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ORLY.OQ - Q2 2022 O'Reilly Automotive Inc Earnings Call

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## OVERVIEW:

Co. reported 2Q22 diluted EPS of \$8.78. Expects 2022 total revenue to be \$14.0-14.3b and EPS to be \$31.25-31.75.

## CORPORATE PARTICIPANTS

**Brad W. Beckham** *O'Reilly Automotive, Inc. - Executive VP & COO*

**Brent G. Kirby** *O'Reilly Automotive, Inc. - Executive VP & Chief Supply Chain Officer*

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

**Jeremy Adam Fletcher** *O'Reilly Automotive, Inc. - Executive VP & CFO*

## CONFERENCE CALL PARTICIPANTS

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

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**Scot Ciccarelli** *Truist Securities, Inc., Research Division - MD*

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## PRESENTATION

### Operator

Welcome to the O'Reilly Automotive, Inc. Second Quarter 2022 Earnings Conference Call. My name is Cheryl, and I will be your operator for today's call. (Operator Instructions)

I will now turn the call over to Jeremy Fletcher. Mr. Fletcher, you may begin.

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### Jeremy Adam Fletcher - O'Reilly Automotive, Inc. - Executive VP & CFO

Thank you, Cheryl. Good morning, everyone, and thank you for joining us. During today's conference call, we will discuss our second quarter 2022 results and our outlook for the remainder of the year. After our prepared comments, we will host a question-and-answer period.

Before we begin this morning, I would 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, 2021, and other recent SEC filings. The company assumes no obligation to update any forward-looking statements made during this call.

At this time, I would like to introduce Greg Johnson.

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

Thanks, Jeremy. Good morning, everyone, and welcome to the O'Reilly Auto Parts second quarter conference call. Participating on the call with me this morning are Brad Beckham, our Chief Operating Officer; and Jeremy Fletcher, our Chief Financial Officer. Brent Kirby, our Chief Supply Chain Officer; Greg Henslee, our Executive Chairman; and David O'Reilly, our Executive Vice Chairman, are also present on the call. I'd also like to welcome Jeremy to his first earnings call.

I'd like to begin our call today by thanking Team O'Reilly for their continued dedication to our customers and their hard work that drove another solid quarter of financial performance. Hopefully, everyone had a chance to review the details in our second quarter earnings release.

During the call today, I will walk through the performance in the quarter and our adjusted outlook for the remainder of the year. I think it's important to begin by highlighting the strong results our team continues to generate and then put them into proper context against the backdrop of the incredible growth we've delivered in the past 3 years.

In the second quarter, our team was able to generate a 4.3% comparable store sales increase after driving comp increases of 9.9% and 16.2% in the second quarters of 2021 and 2020, respectively, resulting in an incredible 3-year stack of 30.4%.

Entering 2022, we knew our team had a daunting task ahead of them with the challenge to deliver continued growth on top of these outstanding results, which were fueled by -- which were fueled in part by government stimulus payments in 2020 and '21 that did not repeat in 2022. Our teams have set an incredibly high performance bar, and their ability to comp the comp yet again is a testament to their relentless focus on providing excellent customer service.

Team O'Reilly has continued to translate the robust sales growth into outstanding returns for our shareholders, highlighted by second quarter diluted earnings per share of \$8.78, which is an increase of 5% over our extremely strong second quarter 2021 when we grew EPS by 17%. On a compounded basis, compared to 2019, our second quarter EPS is up an impressive 25% per year, which is just another testament to the unwavering commitment of our team to growing profitable growth through their dedication to the O'Reilly culture of excellent customer service.

Next, I'd like to spend time walking through some details of our sales performance for the second quarter and the factors that drove our results as well as provide some color on our revised comparable store sales guidance for the full year. As we discussed on our first quarter earnings call in April, we began the second quarter facing headwinds from a delayed start to spring and rising fuel prices. We're also lapping our historically strong comparable store sales performance driven in part by the tailwinds we saw from government stimulus payments in 2021. However, as we moved through the quarter, the volatility from these factors moderated and our business stabilized.

Since the past few years have been so significantly impacted by these -- the effects of the pandemic and timing of the stimulus payments, we think it is most useful to evaluate the cadence of our comp results on a 3-year stack basis. On this basis, our month-to-month results were fairly steady throughout the quarter.

As our business stabilized in the second quarter, we encountered more pronounced ticket count pressures on the DIY side of our business, resulting in top line results below our expectations for the quarter. Our plan for the second quarter included an expected headwind to DIY ticket counts as we were up against extremely strong growth from the comparison to stimulus-driven demand at the beginning of the second quarter of 2021. However, we saw more pressure than expected as our DIY customers faced high fuel prices and continued significant broad-based inflation.

I'll spend some time in a few moments discussing our broader outlook for the industry and our business as we move forward, but for now, I'll point out that it's not completely surprising to us to have experienced these types of pressures. Many of our core DIY customers work on their own vehicles out of economic necessity and can be more susceptible to price inflation in short periods of time. We believe what we're seeing now is comparable to other periods in our history when our customers have gone through these types of fuel price spikes.

The current environment is different to the degree that the spike in fuel prices is occurring at the same time broad-based inflation is elevated, but we expect consumers will adjust to these pressures as we've seen in the past and continue to prioritize vehicle repair and maintenance.

From a total DIY comp perspective, we did see an inflation benefit in average ticket values, but the macroeconomic pressures to ticket counts and difficult compares resulted in total DIY comparable store sales being slightly negative for the quarter.

