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ORLY - Q2 2013 O`Reilly Automotive Earnings Conference Call

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OVERVIEW:

Co. reported YTD 2013 diluted EPS of \$2.94 and 2Q13 diluted EPS of \$1.58. Expects full-year 2013 sales to be \$6.6-6.7b and diluted EPS to be \$5.79-5.89. Expects 3Q13 diluted EPS to be \$1.60-1.64.



CORPORATE PARTICIPANTS

Tom McFall *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Greg Henslee *O'Reilly Automotive, Inc. - President, CEO*

Jeff Shaw *O'Reilly Automotive, Inc. - EVP of Store Operations and Sales*

CONFERENCE CALL PARTICIPANTS

Dan Wewer *Raymond James - Analyst*

Sam Reid *Barclays - Analyst*

Gary Balter *Credit Suisse - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Colin McGranahan *Bernstein - Analyst*

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Michael Lasser *UBS - Analyst*

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PRESENTATION

Operator

Welcome to the O'Reilly Automotive, Inc. second-quarter earnings release conference call. My name is Robert and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session.

I will now turn the call over to Mr. Tom McFall. Mr. McFall, you may begin.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Thank you, Robert. Good morning, everyone and welcome to our conference call. Before I introduce Greg Henslee, our CEO, we have a brief statement.

The Company claims the protection of the safe harbor for forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. You can identify these statements by forward-looking words such as expect, believe, anticipate, should, plan, intend, estimate, project, will, or similar words. In addition, statements contained within the earnings release and on this conference call that are not historical facts are forward-looking statements, such as statements discussing, among other things, expected growth, store development, integration expansion strategy, business strategies, future revenues and future performance. These forward-looking statements are based on estimates, projections, beliefs and assumptions and are not guarantees of future events and results.

Such statements are subject to risks, uncertainties and assumptions, including, but not limited to, competition, product demand, the market for auto parts, the economy in general, inflation, consumer debt levels, governmental regulations, the Company's increased debt levels, credit ratings on the Company's public debt, the Company's ability to hire and retain qualified employees, risks associated with the performance of acquired businesses, weather, terrorist activities, war and the threat of war. Actual results may materially differ from anticipated results described or implied in these forward-looking statements.



Please refer to the Risk Factors section of the annual report on Form 10-K for the year ended December 31, 2012 for additional factors that could materially affect the Company's financial performance. These forward-looking statements speak only as of the date they were made and the Company undertakes no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by applicable law.

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

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts second-quarter conference call. Participating on the call with me this morning is of course Tom McFall, our Chief Financial Officer, and Jeff Shaw, our Executive Vice President of Store Operations and Sales. David O'Reilly, our Executive Chairman, and Ted Wise, our Executive Vice Chairman of Expansion, are also present.

It is my pleasure to once again congratulate Team O'Reilly on another outstanding performance in the second quarter, made possible by our unwavering commitment to providing consistently excellent service to our valued customers. We are very proud of our team's ability to generate comparable store sales growth of 6.5%, which exceeded the 4% to 6% comp guidance we set for the second quarter.

Our second-quarter comp store sales was a significant sequential improvement from our first-quarter results of 0.6%, or 1.9% adjusted for leap day, driven by continued strong business trends and aided by more normal weather patterns and the timing of Easter holiday. These strong business trends that started in the fourth quarter of 2012 have continued and are reflected in the steady improvements in our two-year stack, going from 7.5% in the fourth quarter of last year to 8% in the first quarter of this year to 9% last quarter.

We were also very pleased that our strong sales performance in the second quarter reflected profitable growth, as we successfully increased our gross profit percentage and continued our diligent expense control, resulting in a record operating profit of 17.3%, the first time our Company has ever exceeded 17% for a quarter.

Our profitable market share growth translated into a 22% increase in operating profit dollars, which combined with our ongoing share repurchase program, yielded a 37% increase in earnings per share.

Each of our 60,000-plus Team Members should be proud of this record-setting performance, and I would like to thank all of Team O'Reilly for their contribution in generating these outstanding results in the second quarter.

Moving on to more detail around the sales performance in the quarter, we saw very consistent strong business trends throughout the quarter, with very similar comp store sales growth each month, after adjusting for the number of Sundays. The outperformance in the quarter versus the guidance we set on our first-quarter call was primarily driven by strong May comp store sales, which had the toughest comparisons versus the prior year. However, both April and June also exceeded our expectations.

The cold weather markets, which had presented a headwind over the last several quarters as a result of the mild winter of 2012, bounced back as expected.

Spring demand in categories we typically associate with normal winter weather conditions, including brakes, ride control and driveline, returned to more normal trends and supported the comparable store sales improvements in the cold weather markets.

It's important to note that our non-cold weather markets also performed very well, and the strong comps we generated in the quarter were driven by Companywide performance rather than solely by a catch-up of deferred demand in the cold weather markets.

Because of the very nontypical weather impact over the past year or so, we have spent more time talking about weather than we would ideally like. However, our view is that the impact from weather has now normalized and we are looking forward to setting aside our remedial meteorological skills for some time to come.

The acquired markets again outperformed the rest of the chain, driven by our continued progress in capturing commercial market share. The outperformance gap in the second quarter was less than we have seen in the past, which is consistent with our expectations, since our core stores represent a much higher percentage of the cold weather markets and benefited from the rebound in these markets.

As Jeff will discuss in some detail in his comments regarding expansion later in the call, we remain very excited about the opportunities to drive strong sales results across the country in both established and in new markets.

As we have seen for some time now, increases in the average ticket continue to strongly support our sales growth in the quarter due to the higher cost of parts associated with the increasing complexity and longevity of vehicles on the road today, as well as a mix benefit as we generate a larger percentage of our sales in hard parts categories, which carry a higher average ticket. Increased traffic was also a contributor during the quarter.

