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EDITED TRANSCRIPT

ORLY - Q4 2012 O`Reilly Automotive Earnings Conference Call

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OVERVIEW:

Co. reported 2012 sales of $6.2b and adjusted diluted EPS of $4.75. 4Q12 adjusted diluted EPS was $1.14. Expects 2013 sales to be $6.6-6.7b and diluted EPS to be $5.57-5.67. Co. expects 1Q13 diluted EPS to be $1.30-1.34.

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CORPORATE PARTICIPANTS

Tom McFall *O'Reilly Automotive Inc - CFO*

Greg Henslee *O'Reilly Automotive Inc - CEO*

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

CONFERENCE CALL PARTICIPANTS

Colin McGranahan *Sanford C. Bernstein & Company, Inc. - Analyst*

Dan Wewer *Raymond James & Associates - Analyst*

Scot Ciccarelli *RBC Capital Markets - Analyst*

Daniel Hofkin *William Blair & Company - Analyst*

Michael Lasser *UBS - Analyst*

Alan Rifkin *Barclays Capital - Analyst*

Gary Balter *Credit Suisse - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Christopher Horvers *JPMorgan Chase & Co. - Analyst*

PRESENTATION

Operator

At this time, I would like it welcome everyone to the O'Reilly Automotive fourth quarter and full year 2012 earning release call. All lines have been placed on mute to prevent any background news. After the speaker's remarks there will be a question-and-answer session.

(Operator Instructions)

I will now turn the call over to Tom McFall, Chief Financial Officer. Please go ahead.

Tom McFall - *O'Reilly Automotive Inc - CFO*

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 under the Safe Harbor for forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. You can identify those 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 and 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, 2011, for additional factors that could materially affect the Company's financial performance. These forward looking statements speak only as of

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the date they were made, and the Company undertakes no obligation to publicly update any forward looking statements whether the result of new information, future events, or otherwise, except as required by applicable law. At this time, I'd like to introduce Greg Henslee.

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts fourth 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, is also present.

As many of you know, in mid December, we announced that Ted Wise transitioned from his long-time role as Chief Operating Officer to Executive Vice President of Expansion. Ted continues to be a very actively involved member of our executive management team, and now he is specifically focusing his time and efforts in the areas of new store growth, maintaining our existing installed store base, and new market expansion. Ted's level of passion for the business has not diminished a bit, and he remains extremely committed to the success of our Company, although he will be working a slightly reduced schedule.

Going forward, Ted will continue to attend our quarterly conference calls. However, he is currently enjoying his new role and reduced schedule by taking a well deserved vacation, so he is not present for today's call. We also announced in December that Jeff Shaw was promoted to the position of Executive Vice President of Store Operations and Sales. Jeff has been an O'Reilly team member for 24 years, beginning his career at the store level. He held numerous store, district, and regional manager positions throughout our Company, before being promoted to Vice President of Store Operations in 2003 and then Senior Vice President in 2004. Many of you have met Jeff, and have heard him present at our O'Reilly analyst days. Jeff will be participating in our conference call today and will be an ongoing participant on our quarterly calls.

I would like to begin the discussion of our fourth quarter and full year 2012 results by thanking our 53,000 members of team O'Reilly for their hard work and commitment to our success. During the fourth quarter, we continued to face a very challenging demand environment. However, your dedication to providing the best customer service in our industry yielded a 4.2% increase in comparable store sales, which exceeded our guidance range of 2% to 4%. For the year, your efforts have led to a 3.8% increase in comparable store sales, and by growing profitable sales, and prudently managing our expenses over the long term, we generated another annual operating margin of 15.8%, exceeding our prior year's record adjusted operating margin of 14.9%. Your relentless focus on excellent customer service resulted in a 23% increase in fourth quarter adjusted diluted earnings per share, marking our 16th consecutive quarter of adjusted diluted earnings per share growth of 15% or greater, and our fourth consecutive year of annual adjusted diluted earnings per share growth of 20% or greater. It takes a tremendous team effort to generate these types of record breaking results, and I would like to thank each of you for your hard work and your unrelenting focus on providing outstanding service to each of our valued customers. The great service you provide remains the backbone of our continued success.

During the fourth quarter, our sales continued to be negatively impacted in our central and northern Midwest markets, by unseasonably warm weather. These areas represent approximately 25% of our comparable store sales base, and the impact on our fourth quarter comp was approximately 200 basis points, consistent with the drag these areas had on our third quarter results. However, we did see sequential improvements in these markets as the quarter progressed. And these areas finished the year with solid momentum, consistent with the rest of the chain. All months during the quarter were positive, and performed at or above our expectations, with October and November performing stronger than December. We expected December to be a challenging month, driven by the headwind of the timing with the holidays with Christmas falling on a Tuesday this year, compared to a Sunday last year, coupled with a pressured consumer who has to juggle holiday spending with vehicle maintenance during this period every year.