Turning to the professional side of our business. We're very pleased with our team's performance in the second quarter, where we generated comparable store sales growth in the low double digits as a result of growth of both ticket counts and average ticket size. We continue to be excited about the strength of our professional customer business as we grow our share and consolidate the industry.

As we discussed on the last 2 calls, we anticipated this side of our business will be a larger driver of our growth in 2022, and our results in the second quarter were in line with those expectations. We continue to be pleased with the early returns from our professional pricing initiative, and Brad will cover our professional customer momentum and this initiative in more detail in his prepared comments.

On a combined basis, including both DIY and professional sales, our comparable store sales growth for the quarter was driven by strength in average ticket with professional ticket count growth only partially offsetting pressure we saw in DIY traffic. Average ticket size came in around 10% for the quarter on both sides of our business due to a benefit from same SKU inflation at similar levels.

We have continued to be highly successful in passing through product acquisition and operating expense inflation and selling price increases as we move through 2022, which is a benefit to average ticket values. Beginning in the third quarter, we began to anniversary the onset of higher inflation in 2021, which will moderate the year-over-year increase in average ticket value and is factored into our full year sales expectation.

Now I'd like to provide some color on how we view the conditions of our industry and our outlook on the remainder of the year. As we move through the back half of 2022, it remains a challenge to predict what we will encounter in a rapidly changing macroeconomic environment. Certainly, if we could look in the rearview mirror from the beginning of the year and build our expectations based on inflation we haven't seen in decades and a global conflict accelerating growth in fuel prices, we would have landed in a different spot with our initial guidance.

Despite these headwinds, we're pleased with our performance against this challenging macro backdrop, and we remain very confident in both the fundamental strength of our industry and the quality of our team and their proven ability to outperform the market and gain share.

While we believe we're seeing some short-term impact to demand as consumers respond to economic challenges, we're also confident our industry benefits from the reality that very little of the demand in the automotive aftermarket is truly discretionary and the necessary maintenance and repairs can only be deferred for so long. In fact, as economic conditions worsen, our experience has been that our industry provides even more critical -- I'm sorry. In fact, as economic conditions worsen, our experience has been that the value our industry provides is even more critical to consumers facing economic challenges.

This plays out in many different ways. We see it when one of our customers is able to hold off on a new car purchase and avoid a monthly expense because they're able to invest through repairs and maintenance on a higher-mileage vehicle. Or when we help a DIY customer stretch their wallet a little further by providing incredible service from one of our professional parts people who have technical knowledge and customer service skills to support the customer who needs a DIY fix to keep their vehicle on the road. These are just 2 of the many scenarios, which motivate our customers to prioritize taking care of their vehicles when money is tight or consumers have less confidence in the state of the economy.

The core underlying factors that support demand in our industry also continue to be very healthy. The average age of vehicles on the road continues to increase, aided not only by headwinds to new vehicle sales and mileage and higher resale values -- I'm sorry, of older vehicles, but also the excellent engineering and manufacturing of vehicles on the road today.

We are also bullish on the overall health of our customer base. Unemployment has remained at very low levels, and increasing wage rates have been a positive partial offset to inflation, especially for the more economically constrained DIY customer base. We believe consumers are in a much stronger position than in recent periods of economic uncertainty. As we have discussed often in the past, miles driven is a critical metric for our industry, and we are cognizant that the potential for miles driven growth could slow if the broader economy slows.

As a buffer against this pressure, we believe industry benefits from dynamics that will support miles driven growth over the long term as we still see the potential in incremental miles from post-pandemic return to work, coupled with consumers' willingness to move further away from urban centers and utilize their vehicles to satisfy pent-up demand for personal travel.

Finally, while miles driven is an important factor for our industry, we have proven that during previous periods when miles driven have flattened that we have the ability as a company to drive top line growth as consumers prioritize the care and maintenance of their vehicles.

The broader outlook for our industry is important in how we think about the prospects for future growth, but far more important is the opportunity we have to outperform the industry to drive outstanding financial results. We have the best team of professional parts people in the industry, and we are very confident we are well positioned to deliver excellent customer service and increase our market share in any market condition.

While we remain very positive on the prospects of our industry and our business, we are also cautious in our assessment of the pressures from high fuel prices and broad-based inflation that impacted our second quarter performance and the potential for continued pressure as we move through the balance of 2022.

As a result, we have incorporated our year-to-date performance and expectations for the remainder of the year and our updated comparable sales guidance range of 3% to 5%. Ultimately, we'll have to see how the rest of the year plays out, and we continue to be encouraged by the resilience of our business, but feel the prudent step is to adjust our expectations at this time. At the midpoint, our revised comparable store sales guidance range reflects solid growth over 2021 and a 3-year stack increase of 28%, and we still view this as a very favorable outlook, reflecting our ability to outperform the market and gain share.

Before I move on from sales, I will note that we are pleased with our performance thus far in July. We've seen some improvement in July sales volume trends relative to our expectations partially driven by the extreme heat we're seeing across many of our markets right now. We still have a lot of summer remaining, and ultimately, we'll have to see how the weather plays out for the rest of the year. As such, our guidance forecast assumes a normal weather backdrop for the remainder of the year, in line with our customary practice.

Moving on to gross margin. For the second quarter, our gross margin of 51.3% was a 136 basis point decrease from the second quarter of 2021 gross margin. This is in line with our expectations with a couple of key points I want to highlight.

