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## PRESENTATION

### Operator

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

I will now turn the call over to Jeremy Fletcher. You may begin.

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

Thank you, Vanessa. Good morning, everyone, and thank you for joining us. During today's call, we will discuss our third 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 third 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 like to begin our call today by thanking Team O'Reilly for your hard work and commitment to providing excellent customer service, which drove our strong results in the third quarter. Our quarterly results were highlighted by a 7.6% increase in comparable store sales, resulting in an impressive 2- and 3-year comp sales stacks of 14.3% and 31.2%, respectively.

Before we walk through the details of our performance and our prepared comments, I want to begin the call today by acknowledging all of those affected by Hurricane Ian. On behalf of all of Team O'Reilly, I wanted to express our greatest sympathies for the devastation and loss being felt by so many families in the regions impacted by the hurricane.

As a company, we were very fortunate to have incurred only limited damage and our teams were simply incredible in their rapid response to the recovery from the storm. I am always extremely proud of the way Team O'Reilly shines during these challenging times, and we are all incredibly appreciative of how our team members once again stepped up in the aftermath of Hurricane Ian to serve their communities with critical supplies necessary in the recovery efforts. Thank you to each of our over 84,000 team members for living our culture of excellent customer service so well for truly being the friendliest parts store in town and producing the outstanding results we will discuss today.

Now I'd like to turn to our comparable store sales performance and provide some color on what we saw on both sides of our business as we move through the quarter. We started the quarter in July with improving volume trends, driven in part by warm weather across many of our markets, and we're pleased to see these trends continue through the quarter with positive comparable store sales growth on both the DIY and professional side of the business each month of the quarter. Our sales volumes accelerated as we moved through the quarter and exceeded the guidance we communicated on our second quarter call.

On a 3-year stack basis, our comparable store sales were strong each month, with September finishing as the strongest month of the quarter. Our professional business again outperformed in the third quarter, producing double-digit comparable store sales growth on robust growth in both ticket counts and average ticket size. Our third quarter professional comparable store sales growth was a continuation of the strength we saw in the second quarter with the continued benefit from average ticket growth supplemented by accelerating ticket count gains and we're very pleased to see the strong durable nature of our professional sales volume. We're very excited about the momentum we've seen in our professional business and remain highly confident in our competitive advantages in customer service and inventory availability on this side of our business. We expect to continue to consolidate the industry and grow our professional share, and our team is highly motivated to outperform the competition in all of our market areas.

Shifting to the DIY business. We are pleased to generate positive results in the third quarter against extremely difficult 2- and 3-year comparisons, reversing the trend of pressure to DIY sales in the first half of the year and outperforming our guidance forecast.

As I previously noted, our DIY business was positive each month of the quarter with comparable store sales increases driven by growth in average ticket being partially offset by anticipated traffic pressures with both metrics outperforming our expectations for the quarter.

We saw improvement in ticket counts on the DIY side as we progress through the quarter while calendaring very challenging prior year comparisons, and we are pleased to see the resilience in our DIY customer base in spite of continued pressure from broad-based inflation. Although the professional side of our business continues to be the stronger performer, the improvement in our DIY business was the larger driver in surpassing our expectations for the third quarter. In total, our combined DIY and professional comparable store sales growth was again driven by strength in average ticket, which was approximately 10% on both sides of the business and consistent with what we saw in the second quarter.

Same-SKU inflation benefit in the third quarter were also consistent with the second quarter levels coming in at similar levels to our average ticket increases, which was above our expectations. In the third quarter, we began to anniversary the acceleration of higher inflation in 2021. However, we did not see as much moderation as originally expected in this benefit on a year-over-year basis. We have continued to experience increases in product acquisition and operating costs that we are passing through in selling price increases. Pricing in our industry remains rational, and we continue to be pleased with our ability to pass through cost increases but also maintain an element of caution as our consumers face persistent inflation across the economy that could result in traffic headwinds for our business.

From a category standpoint, we saw broad-based support across our business, including strength in the categories that normally benefit from summer heat as we experience warm temperatures at the beginning of the quarter. However, the benefit in weather-related categories was modest in relationship to our total business, and as such, we do not view weather as a significant contributor to our performance in the quarter. From a regional perspective, our performance was fairly consistent across our market areas with widespread outperformance versus our expectations as we move through the quarter.

Now I'd like to turn to our updated sales guidance and industry outlook. As noticed in our -- as noted in our press release yesterday, we have updated our full year comparable store sales guidance to a range to 4.5% to 5.5%. This increase in our expectations for the full year is primarily a result of updating for third quarter performance.

Looking ahead to the fourth quarter, we are pleased to see the volume trends we have experienced thus far in October, which have been in line with our third quarter results. We have seen sustained resilience in consumer demand but remain cautious as we face continued broad-based inflation, the upcoming holiday season and spending pressures that places on consumers and weather dynamics that can vary significantly for the remainder of the year.