Both the do-it-yourself and professional customer comps were positive contributors to our fourth quarter results. Sequentially, from the third quarter to the fourth quarter, DIY and professional customer comp improvements were very similar. The acquired stores continued to out-comp the core O'Reilly stores, and continue to be accretive to overall comp results. However, the core O'Reilly stores generated solid comps during the fourth quarter, finishing the year strong. Overall, average ticket continues to be the primary driver of our comp results relating primarily to business mix. The professional side of our business continues to grow at a faster rate than the DIY side, driven by market share gains in the acquired markets. However, during the fourth quarter, overall traffic counts were positive, representing the strongest traffic count results we experienced all year.

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For the full year, our comparable store sales results of 3.8% finished in the lower third of our original guidance range of 3% to 6%. Looking back at the full year, 2012 got off to a strong start as early Spring weather in most of our markets, pulled Spring business from the second quarter into the first quarter. But this created a significant headwind in the second and third quarters, as the mild Winter significantly reduced wear and tear on replacement parts. However, throughout the year, we remained focused on providing top-notch customer service, and were able to finish the year on a positive trend. Overall, the macro environment continues to be challenging and a high degree of economic uncertainty remains. However, we have not changed our belief that the fundamental drivers for long-term growth in our industry remain intact.

Total miles driven in the United States increased 60 basis points through November of last year, while gas prices remained relatively flat year over year through December. Over the course of 2012, unemployment rates improved slightly, finishing the year at 7.8%, down from 8.5% at the end of 2011. We expect that these historically high rates will decline over time, and the resulting increase in commuter miles driven will be a tailwind for demand in our industry. We also expect to continue to see an ongoing aging of the vehicle fleet due to better engineered vehicles capable of staying on the road for longer periods of time, and this will also contribute to the overall industry demand. As we look forward to 2013, we are cautiously optimistic that weather will normalize.

We expect year over year miles driven to modestly increase, driven by slowly improving unemployment levels, although we expect the consumer will continue to be under pressure throughout the year. We do not anticipate that inflation will be a major factor in our 2013 results. However, we do expect that our comparable store sales will continue to be driven by average ticket increases, as we expect to again grow our professional business at a faster rate than the DIY business, especially in the acquired markets. In addition, as we have seen in the industry over the past 10 years, the better engineering of the overall vehicle fleet requires less frequent maintenance than we've historically seen, but the repairs continue to be more costly, resulting in higher ticket averages. Based on these factors, for 2013 we are projecting full-year comparable store sales to increase in the range of 3% to 5%.

For the first quarter of this year, we expect the solid sales trends we saw in the fourth quarter of 2012 to continue. So far this quarter, we have been pleased with our comparable store sales results. However, we are facing our most difficult comparison of the year with a 7.4% increase in the first quarter of 2012. As a reminder, leap day added approximately 130 basis points to our first quarter 2012 comp results, which will be a significant headwind in the first quarter of this year. We also face a headwind due to the timing of the Easter holiday, which fell in the second quarter of 2012, but will fall in the first quarter of this year. We expect that this will create a headwind of approximately 20 basis points for the quarter.

In light of these factors, along with the pull-forward of Spring business into the first quarter of 2012 as a result of the early Spring weather in most markets, we are guiding to first quarter comparable store sales in the range of flat to positive 2%, which equates to an increase of approximately 1.5% to 3.5%, excluding the impact of leap day and the timing of the Easter holiday. As we look past the top line in our sequential results for the fourth quarter, we saw improved gross margin, driven by strong merchandise margins as we focused on growing profitable sales. Somewhat offset by higher distribution costs, as a result of less leverage on a seasonably lower sales volume. On a year over year basis, we saw similar improvements in distribution efficiencies and shrink that we saw throughout 2012. For the full year, our gross margin of 50.1% strongly exceeded our original guidance range of 48.9% to 49.3%.

During 2012, the pricing environment remained rational, allowing us to focus on growing profitable sales. Our merchandise group has worked diligently throughout the year at reducing acquisition costs, and our distribution systems teams have focused on efficiency improvements, and our store teams have focused on profitable sales growth, and reducing shrink. Overall, we've worked extremely hard to expand our gross margin throughout the year, and we're proud of the 110 basis point improvement in the year over year gross margin results. For 2013, we expect gross margin to be relatively flat, and are guiding to full-year gross margin in the range of 49.9% to 50.3%. Our expectation is that we will continue to incrementally improve acquisition costs with these gains being offset by a higher mix of professional customer business, which yields a lower gross margin than our retail business.