Our year-over-year gross margin is impacted primarily by the rollout of our professional pricing initiative as well as pressures from a reduced LIFO benefit and higher mix of professional business. As we discussed on last quarter's call, we rolled out our initiative in February and only saw a partial impact to gross margin rate in that quarter. Our second quarter gross margin reflects a full quarter impact from the initiative and is in line with our expectations. We are maintaining our full year gross margin range of 50.8% to 51.3% with the expectation that gross margin in the back half of the year as compared to 2021 will be slightly below where we have run year-to-date based upon mix differences and timing of the reduced LIFO benefit.

Before handing the call off to Brad, I want to update our full year diluted earnings per share expectations. Based on the adjustment to our comparable store sales guidance, we are lowering our full year earnings per share guidance to \$31.25 to \$31.75. At the midpoint, this represents -- this range now represents an increase of 1% compared to 2021 and a 3-year compounded annual growth rate of 21%.

To wrap up my comments, I want to again thank Team O'Reilly for their continued dedication to consistently providing excellent customer service. It's your commitment to our culture, fellow team members and customers that drives our success.

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

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**Brad W. Beckham** - O'Reilly Automotive, Inc. - Executive VP & COO

Thanks, Greg, and good morning, everyone. I would like to begin my comments today by thanking Team O'Reilly for their continued dedication to our company's success and their steadfast commitment to excellent customer service.

Since Greg has already discussed our sales results and how we view the current industry environment, I don't want to spend a lot of time repeating what he said. However, I do want to highlight our company's philosophy for how we execute our business model in more challenging macroeconomic conditions. Simply put, we never accept external market pressures as an excuse for falling short of our goals.

A guiding philosophy in our company, especially in our store operations group from our store manager up through the chain to senior vice presidents, states that as long as there are customer vehicles in the parking lot of our competitors or there are competitors delivering to our professional customers in our markets, we haven't captured all the business we are entitled to, and we are missing out on an opportunity to grow sales. We believe our commitment to never settling for subpar performance is a key to our success and also served us well in the second quarter.

While pressures to our DIY customers from spikes in fuel prices and persistent high inflation weighed down the top line sales growth we were expecting to see, we are still pleased with our team's ability to drive solid, positive sales increases on top of 2 consecutive years of record growth for our company. More importantly, we remain excited about the opportunities we see to grow our business as we move forward.

I'm sure not an expert in predicting what the rest of the year will hold for the U.S. economy, but I am highly confident that even challenging market conditions can present an opportunity for us to capitalize on our competitive advantages. Our focus on maintaining an extremely high standard of customer service in any market environment allows us to build long-term relationships, ultimately reinforcing our industry-leading position.

Now I would like to provide some color on our professional sales performance in the quarter as well as review what we're seeing from our professional pricing initiative. As Greg mentioned in his prepared remarks, our professional business was the driver of our comparable store sales growth with a double-digit increase, in line with our expectations for the quarter.

Before I provide an update on our progress with our professional pricing initiative, I think it's important to first focus on the key factors that drive our professional sales growth. Our company's foundation was largely built on the professional customer, and we have proven decade after decade that the most important drivers of our success on the professional side of the business are also our competitive advantages in strong customer relationships, excellent customer service and superior inventory availability.

For our professional customer base, the efficient and reliable service they receive from their parts supplier is the most important factor in driving the economic success of their business. We strongly believe that professional business can only be won by consistently delivering a high level of customer service, and this was the primary reason we were able to deliver robust comps in the second quarter. We also believe what we're seeing in professional comps is consistent with the long-term demographic industry trend of faster professional growth as well as the stronger economic resilience of the end-user do-it-for-me customer on this side of our business.

However, our professional customers aren't completely insulated from the economic pressures of high fuel prices and inflation that are impacting our DIY business. We believe our ability to post significant professional sales growth in this environment against extremely difficult comparisons reflects the momentum we're generating through our professional pricing initiative, though it's only one piece of our value proposition.

We are very pleased with the response we've seen from our store teams and our sales force as well as our existing and new prospective customers. Our store and sales teams have been energized as they've leveraged this initiative as another tool in their toolbox to win professional business.

It truly is a combination of strong customer relationships, excellent customer service and industry-leading inventory availability, coupled with our more competitive pricing, which drives the superior value proposition we provide to our professional customers. Simply put, the best overall value in the aftermarket has gotten even better.

Since the professional business is driven primarily by strong customer relationships, exceptional customer service and inventory availability, it is difficult for us to parse the direct impact of our pricing initiative now that it has been rolled out across our company for several months. However, we believe the results we are seeing line up favorably with the expectations we developed in our thorough testing process leading up to launching this initiative.

We are excited about the immediate positive results we've seen, but I want to caution everyone that we are still in the early innings of this initiative. Our pricing actions are clearly removing some barriers, which had previously existed. However, business is ultimately won with consistent execution after being given a chance to earn new business.

These new opportunities don't necessarily open up instantly, and we expect that we will have to grind out gains over time, which is no different than how we've executed our playbook for 65 years and in turn, established our company as the premier supplier to the professional market.

Finally, before I move on, I want to reiterate that the execution of our professional pricing initiative hasn't changed the broader pricing dynamic in our industry. We have not seen significant competitive pricing actions in response to our initiative. And as Greg mentioned, we continue as a company and industry to rationally pass along inflation in pricing.

Now I'd like to discuss our SG&A and operating profit results for the second quarter and our updated expectations for the full year. SG&A as a percentage of sales was 29.6%, a leverage of 15 basis points from the second quarter of 2021. At this level, SG&A is down over 400 basis points from prepandemic levels in the second quarter of 2019. This incredible step change in our profitability is a testament to our team's commitment to grow sales, exercise diligent expense control, improve productivity and drive long-term value.