While gas prices have retreated from the peaks we experienced in June, providing some level of relief to many consumers, we recognize that current fuel prices remain very volatile and well above where we started the year as well as this time of last year. It is important to note that the fact these factors can influence demand in the short term such as fuel price spikes, weather and economic uncertainty can be distinguished from the long-term fundamental drivers of demand in our industry. We continue to be confident in the health of the automotive aftermarket, supported by steady recovery in miles driven and very favorable U.S. vehicle fleet dynamics. We still view our customer base is healthy, and believe consumers are in a stronger position now than in recent periods of economic uncertainty with continued support from strong employment and wage growth. Consumers continue to be able to capitalize on the strong value proposition of investing in their existing vehicles at higher and higher mileages as a result of the increasing quality of manufacturing and engineering vehicles on the road. We expect for demand in our industry to remain resilient as consumers who are facing high inflation and economic uncertainty prioritize the maintenance of their existing vehicles in order to avoid taking on a payment for a higher priced newer vehicle.

Now turning to gross margin. For the third quarter, our gross margin of 50.9% was 132 basis point decrease from the third quarter 2021 gross margin, but in line with our guidance expectations. Our year-over-year margin continues to be primarily impacted by the rollout of our professional price initiative, combined with pressures from a reduced LIFO benefit, which Jeremy will discuss in more details in his prepared comments, and a faster growth of our professional business.

After incorporating our third quarter results, we continue to expect full year gross margin to be in the range of 50.8% to 51.3%. Our team worked relentlessly to translate the strong topline results into outstanding earnings per share growth with third quarter diluted EPS increasing to \$9.17, a 14% increase over a strong comparison in 2021.

While the year-over-year increase is impressive alone on a 3-year compounded basis compared to 2019, our third quarter EPS increased 22% per year, highlighting our team's ability to deliver consistent, profitable growth through executing our business model regardless of the tough comparisons we have faced.

We are increasing our full year 2022 EPS guidance to \$32.35 to \$32.85, reflecting our year-to-date results and fourth quarter expectations. As a reminder, our EPS guidance includes the impact of shares repurchased through this call but does not include any additional shares.

To wrap up my comments, I want to again thank Team O'Reilly for never backing down from a challenge and providing consistent, excellent customer service to our customers each and every day. It is your commitment to our culture, your fellow team members and our customers that drives our success and makes you the best team in the business. I'll now turn the call over to Brad Beckham. Brad?

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

Thanks, Greg, and good morning, everyone. I would also like to personally thank Team O'Reilly for their commitment to our continued success and dedication to delivering excellent customer service by outthrusting and outservicing our competition. Our topline results for the quarter are a testament to our team's ability to compete, and I am proud of the way our team members in our stores and distribution centers go to market each and every day to win.

Our team has repeatedly proven they are up to any challenge, and I want to join Greg in showing my appreciation for the way our supply chain teams as well as our store operations and DC leadership in the Southeast took care of our teams and our customers in the aftermath of Hurricane Ian. Since safety has always been a critical culture value for Team O'Reilly, our primary focus during the weather event like Ian is ensuring our team members and their families are safe. Then as soon as we can safely make our way back to our store locations, our leaders and teams waste no time getting their stores back up and running, often on generator power with no communication systems. This incredible hard work and sacrifice creates tremendous goodwill with our customers who often have limited options to source the critical parts and supplies they need to meet the basic needs not only with their vehicles, but at home with their families to start recovering from the storm.

Now I'd like to give some additional color on our professional sales performance for the quarter. As Greg previously discussed, strength in our professional business underpinned our comparable store sales growth for the quarter, and we are extremely pleased to continue to see robust growth in both ticket and traffic on this side of our business. Our commitment to the professional customer has been ingrained in our company's DNA since our founding in 1957. The momentum we've generated on this side of our business is the result of solid fundamental execution of the same core competitive advantages that have driven our business for 65 years. Our professional customers rely on us to be an integral partner in the success of their business. We focus on developing long-lasting, durable relationships with our customers by providing exceptional service from highly qualified, knowledgeable, professional parts people who are committed to overcoming any obstacle to take care of our customers. Our team's sense of urgency, professionalism and dedication to our customers allows us to leverage the significant investments we've made in distribution, hub infrastructure, in inventory to provide industry-leading inventory availability, which is absolutely vital to the success of our customers. Our partnerships with our professional customers go even deeper as we support all aspects of their operations through our investments in technology platforms, shop management systems as well as technical and business management train.

Above and beyond technical training for technicians, this training includes things like how to grow and manage a profitable business, effectively right service, how to market and advertise, and effective strategies to retain the best technicians. It's our execution on these foundational priorities that not only earn the retention of existing business that give us the opportunity to earn new professional customers' business, all aided by a competitive pricing strategy that all equals the best overall value in the automotive aftermarket.