Moving on to a quick review of industry fundamentals, we continue to be very confident in our positive outlook on the long-term drivers of our business. We view a recovering rate of new vehicle sales as a positive indicator of the health of our consumer, and we also believe it supports the long-term fundamentals of our industry, as it adds to the 245 million vehicle population characterized by stable scrappage rates and an increasing average age which now exceeds 11 years.

Vehicles today are simply better engineered and manufactured to stay roadworthy longer and go through more routine maintenance and repair cycles as consumers continue to realize the value of investing in these higher-quality vehicles.

After some softness earlier in the year, vehicle miles driven appear to have stabilized with April and May results -- I think it was 0.9 and 1.2. We believe consumers have largely adjusted to the impact of the lapsing of the payroll tax holiday and the combination of an improving unemployment rate and a recovering rate of new vehicle sales point to the improving health of consumers. We are encouraged by these positive signs, but would emphasize that improvements in unemployment have been gradual, and the overall rate is still at historically high levels. As a result, we continue to believe consumers are facing a high degree of economic uncertainty and we could face short-term headwinds as a result of these macro pressures.

Generally speaking, we remain confident that as the overall health of the economy continues to improve, our industry will benefit from increased miles driven and decreased deferred maintenance.

As we look forward to the third quarter, we are expecting our strong business trends to continue and we are establishing a comparable store sales guidance range of 4% to 6%. Our third quarter benefits from having one less Sunday and the easiest comparison in 2012. So the two-year comp stack at the midpoint of our guidance is a deceleration from the second quarter. However, I would remind everyone that our soft third-quarter comp results from last year were significantly impacted by extremely strong results in 2010 and 2011.

Looking at the three- and four-year comp stack is instructive to understanding our third-quarter guidance.

As we discussed in the past, we generate our comp store sales guidance by forecasting our expected dollar volumes and calculating comps based on those volumes, and the third-quarter range reflects a continuation of the strong volume performance we have seen thus far in 2013.

As we move through the summer, we are also cautious regarding the impact of potential headwinds from macroeconomic pressures, including rising gas prices. Through the second quarter, gas prices were stable and relatively comparable with last year, where prices have begun to tick up in the third quarter and could rise further as crude oil prices impact the price at the pump.

So far, July is off to a good start, and thus far in the third quarter, we are on plan to achieve our guidance range. Our full-year comparable store sales guidance remains at 3% to 5%, after generating comps within our expected range through the first half of the year.

In addition to driving strong sales growth, we are very pleased with our outstanding gross margin performance in the second quarter. Sequentially, our second-quarter margin improved 45 basis points from the first quarter, driven by acquisition costs and product mix improvements and increased distribution costs leveraged through continued efficiency initiatives and higher volumes.



On a year-over-year basis compared to the second quarter of 2012, our 94 basis point improvement was the result of merchandise margin improvements in both product acquisition and pricing management and improved shrink results.

As we look to the back half of the year, we expect to continue to see solid merchandise margins and distribution improvements, but we also expect to face some headwind from our LIFO accounting, which Tom will discuss in detail in a few minutes.

As a result, our gross margin for the second half of the year will be stronger than our initial estimates, but more along the lines of our first-quarter rate than that of the second quarter. Factoring in these expectations and our outperformance in the second quarter, we are raising our full-year gross margin guidance from a range of 50% to 50.4% to a range of 50.3% to 50.7%.

Thus far in 2013, market pricing has remained rational and inflation has been within normal expected ranges and our guidance forecast is predicated on both of these items being stable in the back half of the year.

Next, I would like to switch gears and provide an update on an ongoing initiative we discussed last quarter. At the beginning of the second quarter, we began the pilot of a loyalty card program geared toward enhancing our DIY customer engagement and capturing an increased share of business on this side of the market. We are excited about the opportunities the loyalty program presents to target promotions to our customers, create initiatives to capture a larger percentage of our customers' business and accumulate customer purchase histories to direct our marketing efforts.

We are pleased to report that the initial results of this pilot have been very positive, both because we have received positive feedback from our customers and also because the pilot has identified some opportunities to enhance the program to make it even more customer-friendly. We are aggressively working through these enhancements and now expect to roll out the loyalty program to the full chain at the beginning of the fourth quarter versus our initial end-of-second-quarter target date.

Finally, before I turn the call over to Jeff to discuss some exciting new expansion plans, I want to touch briefly on our progress with the VIP acquisition. We are on plan and have worked through much of the physical integration of the 56 stores we acquired in Maine, New Hampshire and Massachusetts, and are in the process of deploying the additional inventory necessary to put these stores in the commercial business. As we have discussed on previous calls, this acquisition will not have an immediate impact on our operations in 2013, but provides us with a springboard for additional expansion in the Northeast, and we have been pleased with our initial assessment of new store opportunities in these markets.

In closing, I would like to once again congratulate our team members for their outstanding performance in the second quarter and thank them for continuing to provide the absolute best service in our industry to our customers every day. Because of your commitment and dedication to our Company's success, I am more confident than ever that Team O'Reilly will execute our strategy and lead our industry.

I will now turn the call over to Jeff Shaw.

Jeff Shaw - *O'Reilly Automotive, Inc. - EVP of Store Operations and Sales*

Thanks, Greg, and good morning, everyone. I would like to join Greg in thanking Team O'Reilly for their excellent performance in the second quarter. Our teams delivered on the increased comp expectations and drove sales growth at record levels of profitability.

Most importantly, Team O'Reilly demonstrated their rock solid commitment to providing the best customer service in the industry.

I would like to begin my comments today with some exciting distribution operation news. As we have discussed many times, our ability to provide top-notch customer service in our stores is dependent on the work our distribution center teams do to get the right parts to our stores faster than our competitors. The importance of parts availability is the driver behind our long-term investment in our robust regional DC network. That investment continues as we are pleased to announce we've acquired property to build a new DC in Naperville, Illinois, a western suburb of Chicago.