On an average per-store basis, our SG&A grew 2.5%, which was largely in line with our expectations for the quarter. On a full year basis, we are revising our guidance for SG&A per store to grow 3%, up from our previous guidance of 2.5%. Our teams have been diligent in managing costs to mitigate the impact of inflation thus far this year with our overall spend largely in line with our expectations, but the prolonged and heightened inflation we're experiencing, especially in fuel and energy costs, has driven up our forecast for the remainder of the year.

Wage rates have also been in line with our expectations year-to-date. But I could -- but we could also see pressure in the back half of the year if we see further sustained inflation. We are also updating our operating profit guidance and now expect the full year to be in the range of 20% to 20.3%, which reflects the adjustment to SG&A per store in our revised comparable store sales range.

As we look to the back half of the year and plan SG&A, we will be appropriately responsive to the changing business trends and sales opportunities, and we'll make prudent adjustments to staffing levels to provide excellent customer service and grow our business, while at the same time, controlling our expenses.

As we've discussed on multiple occasions over the years, we are very deliberate in how we manage our SG&A spend and leverage a variety of tools to manage store payroll on a store-by-store, day-by-day basis. We believe sudden dramatic changes in store staffing levels have a noticeable negative impact on customer service. And as a result, we manage adjustments gradually over time to match the sales environment in conjunction with the normal seasonality of our business.

As always, our top priority in managing expenses is to ensure consistent, excellent customer service that is critical to building long-lasting relationships with both our DIY and professional customers. We strongly believe this long-term view of never sacrificing excellent customer service has been a key factor in our success and was the foundation that drove the incredible gains in profitability that our team has generated over the last several years.

Next, turning to inventory. We finished the second quarter with an average inventory per store of \$679,000, which was up 7% from both the beginning of 2022 and this time last year. Parts availability is a key driver of our success in our business, and we continue to execute our plan to aggressively add incremental dollars to our store level inventories as we move throughout 2022.

While we still face constraints in certain areas of our supply chain, we are very optimistic we will see continued improvement as we move through the back half of the year and still expect our per-store inventory to be up over 8% by year-end. Our investments in inventory and daily execution both continue to be focused first and foremost on our replenishment and fill rates; then on having the right combination of common as well as hard-to-find parts in every one of our stores that is tailored to that specific market; then backed up by our dynamic, multitier hub and distribution center network. Our extensive, industry-leading network powers our best-in-class parts availability and equips us to be the dominant auto parts supplier in all our market areas.

We feel strongly that these investments in inventory as well as enhanced supply chain capabilities will continue to be a critical part of our success on both sides of the business and in turn, provide long-term share gains as well as returns.

Before turning the call over to Jeremy, I'll provide an update on our store growth during the second quarter. We opened 62 new stores across 28 states in the U.S., bringing our year-to-date total to 116 net new store openings. We are on pace to hit our plan of 175 to 185 net new store openings for the year. We continue to be pleased with our performance of our new stores, and I am very proud of the outstanding teams of professional parts people we have in each of our new stores.

To close my comments, I want to once again thank Team O'Reilly for their continued dedication to our customers. Our teams are committed to winning our customers' business each day by out hustling and outservicing our competition, and I am confident in their ability to deliver a strong finish to 2022.

Now I will turn the call over to Jeremy.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Thanks, Brad. I would also like to add my thanks to all of Team O'Reilly for their continued dedication to our company's long-term success.

Now we will cover some additional details on our quarterly results and updated guidance for the remainder of 2022. For the quarter, sales increased \$205 million comprised of a \$145 million increase in comp store sales, a \$56 million increase in noncomp store sales, a \$5 million increase in noncomp nonstore sales and a \$1 million decrease from closed stores.

For 2022, we now expect our total revenues to be \$14.0 billion to \$14.3 billion, which is a reduction from our previous range of \$14.2 billion to \$14.5 billion as a result of our revised comparable store sales guidance range.

Greg covered our gross margin performance for the second quarter and reiterated our full year guidance, but I want to briefly recap that we are not expecting a significant LIFO benefit to our gross margin results in 2022 as a result of more typical LIFO accounting after our reserve returned to a credit balance in 2021. Our year-to-date results were in line with those expectations, and our outlook on this item for the year is unchanged.

Our second quarter effective tax rate was 23.8% of pretax income comprised of a base rate of 24.3%, reduced by a 0.5% benefit for share-based compensation. This compares to the second quarter of 2021 rate of 23.1% of pretax income, which was comprised of a base tax rate of 24.5%, reduced by a 1.4% benefit for share-based compensation. The second quarter of 2022 base rate was in line with our expectations. For the full year 2022, we now expect an effective tax rate of 23.0% comprised of a base rate of 23.5%, reduced by a benefit of 0.5% per share-based compensation.

Our expected tax rate is down slightly from our previous guidance of 23.2% due to the anticipated benefits from renewable energy tax credits, and we continue to expect the fourth quarter rate to be lower than the other 3 quarters as a result of the timing of these benefits and tolling of certain tax periods. Also, variations in the tax benefit from share-based compensation can create fluctuations in our quarterly tax rate.

Now we will move on to free cash flow and the components that drove our results. Free cash flow for the first 6 months of 2022 was \$1.2 billion versus \$1.5 billion for the first 6 months of 2021 with the decrease driven by a smaller benefit from a reduction in net inventory investment in 2022 versus 2021 and differences in accrued compensation.

Capital expenditures for the first 6 months of 2022 were \$229 million, which was in line with the same period of 2021. We continue to expect CapEx to come in between \$650 million to \$750 million for the full year with the balance of the spend for the remainder of the year supporting new store and DC development initiatives to enhance the image, appearance and convenience of our stores; DC and store fleet upgrades; and strategic investments in information technology projects.