We've discussed our professional pricing initiative at [leak] this year, and we remain very pleased with the results we've seen from our competitive positioning within the broader aftermarket. We are confident that this was the right time to invest in professional pricing, and we continue to see a rational overall pricing environment and normal competitive dynamics.

Our sales teams know we provide a premium service delivered by the best teams in the industry, and we go to market with the confidence that our value proposition is an attractive one for both our existing and future new professional customers alike.

Next, I'd like to discuss our DIY business as well as the opportunities we see to grow share on the retail side of the business. While the DIY market is much more consolidated than the professional business, we see tremendous share growth opportunity. The key value components of parts availability, excellent customer service provided by professional parts people and strong relationships that drive our professional business are also critical to our DIY business. Our DIY customers heavily rely on the service we provide, and you can really see this play out in the highly consulted nature of a DIY customers visit to one of our stores.

The professionalism of our team is on display during a typical customer encounter, creating a DIY customer when they walk in the door or pull in our parking lot and providing technical information and advice to walk them through the total job. This often includes standing side by side with the customer at their vehicle to test an existing part or redo trouble code.

Our professional parts people are committed to ensuring our customers have identified the right solution for their problem and have all the parts, tools, and knowledge necessary to complete the job correctly the first time. When this work is beyond our DIY customers' ability, our professional customers in each market come into play with our shop referral program that we established many decades ago. Simply put, the growth of our DIY and DIFM business go hand in hand.

We believe it was our team's intense focus on fundamental execution of our business model and excellent customer service, coupled with continued improvements in fill rates and store in-stock inventory position that drove our results above our expectations in the third quarter. The DIY environment continues to be challenging with the pressures these customers are facing on a broad scale in turn placing pressure on our DIY ticket counts.

We have also faced extremely difficult comparisons from the surge in DIY transaction counts we've generated over the past 2.5 years and are pleased with our team's ability to grow our DIY share and earn our customers' repeat business.

The professional parts people we have standing ready at every green counter in every one of our stores across the country are ingrained with the understanding that our never say no philosophy is so very important. It means not only putting a part in a customer's hands for a sale today to solve their immediate need, but earning their business the next time they are taking on an automotive repair or maintenance job.

Now I'll turn to our SG&A and operating profit results for the third quarter and our updated expectations for the full year. SG&A as a percentage of sales was 29.8%, a leverage of 80 basis points from the third quarter of 2021. Total SG&A spend for the quarter came largely in line with the expectations given the better-than-expected sales volumes.

On an average per-store basis, our SG&A was up 3.2% for the quarter. For the full year, we now expect SG&A per store to grow between 3% and 3.5% with the increase reflecting incremental variable operating expenses on better-than-expected sales volumes in the third quarter as well as ongoing cost inflation.

Our teams continue to be very prudent in managing expenses in the face of significant inflationary impacts while also being appropriately responsive to current sales trends to ensure we are able to optimize both our service levels and our operating margins. We are raising our full year operating profit guidance and now expect to be in the range of 20.3% to 20.6%, which is reflective of both our adjustment to SG&A per-store growth and our increased comparable store sales range.

Now I'll provide an update to our store growth during the third quarter. We opened 37 net, new stores across 20 states in the U.S. and 1 new store in Mexico, bringing our year-to-date total to 154 net, new store openings. This puts us on track to achieve our target of approximately 180 net, new store openings for 2022.

As we noted in our press release yesterday, we are pleased to announce our 2023 new store opening target of 180 to 190 net, new stores, providing us the opportunity to expand our footprint across the U.S. and Mexico. We continue to be pleased with our new store performance and see store and distribution growth as an attractive deployment of capital.

These new store openings will again be spread across new and existing markets supported by our industry-leading distribution network. This allows us to continue to build on the superior parts availability, our existing and future customers' value and expect. Having the right part, at the right place, at the right time for each 1 of our DIY and professional customers in every single 1 of our markets is more important than ever, and we are fully committed to continue to build on our world-class supply chain.

While we made further investments to enhance our distribution network, we are also making investments in our local inventory position to improve overall inventory availability. We finished the quarter with an average inventory per store of \$697,000, which was up 10% from this time last year and 9% from the beginning of the year.

Our plan when we enter 2022 was to aggressively add incremental dollars to our store level inventories throughout the year with a target to finish the year with an average per-store inventory up over 8%. We are now looking to finish 2022 with average per-store inventory at levels consistent

with our current position. This would have us finishing with a slightly higher inventory increase than originally expected due to cost inflation above our expectations, pushing up unit price, while overall units are in line with expectations.

These continued strategic investments into our inventory position focused around having the right local combination of common and hard-to-find parts for every single market, store and customer are a critical component of our success. Deploying additional inventory dollars into -- and incrementally enhancing our hub network now at approximately 380 hubs strong, has also supported growth on both sides of our business. Particularly with our professional customers, we're turning their base, keeping their technicians productive and in turn, keeping their end DIFM customer truly happy is paramount.