First, I would like to provide some details on the rationale behind the decision to add to our DC network in an existing market. As the third largest population center in the US, Chicago is an important market for us, and we currently have a strong market position with over 100 stores in the greater Chicago Metropolitan area, but we have a tremendous opportunity to increase our market share.

Our current distribution strategy in this market has been in line with our industry-leading model, with five-night-a-week delivery to our Chicago stores from our Indianapolis DC, supplemented with additional inventory availability at hub stores located in the Chicago market.

With the additional inventory provided by a DC location in the Chicago market, we can provide same-day access to the full breadth of our products to all of our customers in this market. The 360,000 square foot facility, which is slated to open in third quarter of 2014, can service up to 250 stores in Chicago and the surrounding markets.

As we've discussed several times in the past, the single most important factor in earning the business of our customers is the ability to provide the parts our customers need faster than the competition. And the addition of the Chicago DC will provide us with a significant competitive advantage in one of our largest markets.

The second benefit of the new Chicago DC will be the additional capacity it will free up in existing DCs, primarily Indianapolis, Minneapolis and Des Moines, which will support growth opportunities for backfill in existing markets and new market expansion. Some of this additional capacity will be created in DCs which are running at or above optimal capacity, and the transfer of stores to the new Chicago DC will allow our DC network in the region to continue to provide outstanding service while driving efficiencies at more optimal store counts and shorter truck routes.

Expanding on our distribution expansion strategy, I am pleased to report we've continued to make great progress on the construction of our 390,000 square foot DC in Lakeland, Florida, and we are on schedule to open on time in Q1 2014. This DC will support our expansion into central and southern Florida, where we are aggressively opening stores.

The Florida market leads our store growth with 14 new stores in the second quarter and 19 year to date. We have been very pleased with the early performance of this market.

Our DC operations team has a proven ability to quickly and effectively bring new DCs online to strategically support our stores, which has always been a competitive advantage for us. Our DC operations team has the ability to effectively execute on multiple new locations at once, as evidenced by the flurry of DCs our team opened during the CSK integration, and we are very confident in continuing that success with our current and future expansion plans.

While we are on the expansion front, I want to spend a few minutes discussing our expansion on the West Coast. In the five years after the acquisition of CSK, we've invested a tremendous amount of capital in DCs, stores and inventory on the West Coast, as well as a tremendous amount of our management teams' focus to improve our leadership and execution growing our business in the acquired markets. We have made great gains in growing our market share, but still have a great opportunity to grow our business in existing locations.

That said, with the conversion work behind us and the long site development timeframe met, we are finally hitting our stride in growing greenfield into the large amount of attractive Western markets. Year to date, we've open 10 new locations in California, and we see significant additional opportunities for store growth in the Western markets.

With the opportunities on the horizon to grow our store base in the Northeast that Greg discussed earlier, the backfill capacity created with the Chicago DC and in the Western US and the new market opportunities in Florida and other expansion markets, we are in an excellent position to continue our history of profitable organic growth, and we are on track to open 190 net new locations in 2013.

Changing gears a bit to our store level execution, we have definitely seen the benefits of our investments in our distribution network and the last year's inventory investment. We are beginning to annualize the 2012 store level inventory additions, and the investments continue to support our store teams' ability to provide top-notch customer service and grow the business.

As we've discussed on this call for several quarters now, we remain focused on prudently adjusting store staffing levels to keep customer service high and grow our business while also managing our expenses. Our history has shown us that providing consistent top-notch customer service and not sacrificing that service during tough comps quarters will drive results over the long term. This quarter is a great example of our ability to see the result of our unwavering service-level commitment to our customers.

To provide a little color to our execution with some numbers. SG&A levered 75 basis points on the strong comparable store sales of 6.5%. Year to date SG&A has delevered seven basis points, which was driven by the tough comp comparisons in the first quarter, and is tracking slightly below our expectations of flat SG&A percentage at this point in the year.

Our SG&A dollars were a little higher than expected in the second quarter, based on higher-than-expected conversion and payroll costs in the VIP stores, higher than planned bonus expenses driven by our strong profit performance and additional legal expenses for general operational items.

For the remainder of the year, we will continue to tightly manage our SG&A expenses, but based on our year-to-date results and the expectation that VIP conversion costs will continue to run higher than planned, we are raising our full-year per-store SG&A growth guidance from approximately 0.5% to a range of 0.5% to 1%.

Finally, I want to touch on an initiative we discussed on the first-quarter call. Over the past few months, we've rolled out to our professional customers a redesigned proprietary business-to-business platform named First Call Online. The enhancements of our platform were designed to give our professional shops access to enriched product content and images with more effective search and identification features.

The initial feedback has been very positive. Customer adoption has been strong in the first phase of the rollout and the redesigned system is meeting and exceeding the goal of providing a tool for our customers to improve their efficiency in locating and ordering parts and moving vehicles through their base.

Before I turn the call over to Tom, I would once again like to congratulate our store and distribution center teams for an excellent quarter and thank them for their continued hard work and dedication to serving our customers. Now I will turn the call over to Tom.

Tom McFall - O'Reilly Automotive, Inc. - EVP of Finance, CFO

Thanks, Jeff. Now I will move on to the numbers and a little more color on our guidance.

Comparable store sales for the quarter increased 6.5% on top of prior year's comps of 2.5%. Both DIY and professional contributed to the increase, with professional again leading the way by solid growth in our acquired Western markets, as well as strong results in our core markets. Both average ticket and ticket count contributed strongly to the positive increase in comparable store sales.

For the quarter, sales increased \$152 million, comprised of \$100 million increase in comp store sales, a \$52 million increase in non-comp store sales and flat non-comp, non-store sales. As Greg mentioned, we are setting our third-quarter comparable store sales guidance at 4% to 6%, to 6%, which is unchanged from our internal expectations created at the beginning of the year.

Year-to-date, our comparable store sales increased 3.6% on top of prior year's comps of 4.9%, and were within our expected range as weather patterns have normalized.