Our AP-to-inventory ratio at the end of the second quarter was 131%, which once again has set an all-time high for our company and was heavily influenced by the extremely strong sales volumes and inventory turns over the last 12 months. We anticipate our AP-to-inventory ratio to moderate off of this historic high as we complete our additional inventory investments.

Based on the anticipated moderation in this ratio and a heavier spend on CapEx for the second half of the year, we are keeping our expected full year free cash flow guidance unchanged at a rate of \$1.3 billion to \$1.6 billion after generating \$1.2 billion in the first half of 2022.

Moving on to debt. In June, we were pleased to execute a very successful debt transaction with the issuance of \$850 million of 10-year senior notes at a rate of 4.7%. As a result of the bond issuance, we finished the second quarter with an adjusted debt-to-EBITDA ratio of 1.95x as compared to our end of 2021 ratio of 1.69x. We continue to be below our leverage target at 2.5x, and we will approach that number when appropriate.

We continue to execute our share repurchase program. And during the second quarter, we repurchased 2.2 million shares at an average share price of \$620.27 for a total investment of \$1.4 billion. Year-to-date through our press release yesterday, we repurchased 3.8 million shares at an average share price of \$637.47 for a total investment of \$2.4 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. As a reminder, our EPS guidance includes the impact of shares repurchased through this call, but does not include any additional share repurchases.

Finally, before I open up our call to your questions, I would like to thank the entire O'Reilly team for their continued dedication to the company's long-term success.

This concludes our prepared comments. At this time, I would like to ask Cheryl, the operator, to return to the line, and we will be happy to answer your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question goes to Michael Lasser with UBS.

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

The auto parts industry has experienced a significant benefit from same SKU inflation over the last several quarters. Now that's starting to moderate. Is your expectation that as the contribution from same SKU inflation moderates, that there will be a corresponding increase in the number of transactions to drive steady growth for the overall sector?

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

Jeremy, you want to take that?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. I can maybe answer that first, Michael. I think when we think about the same SKU dynamics as we move into the back half of the year, we're not going to necessarily see a reversal of some of that inflation. I think the year-over-year benefit, as we see that in the balance of the year, will moderate, as you've mentioned, and we've built that into our plan expectations.

I think from a traffic perspective, since we won't see the actual rate of pricing reverse necessarily, and certainly, we wouldn't want to give back anything on pricing, I don't know that, that's going to be a dynamic that changes the ticket dynamics within our industry.

I think for us, specifically, as we've thought about how the back half of the year lays out, we understand on a 1-year basis that we'll see some pressure as average ticket moderates, but still continue to be very optimistic about continuing traction we'll see on our professional pricing initiative.

And then also, just more broadly, I feel like our industry performs very well in environments where consumers are pressured and that we'll see support to overall demand, but not necessarily an offsetting pickup to the point that you mentioned. I think on top of that, we're cautious as to how the rest of the year will play out from a macroeconomic perspective. And I think that comes into play here as well.

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

My follow-up question is, at the midpoint of your guidance for the back half of the year, have you assumed that the DIY business is going to turn positive? And have you already started to see that in response to the recent decline in gasoline prices?

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

Yes, Michael. I mean our assumption all along has been that our DIFM business would perform stronger than our DIY business. And we don't see that changing. In the back half of the year, our expectations remain that DIFM will outperform DIY.

Will DIY improve in the back half of the year? It's really yet to be seen. It really depends on what happens in the macro, how quickly that turns around. Fuel price is a contributor, but it's one of many contributors. We've historically talked a lot about fuel prices and the impact. This year, we've got a more significant inflationary impact across all of retail on top of fuel prices. So again, as Jeremy said, we remain pretty cautious on our outlook but remain very optimistic on the industry as a whole.

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**Operator**

Our next question comes from Michael Baker from Davidson.

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

So one question and one follow-up. You said July is better versus expectations. Can you tell us if it's better -- and really, I'm talking about on a 1-year comp basis, is it better than the second quarter? Or if you don't want to answer it that way, maybe tell us what your expectation was for July. Did you expect July to be better or worse than the second quarter?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. I guess maybe I just want to clarify, I think our improvement really reflects how we were trending as we finished the second quarter, and we do think we've seen business pick up a little bit there. It's a short period of time. And we tend not to be overinfluenced by what we see, particularly as we've seen a lot of hot weather, and we think that, that's a positive benefit to us.

Beyond that, we feel good about the overall level of what our business is seeing, and we really saw that stabilize as we moved through the second quarter and got past some of the stimulus challenges early in the quarter that we saw. What we've seen is it's at a little bit lower than we had expected, but that has kind of continued. We think that's an appropriate way of thinking about as we move into the back half of the year. Encouraged by July, certainly, but also cognizant that as we move through the rest of the year, weather can normalize a little bit, and we're not going to overreact a few weeks.

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

Fair enough. The follow-up is a follow-up to your answer to Mike Lasser's question. You said you certainly expect to hold on to price. So does that imply that if inflation does start to moderate, you should see a little bit of a gross margin benefit in the back half?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. Certainly, within our industry, we -- and within our history, we want to hang on to price increases that we've passed through. We think that to the extent that we see moderation in price levels or we start to see some reversals, and the question around tariffs has come up some. We would expect to maintain pricing at our current levels and would hope to benefit from the reduction in acquisition costs.