You've heard us say it repeatedly, time is money for our professional customers. So the quicker we can put the right part in their hands, the faster they can turn their base, get their customers back on the road and in turn, the more profitable we become together.

To close my comments, I want to once again thank Team O'Reilly for their hard work and dedication to our customers. Excellent customer service is who we are, but that doesn't mean it comes easy. It takes hustle, hard work, commitment and dedication to every single customer, every single day in each of our 5,900-plus stores, and I am thankful to work with the team who is truly dedicated to make this happen.

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 your performance in the third quarter and 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 \$319 million, comprised of a \$257 million increase in comp store sales, a \$60 million increase in non-comp store sales, a \$4 million increase in noncomp nonstore sales and a \$2 million decrease from closed stores. For 2022, we now expect our total revenues to be \$14.1 billion to \$14.3 billion, which is an increase from our previous range of \$14.0 billion to \$14.3 billion and is in line with the updated comparable store sales guidance range Greg discussed earlier.

Greg covered our gross profit performance earlier, noting that gross margin for the third quarter was in line with our expectations with anticipated year-over-year pressure from the rollout of the Pro pricing initiative, LIFO comparisons and accelerated professional sales mix headwind.

Since I'm sure you're all anxiously awaiting a detailed accounting discussion, I want to provide some additional details on the LIFO comparison and how we view the flow-through of acquisition cost inflation in our gross margin results. We think it is helpful to contrast the impact of our earlier LIFO reporting prior to 2022 when we were still in a debit LIFO position versus the current situation where we have returned to a traditional LIFO credit balance.

As we discussed throughout 2021, the application of LIFO accounting meant that as acquisition costs and selling prices went up, we realized the benefit from the sell-through of existing on-hand inventory that we carried at a lower historical cost due to our debit LIFO position. This nonrecurring benefit is a comparison headwind for 2022, which we anticipated in our gross margin guidance, and we've seen results in line with those expectations.

Since our LIFO reserve flipped back to a credit balance in the third quarter of 2021, we are now back to typical LIFO accounting. And I think it is useful to clarify how we view the application of LIFO and the treatment of inventory acquisition costs in our gross margin results.

Under last in first out accounting, the cost of goods sold that runs through our reported gross margin results most closely reflects our current acquisition costs, and we believe this is the best picture of our gross margin performance. This reporting aligns with how we manage our process of evaluating and adjusting prices based on changes in inventory costs.

Our teams diligently work to pass along cost increases in a timely manner consistent with or ahead of our actual receipt of cost increases from suppliers. From a balance sheet perspective, in periods when costs are rising, we see an increase in our LIFO inventory credit balance which reflects



the application of the LIFO calculation. However, because we evaluate gross margin performance on the basis of current acquisition costs and selling prices, we do not view the normal application of LIFO as a discrete charge to our gross margin results.

Since we take this approach, we can see some temporary impact in our gross margin results to the extent that the timing of cost changes and corresponding pricing movements did not align perfectly. The last several years have created volatility in our reported results, driven by the exhaustion of our debit LIFO balance as well as significant inflation in acquisition costs and disruptions in supply chains. But ultimately, we expect to see a much more muted impact from LIFO moving forward as our reported results reflect a more consistent, relevant picture of gross margin performance.

Our third quarter effective tax rate was 23.2% of pretax income, comprised of a base rate of 24.3%, reduced by a 1.1% benefit for share-based compensation. This compares to the third quarter of 2021 rate of 22.5% of pretax income, comprised of a base rate of 24.2% reduced by a 1.7% benefit for share-based compensation. The third quarter of 2022 base rate was in line with our expectations.

For the full year of 2022, we continue to expect an effective tax rate of 23.0% comprised of a base rate of 23.5% and reduced by a benefit of 0.5% for share-based compensation. Our fourth quarter and full year expected tax rate is expected to be below our year-to-date rate of 23.6% due to anticipated benefits in the fourth quarter from our continued commitment to renewable energy investments and the 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 9 months of 2022 was \$1.9 billion versus \$2.2 billion for the first 9 months of 2021, with the decrease driven by higher capital expenditures in 2022 versus 2021 and differences in accrued compensation.

Capital expenditures for the first 9 months of 2022 were \$389 million versus \$341 million for the first 9 months of 2021. We now expect CapEx to come in between \$550 million to \$650 million for the full year, with the balance of the spend for the remainder of the year continuing to support new store and DC development projects, initiatives to enhance the image appearance and convenience of our stores and strategic investments in the information technology projects.

The reduction in our expected CapEx from our previous guidance range of \$650 million to \$750 million is primarily the result of ongoing supply chain challenges to acquire new fleet vehicles and complete various store and DC projects.

Our AP to inventory ratio at the end of the third quarter was 135%, 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 along with the impact from increased inflation in product acquisition costs.