For the full year, sales and comparable store sales guidance for 2013, it remains unchanged from the beginning of this year at \$6.6 billion to \$6.7 billion in sales and a 3% to 5% increase in comparable store sales, based on expected continued solid sales volumes in the back of the year.

As Greg discussed, our gross margin results exceeded our expectations for the quarter. Gross margin as a percent of sales for the quarter increased 94 basis points over the prior year to 50.8% of sales, driven by strong merchandise margins resulting from improved acquisition costs, pricing management and solid shrink results. Sequentially, our second-quarter gross margin as a percent of sales improved 45 basis points over our strong

first-quarter results, driven by improved acquisition costs, favorable product mix and increased leverage of our distribution costs on higher sales volumes.

As we continue to realize acquisition cost benefits from incremental better purchasing power with our vendors, these -- excuse me -- we continue to realize acquisition cost benefits from incrementally better purchasing power with our vendors. These product acquisition cost reductions may outpace inflation in the near-term, reducing our LIFO reserve to a LIFO debit. The practice in our industry when this situation occurs is not consistent. However, should our LIFO inventory exceed the value of replacement cost, we will elect a conservative approach and not write up our inventory value beyond replacement cost.

To the extent we see acquisition cost improvements while in the zero LIFO reserve balance, it will create a headwind to gross margin over some period of time. Despite the oddities of LIFO accounting, acquisition cost decreases are positive to our business, generating increased profit dollars at the point of sale, and will benefit our gross margin percentage in the long run.

Looking ahead to the second half of the year, we expect to continue to generate solid merchandise margins at the point of sale, offset in part by the potential LIFO headwinds, and gain traction from our distribution efficiencies. However, we will anniversary the benefits we realized in the third and fourth quarters of 2012 from the larger-than-typical amount of capitalized distribution of costs associated with our store level inventory enhancement initiative last year. As a reminder, the stores' [stocked-up] inventory movements last year were more efficient than normal orders, so we realized a benefit related to capitalized distribution costs during this initiative.

Based on these factors and our year-to-date results, we are raising our full-year gross margin as a percent of sales guidance to 50.3% to 50.7%.

SG&A for the quarter was 33.6% of sales versus 34.3% in the prior year and was generally in line with our expectations. This 75 basis point improvement in SG&A as a percent of sales is attributable to leverage on strong comps.

Through the first six months of the year, SG&A as a percent of sales versus the prior year was down seven basis points due to the tough comparison in the first quarter of this year. As Jeff discussed earlier, we expect to continue to see slightly higher-than-planned conversion and payroll cost at the acquired VIP stores in the back half of the year, and as a result, we now expect our full-year per-store SG&A increase to be 0.5% to 1%, up slightly from our previous guidance of an increase of 0.5%.

Operating profit as a percent of sales for the quarter was up 17.3%, which is 169 basis point improvement over the prior year and represents our all-time-high quarterly operating profit. For the first half of 2013, operating profit as a percent of sales improved 71 basis points to 16.6% of sales. Based on our strong year-to-date results and revised gross margin expectations, we're raising our full-year operating profit as a percent of sales to 16% to 16.4%, up from our previous guidance of 15.8% to 16.2%.

Diluted earnings per share for the second quarter was \$1.58 per share, which represents an increase of 37%. For the first six months, diluted earnings per share was \$2.94 per share, which represents an increase of 28%. Our year-to-date EPS benefited from a tax rate of 37.1% of pretax income versus a rate of 38.2% for the first six months of 2012. As a reminder, this beneficial rate was the result of a positive resolution of income tax audits and the benefit of certain job tax credits in the first quarter of 2013. We continue to expect a full-year tax rate of approximately 37.4% of pretax income.

For the third quarter, we are establishing diluted earnings per share guidance of \$1.60 to \$1.64. Based on our above-plan results in the second quarter and additional shares repurchased since our last call, for the full year, we are raising our guidance to \$5.79 to \$5.89 per share. As a reminder, our diluted earnings per share guidance for both the third quarter and the full year take into account the shares repurchased through yesterday, but do not reflect the impact of any potential future share repurchases.

Moving to the balance sheet, our average inventory per store at the end of the second quarter was \$574,000, up 3% from \$556,000 at the end of the second quarter of 2012, and in line with our per-store inventory at the end of 2012. We continue to project inventory per store to be flat in 2013, as we continue to identify opportunities to redeploy our existing investments into more productive inventory.



At the end of the second quarter, our AP-to-inventory ratio was 87.8%, up from 79.2% at the end of the second quarter of 2012 and 84.7% at the end of 2012. The year-to-date increase is better than expected, primarily due to the timing of payments. For the full year, we continue to expect our AP-to-inventory ratio to be flat with the end of 2012.

Earlier in July, we announced the second amendment to our credit facility, which extended the maturity date, reduced the spreads for borrowings and reduced our facility fees, equating to a 25 basis point decrease on drawn funds. This amendment is also a benefit to our vendor financing program as it will allow for reduced spreads for our vendors in the program. These more attractive rates allow us to continue to reduce overall supply chain costs, while also providing the opportunity for extending payment terms.

Capital expenditures for the second quarter were \$103 million, bringing the year-to-date CapEx to \$177 million, which was slightly below our expectations. However, as Jeff discussed, we will be in construction of a new DC in Chicago, and the additional expenditures associated with this project will bring us back into the expected full-year range of \$385 million to \$415 million.

For the quarter, free cash flow declined to \$110 million versus \$201 million in 2012, caused solely by the dramatic improvements we made in our net inventory investments in 2012, driven by the rapid growth in our vendor financing programs. We have not changed our full-year free cash flow expectations and are maintaining our original guidance range of \$450 million to \$500 million.

Next, I will provide you with an update of our share repurchase program. During the second quarter, we repurchased approximately 2.5 million shares with an aggregate cost of \$274 million at an average price of \$107.61. Subsequent to the end of the second quarter and through the date of this earnings release, we repurchased approximately 0.5 million shares at an average price of \$113.66, bringing our cumulative year-to-date repurchases to 5.5 million shares.