That -- I think that's largely in line with how our business operates with price being a secondary or a third factor for the value that we provide to our customers. And being able to drive continued strong performance off of excellent customer service and making sure that we've got the part that our customers need when they need it, I think that allows us -- puts us in a position where we wouldn't have to see a reduction. Ultimately, we'll see how that plays out within the industry as we move through the balance of the year. But it would certainly be our intent to maintain pricing levels and see a benefit from that.

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

And that doesn't seem -- that potential gross margin benefit doesn't seem to be in your back half guidance. Correct me if I'm wrong on that.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. We haven't forecasted a deflation in pricing in how we've thought about where we'll go for the rest of the year.

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**Operator**

Our next question comes from Simeon Gutman from Morgan Stanley.

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

I wanted to ask around -- I guess, you talked about tickets being down. And I guess, I don't know if they are in DIFM, but it sounds like in DIY. This is, I guess, hard to parse, but can you try to talk to how much units or tickets are down because prices are higher versus how much might be reversion or digestion from the last couple of years?

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

Yes. Simeon, good question there. It's really hard to break that out. That almost becomes an opinion. What I would tell you is I think it's more an impact of the inflationary environment. The negative ticket count was on the DIY side of our business. And as we've said, that consumer is a little more pressured right now with higher fuel prices and the overall inflationary environment. And we think it's more of just a cash flow issue for that lower-income consumer than maybe margins or any of that.

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

Okay. That's fair. And maybe the follow-up is connected. Does it feel like -- because you have visibility into units or tickets. Does it feel like if there is any digestion from post stimulus and post what consumers were spending on during the COVID period, that this represents the rebasing? This is the new baseline, and then we move into '23 and we could see the business look or act a little bit more normal. I get there's a lot of moving pieces with price, but at least from a unit perspective or ticket, this puts in the floor?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes, Simeon, I think you're right in saying that there are a lot of moving pieces, and it can be a little bit challenging to get a read through, particularly as we've seen stimulus in some of the comparative periods that have kind of pushed demand around it. And we know as we entered this year, we face some volatility just as weather and timing has impacted us.

I think where we sit today, we probably characterize this as a more normalized broader period around what we would expect for current economic conditions. I don't know what time will tell moving forward, but as we think about just the overall makeup of our business, we certainly don't view it as having still significant drivers that are things that are out of what we would have expected as we move through the pandemic and we sit where we are today.

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**Operator**

Our next question comes from Scot Ciccarelli from Truist Securities.

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**Scot Ciccarelli** - *Truist Securities, Inc., Research Division - MD*

So can you speak to what you guys are seeing on a geographic basis? I think your (inaudible) previously (inaudible) geographically for most of the last 2 years. But I think we're starting to hear about widening performance differences market to market over the last 2 quarters. If you can help clarify that, that would be helpful.

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

Scot, you were breaking up a little bit, but we kind of gathered the geographic performance component of the question. Brad, do you want to take a shot at that?

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**Brad W. Beckham** - *O'Reilly Automotive, Inc. - Executive VP & COO*

Yes, sure. Yes, really similar to last quarter, we were very pleased at the consistency of our business on both sides of the business when we looked across our regions and divisions. Lot of consistency, not a lot of differences from a geography standpoint.

The one that we would call out, Scot, that is a little bit of a tough line to draw, but we did see a little bit of softness on the West Coast, specifically Northern California, even Pacific Northwest, Washington state that we would probably draw a line to some of the fuel prices out there, but that was a very minor difference in the way the rest of the company performed. So a little bit there, but other than that, very consistent.

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**Scot Ciccarelli** - *Truist Securities, Inc., Research Division - MD*

Got it. And then just a quick one. Have you guys seen much of a shift towards private label, just in terms of the whole trade down potential concept?

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

Scot, we've seen -- over the past several years, we've seen more and more volume shift to private label. I think there's a little less brand loyalty than there once was. And throughout the pandemic and supply chain issues, frankly, there's definitely not as much brand loyalty. I think consumers are buying products you have, not necessarily getting the products they want every time.

But our private label program is about 50% of our volume today overall. And in the hard parts category, it's between 60% and 65%. So it continues to grow as a percentage of our overall sales.

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**Brad W. Beckham** - *O'Reilly Automotive, Inc. - Executive VP & COO*

This is Brad. I would just add on that, Scot, that when you think about private label, we don't necessarily think of that as being a trade down. We want you to keep in mind that our exclusive national brands, while we have entry points, we have an equal amount of better and best when it comes to our private label. Good examples would be our Import Direct program, Precision chassis, things like that. So I just want you to keep in mind that when we talk about private label, we're also talking about exclusive national brands that is a premium product.

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**Operator**

Our next question comes from Zack Fadem from Wells Fargo.

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

So following up on the average ticket question. I believe you said it was up 10%. And the question is whether this implies units were down 6% or if there are other factors at play like mix.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. We saw pressure to the units primarily on the DIY side of our business. There are mix dynamics that play into what we've seen. And when we think about our professional business, specifically, continue to be encouraged by the progress we've made there, where our comp was driven by both average ticket growth, but also growth in tickets. And really, I think on that side of the business, the split between that average ticket count can depend on being able to add more things to the shop order when you send it out the door.

So we feel a positive there. We think that we've had the ability to continue to drive incremental business and incremental share relative to where the market is at. But we are pressured on the DIY side business. I expected that we would be as we came into the quarter with some of the stimulus compares. Ended up a little bit softer there than we anticipated because of the -- some of the macroeconomic pressures we've spoken to.

