of 2021, where we let 344 basis points. That's not the right SG&A leverage level for the company long term. We said that then, and we're back more in SG&A spend that's appropriate for the sales we're generating.

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

Okay. So I would say, given that, that was unusual, would you say now we're at a right base this year's margin at 21%, 21.5%?

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

Given the comp levels that we are at? Yes. We're a multi-unit specialty retailer with a high fixed cost base, and we're able to generate exceptionally high sales volumes and increases, we see great leverage.

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

Got it. And I guess my last on this is just to make sure I got the math right. If the comp was 6.7% in the quarter, and price was 5.5% and traffic was slightly down or tick accounts. Is the difference just mix and units in the basket?

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

Well, we have a long-term trend of increasing average ticket as the technology and complexity of parts on newer vehicles become more expensive, and that trend has continued.

**Operator**

And our next question comes from Simeon Gutman from Morgan Stanley.

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

Tom, is there a way to think about or how we should think about the impact of higher distribution cost, the weight of it on the gross margin?

And then I guess, the second question on that is the gross came in at, I think, 53.1% pre-COVID, and I'm sure there was a LIFO impact in there. Now that your volumes are much higher, once supply chain things get back to normal, and I don't know when that is, why shouldn't your gross margin end up being higher than where we were pre-pandemic since there's just more volume in the system.

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

Simeon, would you repeat your first question again?

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

It's basically, can you help us quantify the impact on gross margin from higher distribution or supply chain costs or inefficiency?

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

Got you. In the previous question, I commented that the LIFO benefit and the distribution headwinds were similar. And on the second question, when we look at our distribution centers. They're primarily a variable cost item. There is some leverage from having higher volumes to a point, and I think Greg talked about that on the last call in this call, if we get too much volume within our system, we end up with inefficiencies. So and the other part I would add to that is we are already one of the major suppliers of auto parts. So increased volumes don't necessarily mean a lower cost in the products we purchase at this point in our company's life cycle.

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

Okay. And maybe just a follow-up, maybe to Greg Johnson. Should market share gains continue at this outsized rate or now that there's so much that has happened, it's just going to be hard to maintain the level of outsized market share gains.

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

Yes, Simeon, that's a great question. I wish I had a great crystal ball answer for you. I mean, I think that first of all, this year, when we started the year, we projected flat to negative comps. We certainly didn't expect for our comp growth to continue to be as strong as they have been in 2022. Considering that a lot of the stimulus and benefits have subsided and our sales have remained strong. Our expectation would be for the aftermarket as a whole to continue to perform well going forward. And we'll certainly continue to be a consolidator and continue to try to grow our market share going forward as well.

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**Operator**

The next question comes from Mike Baker from D.A. Davidson.

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**Michael Allen Baker** - D.A. Davidson & Co., Research Division - MD & Senior Research Analyst

I suspect I know the answer to this question, but when you do the implied sort of fourth quarter comp in your full year guidance, you get somewhere -- I was -- I get somewhere at the midpoint around 2% or 3%, which would be a pretty big slowdown on both a 2- and a 3-year basis relative to the first few quarters, which saw a remarkably consistent trends on a 2- and 3-year basis. And your commentary is suggesting that things are continuing.

So why the lower guidance? Is it just conservatism? Is it just the unknown of not having the government stimulus, even though that doesn't seem to be impacting your business? Or is it something else that I'm not thinking about?

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

Well, I guess I'd better answer that one because it sounds like a math question. We kept the 2% full year guidance range because that's what we had given all year and at 10% to 12%. So the math for what the variability for the fourth quarter needs to be to reach those is pretty extensive. So we'll have to look at whether we want to do that next year, tighten the range. I'd say the math for us works out a little different that it works out 1% to 9%. Obviously, we don't anticipate that side of a range of outcomes.

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**Michael Allen Baker** - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Okay. So you're saying you're -- just to clarify, I got an implied range of somewhere around down 1% to plus 6% and 2% to 3% at the midpoint. You're saying that the better math would be somewhere around 1% to 9% or about what is that, about 5% at the midpoint. A, is that what you're saying, just so we're all clear? And then b, again, that does imply a pretty big slowdown on a 2-year basis. Just conservatism in that?

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

The implied range is 1% to 9%. The range was unintended. It was more based on continuing -- giving annual guidance in the same fashion we gave it in the first 3 quarters.

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**Operator**

And our next question comes from Bret Jordan from Jefferies.

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

On the topic of share gain, I mean, it sounded as if you guys were picking up some share in undercar hard parts last quarter, which I think you guys called out as a strong category. Could you talk maybe about the cadence? Are you seeing the smaller or larger competitors seeing increasing difficulties or are things getting better in the supply chain that's allowing that than to hold share better as the quarter progressed?