Our cumulative share repurchase since the inception of our program in January of 2011 through yesterday were 37.6 million shares at an average price of \$79.27. And we have \$521 million remaining under our current Board-approved share repurchase authorizations.

As we've discussed several times since the inception of our repurchase program, we continue to believe the best use of our cash is to reinvest back into our business, but we continue to view buybacks as an effective use of excess available cash and will continue to opportunistically execute the program moving forward.

At the end of the second quarter, our adjusted debt to adjusted EBITDAR was 1.98 times. With the issuance of our \$300 million Senior Notes in June, we expected to enter the lower end of our long-term targeted leverage range of 2 to 2.25 times, but our strong second-quarter EBITDAR results dropped this just below this range.

We continue to believe that our established target leverage range represents the appropriate capital structure of our Company and we will continue to incrementally move toward entering that range. However, we are also very committed to maintaining or improving our investment-grade credit ratings.

Before we turn the call over to the operator to take your questions, I would like to take this opportunity to thank all our store, DC and headquarter team members for their commitment to our Company's success. As we have grown over the years, we've never forgotten that the basic premise of taking care of customers is what made O'Reilly so successful and will be the key to our future profitable growth. Thank you again for your hard work.

At this time, I would like to ask Robert, the operator, to return to the line and we will be happy to answer your questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Dan Wewer, Raymond James.

Dan Wewer - Raymond James - Analyst

Thanks. Good morning. Greg, if I wrote down my notes correctly, you are indicating that commercial was stronger than do-it-yourself.

Greg Henslee - O'Reilly Automotive, Inc. - President, CEO

That is correct, yes.

Dan Wewer - Raymond James - Analyst

That you are seeing cold weather markets rebounding, you are seeing some of the maintenance businesses, such as brakes, recovering. And yet this seems to be a significant divergence with commentary from Monro Muffler this morning. Can you give us a bit more insight? Is there like a massive market share shift that's taking place to O'Reilly's advantage? Or are you seeing strength in different types of commercial customers than you have in the past?

Greg Henslee - O'Reilly Automotive, Inc. - President, CEO

Well, what I would say is that from our side, it's a little hard to tell when you are gaining market share and not without having all of us report at the same time and so forth.

What I would say is that our DIY business was the best we've seen it for a long time, and the gap between our DIY and commercial was closer this past quarter than it has been for a while. Our CSK markets continued to outperform the core O'Reilly markets by a smaller margin, as the core O'Reilly markets continue to improve a little bit.

And then on a by-category basis, some of the things like brakes, maybe some other categories that were -- and chassis -- that were affected by weather in the cold weather markets more than would be typical, I think they rebounded for us. I don't know about the whole industry. I didn't have a chance to read Monro's report yet, so I don't know what they experienced. But our experience was that many of these maintenance and repair categories recovered nicely for us, and it wasn't just the cold weather markets.

We have seen kind of the recovery in some of the warm weather markets also, which indicate that some of the maintenance and repair items that have been deferred, that there's been a little bit of catch-up on some of that deferred maintenance. And hopefully that continues. Like I said, so far in July, the trend has continued and business has been pretty good. So we are pretty happy with how we performed and how the industry appears to be performing from our perspective.

But again, it's hard for us to know how the whole industry does in these short windows of time without having public reports from all the other players.

Dan Wewer - Raymond James - Analyst

Right. And just as a follow-up question. There continues to be a significant number of acquisition opportunities that are shopped around. Can you remind us what type of acquisitions would now be of interest to O'Reilly? Are they more small acquisitions of independent jobbers to grow your commercial business in acquired markets at a faster rate? Or are you still inclined to look at more VIP type acquisitions that are perhaps still available?



Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

The acquisitions that mean the most to us are ones that put us in a new geography. So where we don't have stores today, if we can acquire a company. And they would typically be smaller companies, as you said, that where they establish and O'Reilly presence in a market where we don't exist, those are of most value to us.

But there is some value to gaining market share in existing markets through acquisitions. But of course, it's harder to pay a price that may seem like a good price to the seller in those situations, because we are already there and have a piece of the market.

But we are opportunistic acquirers of companies in our industry and plan to continue to consolidate where it makes sense for us. So we are always open to looking at acquisitions that makes sense for us. And we actively do that. As we will expand in these markets where we don't have a presence, we will continue to look at some of the smaller players.

Now that's not to say that a larger acquisition couldn't make sense to us, but it would have to be rationalized considering the fact that we would have significant overlap with any of the larger companies that could potentially be acquired at this point.

Dan Wewer - *Raymond James - Analyst*

Okay, great. Thank you.

Operator

Alan Rifkin, Barclays.

Sam Reid - *Barclays - Analyst*

Hey, guys. This is Sam Reid pinch hitting for Alan Rifkin. Congratulations on the really good quarter here.

I just have a quick question from -- it's kind of actually a follow-up question from your last conference call. How much would you guys say of your comp this quarter would be attributable to delayed tax returns finally being spent at your stores? Have you guys done some work around that?

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

I don't know, Sam. That's a good question. It's just hard to know where your customers' money comes from. There's no question there was a delay in some of the things people put off to spend money on when they get their taxes back. It's just one of those things that we don't have a good way of measuring.

There's no question that they were definitely deferred, and since we don't cash the IRS checks, then we don't have a measurement there. It's a good question, but I would say that some piece of our second-quarter revenue was driven by people that were using tax refund money to fix up things they had deferred on their cars.

Sam Reid - *Barclays - Analyst*

Fair enough, fair enough. And then my second question here, I think in the past you guys had suggested inflation would trend about 1% to 1.5% this year. I was wondering if that's correct and if you guys still see that as kind of the ongoing trend for the remainder of the year.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Sam, this is Tom. We are experiencing what we would say would be relatively normal levels of price inflation, and we continue to expect for the remainder of the year that we will fall within that range.