We expect to continue to improve our distribution efficiencies, especially in our newer DC's, but this improvement will be offset by a reduced benefit from capitalized distribution costs, as compared to 2012, related to the store inventory expansion initiatives we completed throughout the year. We would anticipate maintaining our solid shrink results throughout the year. On the expansion front, we again had a very busy year. We accomplished our goal of 180 net new stores, and we are very well positioned to meet our goal of 190 net new stores for 2013. As we previously announced, we opened our 4,000th store on January 19 of this year in Tampa, Florida, marking another significant milestone in our Company's

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history. As we discussed on our third quarter conference call, we are moving forward with the construction of a distribution center in Lakeland, Florida, which will support our expansion further south into the sunshine state. Finally, I would like to spend a little time discussing our acquisition of the auto parts and distribution related assets of VIP Parts, Tires, and Service.

VIP is based in the state of Maine, and operated 56 stores throughout Maine, New Hampshire, and Massachusetts. VIP will continue to operate the service bays at these 56 locations, and will operate -- and we will operate the parts stores. While this is our first acquisition of a regional chain that is a combination service and parts store, we have several locations throughout our existing store base where our store is connected to a service center. While this combined format is clearly not our preference, we feel confident in our ability to execute our dual market strategy in these locations and are pleased to be the primary supplier for the VIP service centers. Over the next six to eight months, we will work to reset our portion of the store, add our signage and planograms, implement our systems and introduce a significantly more effective inventory mix. During the same period, we will modify the existing distribution center, to significantly increase the service to those stores, and to improve their SKU availability, as well as increase the number of deliveries made from the DC to the stores.

Once the store and DC conversion is complete, we will work to aggressively build a professional customer side of the business in these markets. Based on the time required to convert these locations to our business model, we do not expect to see meaningful profitability from these stores in 2013. However, we will be well positioned to grow our market share in 2014 from these locations, and begin additional expansion into the northeast. In addition to the conversion of the VIP stores to the O'Reilly model, we'll continue to actively look for additional bolt on acquisitions in our existing markets, as well as new markets.

Before I turn the call over to Jeff, I would like to once again thank our team members for another record breaking year in 2012. Your focus on the fundamentals of providing unsurpassed levels of customer service, in the midst of a very challenging macro environment, has allowed our Company to continue to gain market share. And I want to thank you all of you for your commitment to our Company's continued success. I'll 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. It's an honor to get the opportunity to represent our 53,000 hard working and dedicated team members on this call. When Greg asked me to begin participating on these calls, I was extremely humbled. What he didn't tell me at the time was Ted wouldn't be here for my first call, so I'd immediately have to try and provide the level of color regarding our operations that Ted has provided for so many years. So I guess I'll begin today by thanking Ted for this opportunity. Ted, not sure if you're listening in, but sure hope you're having a great time in South America.

Our business has always been and always will be about providing consistent and outstanding customer service. We sell parts, but we're really in the customer service business. I'd like to focus my comments today on assessing our operational results for the year, on the investments we made during the year to improve our service levels, and on the expected impact these investments will make as we look forward into 2013.

During 2012, we generated a fairly respectable 3.8% increase in comparable store sales. In the midst of a challenging year for our industry, these results were within our guidance range, but below our expectations. Thanks to the hard work of our team, we finished the year beating our forecasted fourth quarter comparable store sales guidance range, which provides us solid momentum coming into 2013.

For the year, our SG&A per store was higher than we expected, finishing at an increase of 2.2% over 2011, and above our beginning of the year guidance of 1.5% to 2% growth. For the fourth quarter, our SG&A as a percentage of sales was 35.4%, a deleverage of 10 basis points over the prior period. And for the year, we finished with 34.3%, a deleverage of 20 basis points over the prior year. The deleverage was primarily due to higher store level payroll and benefits. As I mentioned earlier, we're in the business of providing excellent customer service, and we've been able to profitably grow our business over the long term, by being equally committed to providing great service in periods of strong industry growth, as well as in times of less robust growth. Our customers, whether DIY or professional shops are focused on their bottom line, not ours, and expect great service every time they call or walk in our stores. Therefore, we always need to be staffed to provide that top notch and consistent service we've always been known for over the years.

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As Ted's mentioned in the past, we do gradually adjust staffing levels in our stores in reaction to the sales environment. However, we don't make dramatic changes resulting in poor service levels in response to short term periods of slower demand. As a commitment of this to always providing great customer service, we've always been able to build market share in both strong and less robust demand environments, as demonstrated by our 20 consecutive years of comparable store sales increases. For 2013, we expect a more normalized year, and expect that the relationships that we strengthened and the new ones we built in 2012 will yield even stronger market share gains. In the acquired markets, we continue to see impressive improvements in our ability to execute our dual market strategy. Day by day, we're improving our store level leadership in these markets, and as a result, our ability to provide consistent, excellent customer service continues to improve.