We do not anticipate our AP to inventory ratio to moderate off of this -- I'm sorry, we do anticipate our AP to inventory ratio to moderate off of this historic high as we complete our inventory -- additional inventory investments but we now expect to finish the year slightly below our third quarter ratio.

After generating \$1.9 billion in year-to-date free cash flow and based on our updated net inventory and CapEx spend expectations for the remainder of the year, we are increasing our expected full year free cash flow guidance to a range of \$1.8 billion to \$2.1 billion, an increase of \$0.5 billion from our previous guidance of \$1.3 billion to \$1.6 billion.

Moving on to debt. In September, we retired \$300 million of maturing 10-year senior notes using available cash on hand. As a result of the maturity, we finished the third quarter with an adjusted debt-to-EBITDAR ratio of 1.84x, which is down from our second quarter ratio of 1.95x and but above our end of 2021 ratio of 1.69x. We continue to be below our leverage target of 2.5x, and we'll approach that number when appropriate.

We continue to be pleased with the execution of our share repurchase program. And during the third quarter, we repurchased 1 million shares at an average share price of \$683.09 for a total investment of \$710 million. Year-to-date through our press release yesterday, we repurchased 4.6 million shares at an average share price of \$650.43 for a total investment of \$3 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.

Finally, before I open up our call to your questions, I would like to again thank the entire O'Reilly team for their commitment to our customers and our company. This concludes our prepared comments. At this time, I would like to ask Vanessa, 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) We have our first question from Greg Melich with Evercore ISI.

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

Just to kick it off on the current trends into the quarter, -- when you say that it's as strong as it was in the third quarter, is that on a 3-year view or year-over-year? Or how are you measuring that?

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

Yes, Greg, thanks for the question. I think really when we think about that, it's versus our expectations as we kind of move through the year, and those factor and the comparisons we're up against. So [we've] just been in this unique environment where you really do have to look at kind of 2-year, 3-year performance. So what we'd say is it's up kind of on that basis, the nominal comps do move around just based upon the comparisons.

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

Got it. And then second, could you give us a little more color on inflation and average ticket size between Pro and DIY. It seems like they would be a little higher in DIY and a little less in Pro because of PPI, but any color there would be great.

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

Yes, Greg, I think you're thinking about it the right way. We're seeing similar inflation benefits when we think about SKU level year-over-year when you exclude the specific strategic moves that we've made on the professional side of our business. That's the largest driver of the strength that we've seen in average ticket.

Average ticket always has other components to it as well. And we think on the professional side, just because of the success of what we've seen in the Pro pricing initiative, we've benefited from growing our average ticket beyond just price that we've seen. But -- so that's probably a little bit of a helper. But we continue to view both sides very favorably given the ability to pass through cost increases really very effectively all year long.

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

And then last is trade down. Have you seen anything through the box on either side of the business?

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

Greg, we really haven't seen anything material that stands out. We look at this very closely, both on a consolidated basis and category by category. And where we have seen movement, either up or down, it's really been more a result of supplier performance and inventory availability. Trading across brands of oil, for example, or up and down the value perspective for both our proprietary brands and national brands.

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**Operator**

We have our next question from Christopher Horvers with JPMorgan.

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

So maybe following up on the question about cadence. So it was the best month on a 3-year basis. So basically, September is sort of an 8-handle comp. And then as we look in the fourth quarter, we degrade that by a few hundred basis points for the inflation comparison and then you're basically some plus or minus around the consumer and the holidays and weather uncertainty versus accelerated pro pricing gains?

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

Yes. Yes, Chris. I think you're thinking about this right. As we called out, we are pleased with our third quarter performance. We're pleased with quarter-to-date through October without a doubt. The challenge we have is the unknowns and the volatility. And frankly, the challenges that we may very well experience in the back half of the quarter.

When you look at fourth quarter, we always worry about weather, volatility, you'd layer on the volatility in fuel prices, you layer on beyond the weather, just the uncertainty of the consumer and what they're going to do. And frankly, Chris, we just haven't seen an inflationary environment around the holidays in many, many years. And the holidays are always a wildcard in the fourth quarter as well. You layer on the inflation component. Those are all the reasons we're cautious in our outlook for the fourth quarter.

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

Got it. And then maybe gross margin and open up LIFO a little bit, which everybody loves. So basically, as you go forward, your expectation is product acquisition costs go lower, so there should be really no -- and you've lapped through all the LIFO headwind from last year or substantially. Maybe there's a little bit left in the fourth quarter. And so then as you go forward, if you expect lower product acquisition costs getting into '23, does that mean that you could start to see actually some gross margin tailwinds on the product acquisition side?

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

Yes, Chris, I don't know that we really would view it that optimistically. We're always going to work with our supplier base to ensure that we're walking a lockstep with any relief from pressure that they've seen from an input cost perspective.