Sam Reid - *Barclays - Analyst*

Awesome. Thanks much, guys.

Operator

Gary Balter, Credit Suisse.

Gary Balter - *Credit Suisse - Analyst*

Thank you. First question is we notice in visiting stores you've expanded out some of your retail offerings and really improved the presentation there. Can you talk about what's going on in retail? Because your comps in retail have been stronger than the competitors. So are you pleased with what you've seen as it rolled out to all the stores, et cetera?

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Yes, our retail comps are good. This past quarter is the best retail quarter we have had for some time, and we see a significant growth opportunity for us on the retail side of the business just by virtue of comparing the amount of retail business that we do as compared to what some of our competitors do retail who have a little richer retail business mix than what we have.

So with that in mind, we've worked to improve the adjacency of some of the product offerings we have in our display areas, the planograms and the products on this planograms, and making sure that we've optimized the categories that we carry out front and that we just put ourselves in a position to be the best DIY retail supplier that we can be.

And then it's also driven by some of the things that we are doing from a marketing and advertising standpoint, including our loyalty program, which will give us a way to better tie ourselves to customers and market directly to customers who have an interest in receiving information and discounts and things from us.

So we are pretty excited about how we are doing in retail and how we feel like we will continue to do in the future.

But that said, our foundation is on the professional side or the commercial side of the business, and we continue to work to enhance those relationships and make sure that we don't do anything to sacrifice what we view as a pretty dominant position we have on the professional side of the business.

Gary Balter - *Credit Suisse - Analyst*

Great. And just a follow-up, the parts lookup system, could you update us on if that's now rolled in how the employees are using that and has it made a difference in your results?



Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Jeff, you want to answer that?

Jeff Shaw - *O'Reilly Automotive, Inc. - EVP of Store Operations and Sales*

Yes, OCAT is fully rolled out. The feedback we get from the field, it's a much better catalog than we had previously. We can update it much quicker than we could previously. We have several things that we are working on to continue to enhance OCAT. We just rolled out kind of a power sports part in OCAT, and several more things on the slate moving forward. But all in all, it's worked out very well. The field is very happy with it.

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

The thing that this really does for us, Gary, is gives us a platform on which to communicate with our team members on a by-part basis. So if we know that the issue that a customer may be having with a particular part requires that the part be compared to a picture that you can rotate or see multiple sides of, we now have the ability to make sure that our team members have on their computer screens what they really need to sell the part. And we are leveraging that to make sure that we do a better job at point-of-sale.

Now this comes into play both on the professional side and the retail side. But it's really strong on the retail side, where the customers maybe aren't quite as informed on auto repair as what our professional customers are. There's also a benefit with our First Call Online system since it uses that system and gives our shops access to that information.

Gary Balter - *Credit Suisse - Analyst*

That's great. Thank you very much.

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks a lot and good morning. A couple of questions. First of all, your decision to open the Chicago DC and the expansion work it will let you do in some of your more mature Midwestern markets, was there any kind of epiphany or change in perspective that you developed about your expansion potential in some of those more mature markets, where you think they are perhaps less penetrated or have more opportunity than you previously had surmised that drove that decision?

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

No, I think we've known we've had expansion capability in those markets for some time and we've continued to expand in those markets. But as we do so, we have put some of our distribution centers at a point where we've got to make some shifts to accommodate the number of stores that they supply.

And then another factor that we've known for some time, even going back to when we bought CSK, is that to be what we should be in the third largest population center in the US, we are going to have to have better distribution support in Chicago. So our plan all along has been to do this at some point.

As we bought CSK, the most pressing needs were putting a distribution infrastructure out West, and we had the ability to service Chicago out of Indianapolis. But now that we have got Indianapolis operating at capacity, we need to offload some stores from it and give us the ability to backfill some markets. We ideally would be in a position in Chicago where we would have a distribution center and be able to leverage that distribution center to grow our professional and DIY business in the third largest population center in the US.

Matthew Fassler - *Goldman Sachs - Analyst*

Great, that's helpful. And then just a second question. On the loyalty program, if you could talk about the characteristics of your customer in terms of both frequency and in terms of your share of their wallet in the category that you tend to have as we think about what this card could do for you as the program builds.

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Yes, well, there's really not as much known about this, Matt, as we would ideally like to know. We think our typical customer who visits our store -- a heavy DIYer would visit our store more than four times a year, and average would be maybe two or three times a year. As we start gathering data from the deployment of our loyalty program across our Company, we will have a lot better idea as to how our customers behave with regard to us. Because some of the surveys that we've had other companies do have indicated that in some cases, us and our competitors share customers, that sometimes it's a matter of convenience. And the loyalty card program is a way, we think, for us to market directly to those customers and try to gain a bigger share of their wallet. But to this point, there's just not good information that I would be able to express to everyone to define exactly what that share is.

Matthew Fassler - *Goldman Sachs - Analyst*

And just a closing question on that. Does the loyalty program play into your e-commerce effort at all, as you think about the DIY customer in that regard? Do see that perhaps being a traffic driver once you have that information locked up?

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Yes, and it gives us a means to market directly to the customer and connecting them to our -- through our website or an app, if we want to, or however we do it to give them access to information on the kinds of repairs they are doing, reminders of things they might want to do based on the age of their vehicle or the miles on their vehicle. All those kinds of things tie into this loyalty program. So it just gives us the ability to have a tighter relationship with our customers in kind of a digital way and we plan to leverage that once deployed.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you.

Operator

Colin McGranahan, Bernstein.

Colin McGranahan - *Bernstein - Analyst*

Good morning, thank you. First question on gross margin. It sounds like -- obviously a nice improvement both sequentially and year-over-year. The inventory acquisition cost was a big part of it. Could you give us a little bit more color on where that's sourcing from or where that's coming from? Is it volume rebates, is it more private label? What's the source of that better inventory acquisition?



Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Well, it's many things. We work hard with our vendors to make sure that we have the most efficient supply chain we can have. And in doing that, we've been able to -- over time as we've imported more products and we've had a little bit of an improvement in our private-label product performance and growth -- we have yielded a little better gross margin.

We also work hard to manage our prices. We've been a company that has over the years been pretty traditional in the way we price products to professional customers, are becoming a little more scientific in the way we do that.

So we have opportunities -- we've yielded some opportunities and we continue to have opportunities, both on the cost side and on the selling price side, that we will continue to try and take advantage of over the next few years. Tom?

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Collin, this is Tom. What I would also add to that is when we bought CSK, obviously, our volumes went up a lot. But there was uncertainty on how well we'd execute the transaction. Now that we are five years out, most of the biggest vendor deals were five-year deals. So as we start tripping over these five-year deals and look at repapering the deal, the volumes that we've achieved have in most parts exceeded expectations, and it has allowed us to go back and look at those deals and get pricing for where our volume is now. And that's been a big driver for our gross margin improvement.

Colin McGranahan - *Bernstein - Analyst*

Tom, that's really helpful. So that sounds like it's a bit of a persistent effect. And how do I think about that relative to probably no supply chain leverage or even maybe some supply chain deleverage next year with two new DCs coming on? I guess the ultimate question is you are at 50.5%, 50.6%. How do you think about that margin rate going forward?

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Well, we have given guidance for the back half of the year. We are not ready to give guidance for next year. What I would tell you on the distribution side is right now, we have a number of distribution centers that are running over capacity, which makes them inefficient across the whole spectrum of stores that they support. And when we open these two new DCs, they are going to be less efficient. But the existing DC's whether it be Mobile, Atlanta or Des Moines or Minneapolis or Indy, are going to become more efficient, and we'd expect to not delever, even though we have two new DCs.

Colin McGranahan - *Bernstein - Analyst*

Okay, that's helpful. And then if I can sneak in one follow-up here. I know the weather issue has been long-suffering. But what I'm trying to get a sense of, given very disparate results out of you and Monro and others, if you look at your stores that are core stores, so legacy O'Reilly stores, in non-cold-weather markets, what kind of a differential in comp is that to your average?

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Well, as you know, Colin, we've always tried to stay away from giving geographic comp results just for competitive reasons. And we spoke to geography more than we typically would have through this mild winter of 2012 just because we thought it was something that needed to be talked about.



I can tell you that, for instance, in the Southeast, we comped very well, probably -- well, in our case, we comped a little better than we did in some of the cold-weather markets. But we've had a good rebound in the cold-weather markets. There's no question that the issue we had there was real and that it has recovered. But we had good comp results across the country, and even in some of the warm weather markets we've done very well.

Colin McGranahan - *Bernstein - Analyst*

That's super helpful. Thank you very much.

Operator

Scot Ciccarelli, RBC Capital Markets.

Patrick Palfrey - *RBC Capital Markets - Analyst*

Hi, this is Patrick Palfrey on for Scot today. Thanks for taking my questions. I guess can you give us a sense as to the amount of deferred maintenance out there? And then I guess maybe put that in the context of people putting off maintenance in anticipation of getting a new vehicle or perhaps in the context of some of the macroeconomic pressures that you are seeing on your consumers.

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Well, we get our deferred maintenance number from one of our industry associations, and it has been -- I think it's a little bit north of \$60 billion right now -- I'm sorry -- \$60 billion, is what they say it is.

Who really knows? It's hard for us to really have a solid bead on that. I think we are able to identify it better through just the behaviors of some of our product category performance. When we see something that we know wears on automobiles, like brakes or belts and hoses, things like that, when we see those categories get soft for a while, you kind of know that there's some maintenance being deferred.

But what I would say is our industry refers to the deferred maintenance number right now being just a little bit north of \$60 billion. And our associations calculate that by just taking the number of miles driven and the age of vehicles and knowing what the typical spend would be on those vehicles of certain ages and coming up with that number. And I don't know if it's 100% accurate, but it's the best that we have.

Patrick Palfrey - *RBC Capital Markets - Analyst*

And then I guess put it in the context of people looking at new vehicles, do you guys have a sense that people are actually deferring the maintenance and you perhaps maybe won't see this maintenance come back? Or is it sort of a greater percentage of people just being under pressure from some of the macroeconomic things that you cited?

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Well, I think what you said, I think there is some merit to that. I think if you are planning to trade a vehicle, you may not maintain it as well as you would one you are going to keep. And typically, and especially in today's world, with vehicles being capable of being on the road so long, those vehicles are not scrapped. And that's what's encouraging to us, is the scrap rates continue to stay very stable as new vehicle sales has improved over the last couple years. Those vehicles are going back out on the road as used cars.

And when you buy a used car, it is a new car to you and it may go through a very heavy routine maintenance cycle as a point of a new acquisition of a car. So to us, the fact that new cars are selling and these cars might be traded in, yes, you might have a little bit of a deferral for a while before



the car gets traded in, but once it's bought as a new car to someone else, even though it's used, it becomes one that becomes a well-maintained car, because it may be the family's primary driver.

Patrick Palfrey - RBC Capital Markets - Analyst

Okay, thank you for taking my questions.

Operator

John Lawrence, Stephens Inc. John, your line is open.

Michael Lasser, UBS

Michael Lasser - UBS - Analyst

Good morning. Thanks a lot for taking my question. If you look at your performance by geography based on where your market shares are, are you starting to see you tap out in certain areas and that's eliminating your ability to grow within some of your more established markets? And I'm not just talking West Coast versus East Coast; I'm talking as you get down to a more micro level. Is that a governing factor at this point?

Tom McFall - O'Reilly Automotive, Inc. - EVP of Finance, CFO

Michael, this is Tom. I think we are always in that situation; where we have a high level of the market share and we have mature stores, there's not the large amount of market share to go out and grab. So if we are in Missouri or Oklahoma, those store accounts have been relatively stable for a long period of time versus markets that were newer and where we are underpenetrated give tremendous opportunity to grow in those markets. So that's the typical results that we would see.