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

Got it. And then on your gross margin outlook. It looks like on an ex LIFO basis, gross margin has been tracking at about 51.5% in the first half of the year, assuming my math is right. And it looks like you're guiding the second half about 100 basis points lower. And I'm just trying to understand the moving parts. How much of this is incremental pricing versus Q2? And any other factors that we should consider on the input cost side?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. I can take that one, Zack. The sequential first half to back half can be a little bit challenging because we do have different seasonality dynamics that come into play. So maybe to directly answer a few points to the questions, we're not anticipating incremental price investments on the professional side of our business. We expect that what we've done there is the full amount of what our plan was and that we would continue to

maintain those levels and that, that in and of itself doesn't create incremental pressure other than you'll have 2 full quarters of the impact versus first quarter being [a bit light.]

Beyond that, when we think about the back half of the year, we do have different mix dynamics from a seasonality perspective that we think will impact the gross margin rate some. But as we think about it on a more normalized basis, year-over-year, the pressures that we'll see are because of some of the LIFO comparison, because of some of mix. But the rest of what we would anticipate is -- would have been incorporated in how we thought about or planned for the year just given those mix differences.

The prior year comparable is going to be a little bit tough because we have had some LIFO impacts that have caused some of that normal cadence of the year to change for us. But really, that's in line with what we would have thought when we came into the year.

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### Operator

Our next question comes from Chris Horvers from JPMorgan.

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

So my first question is a follow-up on the top line outlook in the back half of the year. On the pro pricing initiative, you had baked in some share gains in the back half and the original guidance, causing some trend acceleration in the overall comp in the back half despite lapping inflation. In the updated guide, did you take that out given your heightened caution on the macro and that was part of the back half revision?

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### Jeremy Adam Fletcher - O'Reilly Automotive, Inc. - Executive VP & CFO

Yes. Chris, I would tell you, as we thought about how our expectations would have changed in the back half, it was really geared around what we said in the script and in the press release around the pressures we're seeing on the DIY side of our business from a ticket perspective. And even as we've talked about our full year expectations this year, we've been cognizant of continued pressure that we could see there, and that's really the change that we see.

As Brad mentioned in his prepared comments, we're still early stages on our professional pricing initiative. We still have gains that we think that we can make there, and we have built in incremental improvements as we move through the year. But there's nothing in our initial indications that have changed our outlook and perspective on that for the balance of the year. And there's a lot of excitement, I think, on not just how professional play out for the balance of the year, but as we move past this year, what that will look like.

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

That's very helpful. And on 2 follow-ups. First, can you lay out what the LIFO headwind was and if anything changed in the back half of the year in the second quarter? And then secondly, you bought back a lot of stock in the second quarter. The cash balance has come down quite a bit, but you're also sitting below your long-term leverage target. So how do you think about deployment of capital and use of the balance sheet in the back half of the year to help sort of the earnings and capital return to shareholders?

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### Jeremy Adam Fletcher - O'Reilly Automotive, Inc. - Executive VP & CFO

Yes. Absolutely. I can take those, Chris. From a LIFO perspective, our LIFO was neutral in the second quarter, and that's where we expect we'll be for the full year. So really, our headwind is what we would have talked about as a positive last year as we move through the year.

From a repurchase perspective, we continue to feel like we utilize our repurchase program as an effective means of returning capital to our shareholders. And I think for us, over the course of time, it has been successful really because it's been driven by our ability to be both consistent

and drive repurchases really month in, month out because of the consistent nature of our cash flows, but then also when we have opportunities to be opportunistic at times. And I think you probably saw some of that in the first half of the year.

That philosophy hasn't changed. We'll prioritize our capital for reinvestment in our business because we like those returns the best. But when we have an opportunity, we'll execute our buyback program with that same philosophy.

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**Operator**

Our next question comes from Brian Nagel from Oppenheimer.

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

Question I want to ask, just with regard to the commentary around inflation. So you and other -- a number of other retailers now are saying the same thing. There's this view that broad-based inflationary pressures are weighing upon your sales. So I guess the question I have is as you think about that and this dynamic taking hold, at the same time, O'Reilly has been very good at sort of, say, strategically passing along higher costs. So as you look at that -- I guess the question I'm working towards, as you look at that DIY category, recognizing this broader-based inflation is now impacting your business, is there a thought to maybe adjusting pricing or even rethinking the inflation within O'Reilly stores to help stimulate that business?

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

No. No, Brian, we haven't considered that. Obviously, that would just create a race to the bottom in retail, which is not something we want. We feel like we're competitively priced for our DIY and our DIFM customers. We commented on the DIFM price adjustments. And while we're constantly monitoring and adjusting prices on both sides of our business, that one really philosophy change that we made earlier in the year was a onetime event on the DIFM side, and we have not had any consideration of making any type of mass change to the DIY side or retail side of our pricing.

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

And maybe the only thing I would add to that, Brian, is as we think about how we'll be impacted by or are being impacted by what consumers are seeing, even though we think we're seeing some pressure, it's not as significant as where other areas of retail will see it. And I think our customer responds differently to it over the course of time. We view a lot of these shocks as transitory because ultimately, consumers need their vehicles. They need to stay on the road, but there is a real value proposition in being able to maintain an older vehicle and invest in it.

So I think some of what we see on our business is -- it's less impacted and it's probably shorter term in nature. And as a result of that, there's -- that nature of the demand doesn't really make it something that we can move around by moving prices, and that's why our industry has been as rational as we've seen it.

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

Yes. Brian, keep in mind that we operate in an industry that's mostly nondiscretionary. And it's not a situation where if you lower the price on a category, the consumer is going to buy more of it. That's typically not the way it works. It's -- the customer buys products from us because they have a problem and that purchase solves the problem in most cases in our environment.