A lot of what we've seen so far over the course of the last year plus, has been driven by several factors, including raw materials cost, wage rates, pressures, obviously, from freight that our suppliers have seen, and we're always going to work to be sure that we're realizing appropriate reductions in rolling back cost increases where we can.

But we're pretty cautious in building any expectation that, that's going to be a significant helper for us as we move forward. Obviously, we'll see -- and we'll see that play out. We do feel very confident that to whatever degree that we do see any relief on the cost side that the industry will be able to maintain those selling prices. That's certainly our intent. We'll obviously see how that plays out as well, but some of these cost increases are probably around to stay.

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

Got it. And then just one quick one, Jeremy, on the LIFO side, I mean, can you maybe give us some numbers in terms of how many basis points that was in the third quarter? I mean, we're around 120. And does that go down to really a de minimis amount in the fourth quarter?

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

Yes, Chris, I think the best way to look at that is just really kind of what we called out as positive good guys last year. We still have a headwind in the fourth quarter. It softens up a little bit. For us now, it's really more a function of as the cost environment moves around, how quickly and seem can you be sure to adjust prices. Sometimes we're out ahead. Other times, we're just in line. But the more significant comparison headwinds for how we would have looked prior to when our LIFO credit foot back, will largely be behind us after fourth quarter, a little bit less than fourth quarter and then first quarter in next year, a little bit less than that.

**Operator**

We have our next question from Bret Jordan with Jefferies.

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

Question around fill rates, I guess, my usual. Are you guys back to where you'd like to be from an inventory standpoint versus pre-COVID? And I guess, how do you see your fill rates versus the broader market? Are the WDs and some of the other competitors in the space relatively in stock as well? Or is that still helping your market share?

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

Brent, do you want to start that and then maybe Brad can talk about the competitive situation?

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

Yes. Sure, Bret, great question. Yes, fill rates have improved sequentially from suppliers. We've got some suppliers that are really back to healthy fill rates. We've got a few that still are making sequential improvements but aren't fully back to where they were pre-COVID. I could give our supply chain team a lot of credit for the work with our suppliers to make sure we've got the parts available that our customers need, both DIY and professional. So we feel good with our availability position given the market backdrop that we're operating in. But yes, sequentially, we're continuing to get better, but still a little work to do in some areas.

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

Okay. Another question on -- go ahead, please.

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

Sorry, Bret. Just real quick, I'll just back up what Brent said, maybe from the Street and from the sales and store operations standpoint, Brent hit it pretty good. But we're basically -- we're pleased especially in some categories that we needed to get better, we got better.

We have a few that we still have some work to do, but really just from a competitive landscape, Bret, we feel like our large competitors, they're great competitors that we always say, we have tremendous respect for. They've done a good job. We hope we've done as good or better, but we are feeling like there's some share gains, maybe against some of the smaller players, for sure.

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

Okay. Great. And then a question on the supplier cost or pricing side. I mean, obviously, the rates are hitting factoring expenses. Do you see a step-up in pricing again to offset that or some of the other expenses like shipping that have come down that offset that?

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

Yes. I think, Bret, maybe to add a little to Jeremy's color around that on the previous question. While we've seen costs certainly can't go up forever, and we are seeing some of that begin to normalize with suppliers and in the market. But if you think about wage inflation is pretty much baked into some of the cost of goods now. Yes, we've seen notion rates go down some, but we've seen rail rates come up.

We've seen some domestic lanes come up. So trend is still high, elevated versus historicals and probably is going to remain that way. So to Jeremy's point earlier, we remain cautious there, and we remain confident in our ability to be able to pass those increases on in the event we see any more of those.

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

I guess, specifically around rates though, since most of the suppliers are saying they're going to ask for pricing to offset the factoring expense, is that a near-term incremental inflation? Or do you not see that necessarily the case?

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

Bret, there's a potential that it could work out that way. It's, I think, going to be determined a little bit by -- more broadly in the market where it hits. Those rates have more of a relative impact supplier to supplier than maybe some of the other things that go into the cost of providing the products that we buy in, some won't have the same pressure that others may have. And so I think competitively, you'll see some ability to push back on some of those, and in other instances, they will flow through.

We're obviously active in those conversations and we'll work. There'll probably be some equilibrium that gets stuck at some point. But in the greater scheme of things, I think it is a part of how we think about acquisition costs. Some of the other things that Brent identified are obviously the bigger drivers. And in we -- our views on that is that we do expect it to continue to stay around for a while.

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**Operator**

Our next question is from Simeon Gutman with Morgan Stanley.

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

First topic is on pricing and inflation and maybe the outlook, trying to think about how you're thinking about the cadence, we're about to lap some heavier price increases or inflation from a year ago. Does it -- and I think based on the prior answer, it seems like we're not going to have any material step down in the rate of inflation. It feels like it's structural. And if it subsides, it doesn't feel like there will be a shock where we lose 5 points. Is that a fair way to think about it? And then I have a follow-up.