Michael Lasser - UBS - Analyst

My second question is on the situation in Chicago. How many other opportunities like that exist, where if you add a DC it will free up and perhaps lead to some nice gains?

Tom McFall - O'Reilly Automotive, Inc. - EVP of Finance, CFO

There is another one or two that I can think of that we don't have any immediate plans for. But over time, I think it will make sense for us to possibly relieve a DC here or there from a store count perspective and allow them to better leverage their costs through better efficiency and then put us in a better market position in some large markets. So I would say that over the next five years, you will see us do something like this another time or two.

Michael Lasser - UBS - Analyst

And my last question is can you remind us of the cadence of how the end of the summer flowed last year? Was it -- or the third quarter? Was it pretty consistent across each month? Just to get a sense of do you face some more difficult comparison as the quarter goes on. Thank you so much.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Yes, last year, of course we didn't have any real standout quarters from a comp store sales perspective, last year third quarter. I would say that August was slightly the best month of the quarter, but it wasn't much difference, and all three months generating the comp store sales that we had were pretty low comp months.

Michael Lasser - *UBS - Analyst*

Okay. That's very helpful. Thank you.

Operator

David Gober, Morgan Stanley.

David Gober - *Morgan Stanley - Analyst*

Good morning, guys. Thanks for taking the question. Just a quick follow-up on inflation. It sounds like you guys are seeing fairly steady trends there. And I know GPC has talked a little bit more about seeing some headwinds to inflation, and the CPI data out there has been a little bit weaker. Just curious if you guys have any idea why there'd be some inconsistency across kind of (inaudible) sources there.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

I think what you will see is that certain categories, especially more DIY categories that are more oil and commodity-based, have seen a little bit more pressure and that could be just the difference in our mix.

David Gober - *Morgan Stanley - Analyst*

Okay, that's helpful. Just on the VIP acquisition, it sounds like that's going along nicely, as planned. Just curious when you'd expect to start to explore more greenfield store rollouts there, what the distribution plan looks like and how far along you are there.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Well, we are in the process now of exploring more greenfield expansion up there. It's, of course, a market that's not easy to expand in because it's very congested. A lot of people, which is a great opportunity for us. But we are working on that right now.

We have not yet defined our distribution strategy up there publicly, and will be over the next few months. But we are in the process right now of evaluating what our long-term distribution strategy up there will be. Because the VIP acquisition was an acquisition that was strategic from the perspective that it put us in a position to grow into the Northeast. Those stores will help leverage our distribution costs as we put ourselves in a position to grow up there, but we are not ready to announce what our long-term plan is up there yet.

David Gober - *Morgan Stanley - Analyst*

That makes sense. Do you think as you head into 2014 that the growth -- given that you now have a base to grow off of, that that's going to actually accelerate the overall store growth potential for the next couple of years?



Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

For some time to come, more than a couple years, we will be growing in the Northeast. So yes, starting -- 2014, there won't be much growth up there, but there will be a little bit maybe towards the tail end of the year. But for several years to come, I think part of our growth will be up in the Northeast.

David Gober - *Morgan Stanley - Analyst*

Sorry, I guess where I was coming from is, is it a matter of shifting growth to the Northeast versus actually moving from 200 to 250 or 300 stores? That was kind of the direction of the question there.

Tom McFall - *O'Reilly Automotive, Inc. - EVP of Finance, CFO*

Basically, we want to make sure that we have capacity in all of our DCs to seize the best opportunities. We haven't determined what store count we are going to do next year and the following year, but we will let you know on the -- easily the third quarter call.

David Gober - *Morgan Stanley - Analyst*

Great. Thanks, guys.

Operator

Daniel Hofkin, William Blair & Company.

Daniel Hofkin - *William Blair & Company - Analyst*

Good morning. So just a question regarding the, I guess, core O'Reilly versus converted CSK. In general, I know the do-it-for-me business tends to be lower gross margin. But I'm curious to what degree you can say whether the CSK ramp of their commercial business is hurting or helping your overall gross margin, given that it's my understanding the improved hard parts mix theoretically could be a benefit.

Just be interested in how much of your overall gross margin improvement is coming from core. Is it all the core or is some of it also from converted CSK? And what that says about your long-term gross margin opportunity. Thank you.

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Of course their gross margin dollars come from the growth in both, but the rate, of course, is lower on the do-it-for-me side. As we expand our do-it-for-me business in the CSK stores, it does pull our rate back up a little bit. Although we have the mitigating factors of the acquisition cost benefits that Tom referred to earlier, and then of course the better pricing management that we are trying to execute. But there's no question that the do-it-for-me business is at a lower gross margin rate than the DIY business.

Daniel Hofkin - *William Blair & Company - Analyst*

Okay, so even though you are adding more hard parts to CSK, the net effect is that it is pulling down your overall gross margin. Therefore the improvement in the core O'Reilly is even larger than what is implied by the rolled-up number.

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Well, no, what I would say is that we have a mix shift there. Also what comes into it is as we work our way up call lists, as you sell more of the hard parts, we tend to have better margins with our commercial customers. And then the acquisition cost, improvements and pricing management are chainwide.

So I wouldn't say that the math on the numbers you are pushing gives us a significantly different improvement in gross margin in core as opposed to acquired markets.

Daniel Hofkin - *William Blair & Company - Analyst*

Okay, thanks very much.

Operator

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

Greg Henslee - *O'Reilly Automotive, Inc. - President, CEO*

Thanks, Robert. We would like to conclude our call today by again thanking our 60,000 team members (technical difficulty) commitment to providing the best customer service in our industry. It is your hard work and dedication to serving our customers that drives the outstanding financial performance we delivered this past quarter.

I would also like to thank everyone for their time in attending to our call today. We look forward to reporting our third-quarter results in October. Thank you.

Operator

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

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