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

Yes, Bret, I would -- I'll say a few things here and then let Brad comment on what he's hearing from the field. He's closer to the store operators than I am on a day-to-day basis. But generally, as I said, I -- while we really have no way of knowing other than the more macro view by category on industry reporting. The perception is, and we feel pretty strongly that this is the case that considering the supply chain pressures that we're facing, the smaller players would have to be facing at least equal to, if not much greater pressures, which would be impacting their in-stock position and their ability to comp as strongly as we have.

Brad, you want to add anything to that?

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

Yes. As you well know, we have a tremendous respect for all our competitors. I've been here 25 years this year, and I grew up competing against some very strong independents and the independents that are still alive and well in the United States are pretty tough competitors and very tough on the professional side, as you know, better than anybody, and we have equal amount of respect for our larger retail competitors that have gotten

better in some areas of professional. But when I think of share gains, I definitely think there's something to what Greg mentioned in terms of some of maybe the struggling independents and maybe some of the mediocre or weaker independent competitors. But again, as you know, the big strong independence in the United States are very tough. But Bret, me and my team, what we spend our time on is a little bit less of where the share gains are coming from and more about what we know works and what we're doing right now that is equaling share gains. And those things are just around some of the things we mentioned earlier.

We talked about supply chain struggles. But as you well know, the supply chain struggles are a level playing field for everybody, us and our competitors in the United States, and it's about who's going to step up and execute better under the conditions. And I'm just extremely proud of our supply chain team from distribution to merchandise inventory control that gives my team in the stores not many excuses. They've done a tremendous job backing stuff when it comes to what Greg said earlier. They're getting better every month, even though we still do have challenges in there ensuring we have the right part at the right place at the right time. And we feel like that's a big part of the gains. We also feel like that as you've always heard us talk, our professional parts people, what we're doing with our shops, creating value, better delivery times, helping them get a car off the rack and just really our professional parts people. And everything we focus on in our stores is really what's equaling those gains.

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

Appreciate that. And I guess, last quarter, you guys talked about some standout suppliers that -- or issues with suppliers in certain categories that were material challenges. Are you seeing, I guess, the supply chain issues moderating? I mean, are there big holes in in-stocks? Or is it just sort of tough across the board, but no real areas to call out?

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

Yes, Bret. I mean some of the categories we talked about last quarter, we're still having challenges with. Maybe some of those challenges have changed or evolved. Some of those challenges may have been labor-related for domestic suppliers last quarter and it's transitioned more to raw material or component challenges now coming from China. But our suppliers, as a whole, are doing a good job. We've got some suppliers, especially those with products coming out of China that continue to struggle.

Another challenge, and I keep sounding like a broken record here of all the woes and challenges we're facing. But it has been the most challenging supply chain year in my 40-year career in the industry is on top of everything else, some of the things we haven't talked about was simple things that you might not consider like the freeze in Houston earlier this year that's impacted the production of plastic bottles and additives for oil. And some of those things still linger within the industry. So some of the issues have subsided or lessened. Some of them have become more material.

So I think on a category-by-category basis, supplier-by-supplier, as a whole. We're starting to see the light at the end of the tunnel. It's just how much further is the track to get us to that light what we're trying to determine now.

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**Operator**

And our next question from Katie McShane from Goldman Sachs.

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

Tom, you had mentioned towards the end of the prepared comments about reducing the CapEx and pushing some investments out. Is there a way to quantify or not quantify, but list what some of those investments would be?

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

Well, so when we look at our store DC growth, just getting some of the work done has been a challenge. We look at updating our over-the-road truck fleet and our store fleet to more fuel-efficient vehicles with safety features. That was a big initiative this year, obviously, getting new small, like cars and trucks have been tough this year. Some of our store development isn't quite as far ahead as we would like, there are supply chain issues within construction materials and there's a lot of construction going on. So those are the general items that have been pushed into next year.

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

Okay. Great. And if we could just go back to the question on what the comp guidance implies for Q4. I wondered if you could tell us what you're thinking with regards to how much price would influence that comp range in Q4?

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

We would expect that it would be at least as much as this quarter.

**Operator**

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

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

Thank you, Adrian. We'd like to conclude our call today by again thanking the 80,000 team members of Team O'Reilly for their hard work and dedication to our ongoing success. You have proven time and time again that the relentless focus on providing consistent, excellent customer service is the key to long-term profitable growth. I'd like to thank everyone for joining our call today, and we look forward to reporting our fourth quarter earnings and full year results in February. Thank you.

**Operator**

Thank you, ladies and gentlemen. This concludes today's conference call. Thank you for participating. You may now disconnect.

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