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

Yes, Simeon, I think that's fair. As we came into this year, just from a purely comparison standpoint, we had expected moderation really in the third quarter and fourth quarter from that year-over-year benefit. As we move through the year, we've had continued incremental cost increases, we've passed them through.

As you know, it's benefited our topline. I think that's been pretty rational. And because of that, we end up with more of a positive for that than we would have expected. And we'll see where the rest of the year plays out, I think, versus where we would have thought at the beginning of the year, that year-over-year pressure won't be as significant in the fourth quarter, there's still some extent to where it's there.

Moving forward, we'll see -- I think our caution is on an expectation that we're going to see dramatic rollbacks that match some level of the volume or magnitude that we've seen since really the middle of 2021. We don't anticipate that. Hopefully, we'll work to get some of the cost improvements moved down.

But from a pricing to the Street perspective, we would continue to expect that to be resilient, to market to be rational and for that not to change.

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

And maybe the follow-up, thinking about gross margin, this is directionally, obviously not in magnitude. It does feel like and maybe some headwinds go away. I wouldn't jump to say there are tailwinds, and I wanted to hear the reaction to it. Greg Johnson mentioned some of the pricing may hold, industry has been rational.

So that, in theory, should be a good guide to the margin if pricing holds, and there are some cost pullbacks. You're lapping PPI, it doesn't become an incremental headwind. And then to whatever extent freight and even some raw material costs moderate, that could be favorable for you. So is it fair to say that some of the headwinds maybe go away, they may not flip to tailwinds per se? I think you're being hesitant to acknowledge that, but at least the removal of headwinds.

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

Yes. The one thing maybe I would caution on that, Simeon, is as you think about those being headwinds, we've worked, I think, appropriately and aggressively to stay out in front of those pressures as we passed along in pricing really since the middle of last year.

Our approach has always been from a pricing perspective to highly scrutinize anything we see from our suppliers to make sure that we're making them provide the right justification for taking -- for sending a cost increase through to us.

And then often, we've got some ability to hold off the impact of that through the course of the negotiations that we've had and not see it for a month or 2. And then you couple that with really during the tail end of last year, we also had some supply chain delays that push those costs back further.

So that's given us ample opportunity. We feel like to be sure that by the time we really see the impact of that, we've already started to float those prices to the Street. So I think for us, they maybe have not created the same level of headwinds that because of just our approach in doing that, that you might otherwise expect?

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

And Simeon, one other thing maybe to add on that topic. As you think about growth in our proprietary brands and our offering across good, better, best in those brands, we're able to further diversify that supplier base than we are a national supplier base. So that kind of speaks to some of the point Jeremy just made as well if you think about it that way.

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**Operator**

Our next question is from Michael Lasser with UBS.

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

One of the key debates on O'Reilly and the auto part retail sector more broadly, is whether or not it can generate growth in 2023 in the absence of passing along all these price increases that have been the principal driver of growth up until now. So a, do you think that there is elasticity within the category whereas the pricing pressure abates, there will be elasticity of demand, so volumes will improve. And b, even if the industry doesn't pick up and see elasticity next year, can O'Reilly's share continue to grow at what seemed like an accelerating rate in the third quarter, likely in response to a delayed reaction to the Pro pricing initiative that you implemented earlier this year?

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

Michael, it's Jeremy. Thanks. There are a lot of questions within that question. So just maybe you want to take a little bit of a step back. We haven't -- actually haven't guided to 2023 yet in we're in a unique situation where there continue to be cost impact -- cost inflation impacts, pricing inflation that are being passed through.

I think what we would tell you is we'll see where that flattens out or what it does. I think for us, our expectation is if we see modest inflation or we see more elevated inflation that we will continue to be able to effectively pass that through to our customers. And that becomes very rational and relatively inelastic.

So to whatever degree that we see that any relief from that type of pressure. I don't know that we would say that we think it bounces back. For us, from a broader perspective, we think that the automotive aftermarket is in -- just from an industry perspective in pretty good shape and have an expectation that the prospects for our industry in general grow and for all the things that Greg talked about within his prepared comments, the vehicle fleet dynamics, the miles driven, I think, continue to recover and be positive, the incredible value proposition for consumers to invest in their existing vehicles.

Those things we all feel like will be a positive and where that shakes out for the pieces of what drives the comp. We think that, that's helpful. And then we continue to think that we have the ability to grow our share. That's always been our approach, and we will aggressively pursue that.

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

Yes, Michael, just to add to that, we remain very bullish on both the industry as a whole, as I said in my prepared comments and our ability to continue to take market share. I don't want anyone to think that our growth this year has been purely the result of inflation or price inflation. We feel very confident that we're taking market share on both sides of the business, and we'll continue to do so into 2023.