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

Got it. That's very helpful. And then a follow-up to that. So look, I mean, I think what's happening right now, to some extent, is unprecedented out there. But we've talked in the past about the higher fuel prices and impacts upon O'Reilly. For many reasons, the DIFM or the commercial business should be more insulated. But have you -- historically, if you look back over time, has there been any indication that there's a lead-lag relationship where maybe you see the impacts first in DIY, and that ultimately spills into commercial? Or are they 2 really distinct businesses in this regard?

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

No. DIFM is not immune to impacts in the economy like the fuel prices. To your point, you're spot on. It typically hits our more cash-constrained DIY customer before it would impact the typical DIFM customer, who typically has -- is in a better cash flow position. But they're definitely not immune to it. We haven't seen significant evidence of that thus far.

**Operator**

Our next question comes from Bret Jordan from Jefferies.

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

Now that the price initiative is, I guess, largely rolled out and complete, could you talk to us maybe about sort of how broadly staked it was? Like maybe what percentage of your DIFM sales were touched by that pricing initiative? It seemed like maybe it was product or customer sort of narrowly focused, but could you give us some color?

**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. Maybe I'll step into that first, and then Brad can add comments. We very intentionally haven't been too detailed on how we thought about that and talked to folks about the specifics on that. I can tell you that obviously, it was significant in across lots of different customer segments. It wasn't every item. It wasn't every line. It was very specifically focused on areas where we thought we would have opportunity, and it was something, as Brad mentioned in his prepared comments, was thoroughly tested.

Brad, do you want to add anything to that?

**Brad W. Beckham** - *O'Reilly Automotive, Inc. - Executive VP & COO*

Yes. Bret, just maybe keep in mind that where the majority of the share on the DIFM side lays in the U.S., with the amount of incredible independents out there, solid competition and with 2-step models, that our goal, like, wasn't be as cheaper than those. But that's where the majority of the opportunity for share gains was for our professional pricing initiative. And so in turn, it was in those key categories where we felt like we may have been too far out of line with those traditional players that had a lot of volume, and we're gaining some -- either half a basket or half a delivery that we wanted to turn into an entire delivery and jobs and change those buying habits over time.

And so we're really pleased with where we're at with it. The team is excited. But like we mentioned earlier, it's just going to continue to take time. The point that we lower price, it could take 6, 7, 8 sales calls on an individual garage if they were previously buying from a local independent that they trusted for decades or more. Just because we're that much more competitive, the first time we call on them doesn't mean they're going to call the next day. It can take months to really get that opportunity, and it may just be for a second or third call. But we're very pleased with what we're seeing on that front.



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

Great. And a quick question on inflation for the second half. I think one of your peers yesterday was talking about second half inflation expectations in line with what they saw in the second quarter. But I think you're talking about maybe a little bit lower price impact in the second half. How should we think about that? I mean I think you were close to 10% in the second quarter. Just as we model it, what should we think about top line from price?

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**Jeremy Adam Fletcher** - *O'Reilly Automotive, Inc. - Executive VP & CFO*

Yes. I think for us, the way we think about that question is from an overall price level perspective, we would expect the balance of the year to be relatively in line with where we are today. I think when we've talked about that, from a year-over-year perspective, we are up against bigger comparison. So where we would have seen the same SKU number in second quarter at price levels that are consistent with where we sit today, there was a bigger year-over-year change because some of that increase happened in third and fourth quarter of last year, beginning part of this year. So that's really how we think about the impact of that as we move through the rest of the year.

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**Operator**

Our next question comes from Liz Suzuki from Bank of America.

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

Just curious what the M&A environment looks like. Are any small chains feeling a little bit more pressure in these challenging times and maybe the valuation multiples they were expecting have come down a little bit?

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

Liz, we -- like I've said before, we're always looking for potential acquisition targets, both inside and outside of the U.S. And really, nothing's changed. Over the years, the players that are out there that remain, especially the smaller chains, they're just solid performers. A lot of these regional players that have survived what's happened in the past several years are solid performers.

We're constantly looking at smaller, 1-, 2-store chains, and we buy some of those throughout the year, year-over-year, and we'll continue to do that. Those are the things that don't make the headlines, we don't talk a lot about. But we've not seen any real uptick in opportunities from an M&A standpoint as far as seeing companies that are reaching out, looking for an exit strategy.

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

Great. And just a quick one on inventory. I mean it sounds like overall, inventory per store grew at a similar rate to your plan. But with the slowdown in DIY demand, are you finding that you have pockets of excess inventory in products like fluids that have more limited shelf life and you have to discount them? Or are you just -- are you able to just keep the product on the shelf and then pace your orders from your suppliers accordingly?

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

Brent, do you want to take that one?

**Brent G. Kirby** - *O'Reilly Automotive, Inc. - Executive VP & Chief Supply Chain Officer*

Yes. This is Brent. I'll take that one. Yes. A lot of the inventory growth is really -- Brad talked about it in his prepared comments, a lot of it was really built into our plan this year. We had some -- we typically are always looking to try to get inventory closest to customers and get it in the markets where we think it's going to serve us best.

And we had to slow down some of that expansion at the local level last year with some of the supply chain constraints that were out there. And this year, we set a plan to kind of make up some of that ground as we went into 2022, and we're continuing to do that. That's really what's driving it. There's not really anything there that is hangover or nonproductive inventory.

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**Operator**

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

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

Thank you, Cheryl. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued hard work in the second quarter. I'd like to also remind everyone that we will be webcasting our Analyst Day on Tuesday, August 23, beginning at 8:30 Central time. Details are available on our website, and we hope you'll be able to join us.

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.

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**Operator**

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

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