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

And just a follow-up on that one, Greg. You're not going to quantify what you think the impact has been from the return on investment in the Pro pricing initiative. But could you qualify it to say that you think the impact was greater in the third quarter than it was in the second quarter? And

is it reasonable just given the lag that it might take for your commercial customers to recognize some of these pricing changes that the impact could grow in the fourth quarter and into the beginning of next year?

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

Yes, Michael, I'll generally answer your question and then kick it across to Brad. He's obviously living these professional pricing programs day in and day out and dealing with our competitors and out in the marketplace. We said from the very beginning that it was going to take time to gain traction, that this was not as easy as flipping a switch and everybody realizes our pricing is better and all of a sudden miraculously our sales grow.

We knew it was going to take time, and I think it did compound in the third quarter and will continue to grow over a reasonable period of time. At some point, it will stabilize. But we do expect to see continued benefit from that. Brad, do you want to talk to any specifics or anything you've seen?

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

Yes. Michael, Greg said it pretty well. Really, what we saw in our testing, as we mentioned, I think both after we rolled it out in the last quarter is we saw some immediate impact, but we also saw a delayed impact. And to answer your question directly, as Greg did, yes, we do feel like there's a building effect for sure.

Kind of what we see, Michael, just maybe at the street level is if you have a really big repair shop in a particular market that has bought from an independent may be on the traditional side of the business for a couple of decades. And maybe we're second or third or fourth call even.

Just because we lower our price to be a lot more competitive with that 2-step independent competitor, that doesn't mean that they just start buying from us the day after we call on them. It means that what may happen if we combine our pricing with the best team in town, the best service, the best availability and sense of urgency and everything that goes along with the relationship, then what happens is, is we may just move up the call list.

We may move from fourth to third and third to second. And then it could be a month later, it could be 6 months later, it could be a year later. If 1 of our independent competitors, for example, drops the ball, that could be the time that we moved from second to first. So there's some immediate impact, but there's also that building effect.

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**Operator**

Our next question comes from Scot Ciccarelli with Truist Securities.

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

I guess I have a follow-up on Michael's question. Basically, it sounds like there's a, let's call it, almost a new store maturity curve that occurs with these pricing changes, is that fair? I mean a typical store is going to kind of mature that Pro business over, what, a 5, 6 kind of year time frame, like -- are we talking about that kind of waterfall or is it something presumably much shorter than that?

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

Yes, Scot, I think that's a hard comparison to draw. The dynamics are just different. It's definitely a ramp. But I think the best way to guide you on that from our perspective is those are harder end gain. So they're incremental improvements that build over time, they're not huge level of stepped up. So to Brad's point, we think that, that will continue to get a little bit better as we move through that. And then at some point, I think we'll have realized the benefit of it. But to try to make the same analogy, I think it's a little bit tough.



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

Yes, Scot and I want to add to that. Let's keep in mind that pricing is only 1 component of market share growth, and it's a smaller component than execution service level, inventory availability, and we continue to focus on those items as well to ensure market share growth. It's a lot more than just the pricing piece.

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

So as you guys have gained share with some of those customers that maybe you weren't doing business with or as much business with. Are there any other changes outside of the pricing initiatives that we're all familiar with that you guys have started to make where maybe there was a reluctance on Riley's kind of game plan for one piece or another?

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

No, Scot, I don't know that we pointed out any real fundamental differences to what we do. Brad talked about it earlier, the keys to success -- and it was in our prepared comments, the keys success on the professional side of our business are helping our customer partners run a more profitable business. So the things that we do to be sure that we're the best partner with our customers are the same things we've talked about for a long time.

I think for us, continuing to push inventory availability, the investments that Brad talked about in the script in terms of what we've added stores this year, improvements in supply chain. I think those have helped us reap some of the benefit, too. But this is a blocking and tackling business.

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

Yes, Scot, the only thing I might add to that is we've been able to get back to a lot of our in-person relationship type things with supplier customers. Our training programs are back fully in place. Some of the things that we haven't been able to do because of the pandemic, we're back to doing day in and day out. That's probably helped from a relationship and strengthening perspective.

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

Yes, Scot, this is Brad. I just want to real quick add, nothing new, Jeremy said it best, blocking and tackling. We work in a simple business. It's not easy, but it's simple. And really, we had our regional managers from the field into Springfield last month.

And our focus was on our fundamental execution. That didn't start in that meeting. But really all year, our battle cry from our EVP of Stores, Doug Bragg, has been, we're going to get out of the COVID funk and not accept where we may have high turnover in stores, high team member turnover, high store manager turnover, that's just not acceptable with the way we built our business getting out, seeing more customers, not having that excuse that unfortunately, we made for ourselves the last couple of years that we're just getting back to the execution that built our company and making sure that we don't have that hangover from COVID and everything we did.

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**Operator**

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

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

Thank you, Vanessa. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued hard work in the third quarter. I'd like to thank everyone for joining our call today, and we look forward to reporting our fourth quarter and full year results in February. Thank you.

**Operator**

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

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