The continued strong comparable sales performance of these acquired markets is validation that our ability to consistently execute our dual market strategy is getting better. However, we're not there yet. We're encouraged by the growth we see in these acquired markets, but we feel that we have strong growth ahead of us, and we're excited about the continued opportunities that 2013 will bring for these markets.

As Greg mentioned, we opened 180 net new stores in 2012. As in the acquired stores, for a new store to perform well, it must have great leadership. With our expanded footprint now across 42 states, we've been able to spread our organic growth over a much wider area and, therefore, we can draw from a deeper bench of future leaders that we've developed internally over time. By placing well trained and aggressive managers in our 2012 new stores, these locations hit the ground running and performed above expectations.

We continue to work throughout 2012 on identifying and developing the next group of solid leaders, and are confident that our 190 net new stores in 2013 will be staffed with great managers and teams, ready to provide industry leading customer service. In addition to great leadership, great service requires industry leading access to the parts customers need. During 2012, we increased our inventory per store by $42,000, representing a total investment of $155 million. We can't stress enough that this is store level inventory deployed closest to the customer. As we plan for 2012, we felt that this investment was necessary to maintain our superior in stock position.

This enhancement -- this investment entailed the enhancement of SKU breadth stocked at every store. We also evaluated and enhanced our hub store network, by adding 48 hub locations representing a 24% increase over 2011. These additional hubs increased our store level expenses. However, we firmly believe that this additional expense along with the additional store level inventories, has helped build our sales momentum in the latter portion of the year, and will generate solid returns in 2013. Over time, there's been a dramatic increase in the number of makes, models, and years of vehicles on the road.

The resulting expansion of SKUs has made it nearly impossible to stock at the store or hub level, all of the parts a store needs to provide top notch customer service. That's the reason why our 24 regionally deployed DCs play such a vital role in our long term ability to provide better customer service than our competition. At the same time our DCs were supporting our store level inventory build in 2012, which was a tremendous accomplishment in and of itself, our DCs and hub networks stepped up the level of service provided to our stores by expanding our weekend deliveries. This increased level of service greatly improved our ability to find -- provide those hard to find parts to our customers over the weekends, significantly improving our DIY service levels, as well as helping our professional customers open on the weekends. I want to take this opportunity to thank our DC leadership team for supporting this higher level of service to our stores, while at the same time operating more efficiently and contributing to our improved gross margin.

I'd like to finish up today by quickly mentioning our upcoming managers conference. Each year, we have the opportunity to get all of our store managers, DMs, RMs, and DVPs, as well as our sales and DC management teams together in one place at one time. This is a great opportunity to reinforce that our ability to grow market share truly hinges on providing that top notch customer service, as well as the importance of continually identifying, mentoring, and promoting the next generation of leadership. And most importantly, perpetuating the O'Reilly culture. We'll use the conference as a springboard to continue our solid sales momentum from the fourth quarter, and further leverage the investments we've made in building customer relationships and product availability. Once again, it's an honor to represent all of our team members on this call. Our success has always been the result of the great service each of them provide to our customers every day. And I can't thank them enough for their hard work and dedication. Now I'd like to turn the call over to Tom.

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Tom McFall - *O'Reilly Automotive Inc - CFO*

Thanks, Jeff. Now we'll take a closer look at our results and add some color to our guidance for 2013. Comparable store sales for the quarter increased 4.2%, on top of the prior year's comps of 3.3%. DIY and professional comps were again both positive for the quarter, with professional contributing a larger percent to our growth. Average ticket growth for both the DIY and professional sides of the business was again a driver to the comp improvement. For the quarter, sales increased $97 million, comprised of a $57 million increase in comp store sales, a $39 million increase in non comp store sales, a $2 million increase in non comp non store sales and a $1 million decrease from closed stores.

For the year sales increased 7% to $6.2 billion, primarily driven by our 3.8% comparable store sales growth, which was on top of the prior year's comps of 4.6%. Our sales guidance for 2013 is $6.6 billion to $6.7 billion. Our comparable store sales guidance is 3% to 5%, driven by expected strong growth in the professional side of the business, especially in the acquired markets, and moderate growth in the DIY side of the business. Gross profit for the quarter increased 50 basis points over the prior year. We were able to maintain our strong merchandise margins in the fourth quarter, and drive an increased gross margin percentage against the tough compares versus the prior year, through distribution efficiencies, improved shrink, and a benefit from the amount of capitalized distribution costs. As a result of our initiatives to put more inventory closer to our customers, as Jeff has already discussed, we added significantly to our store level inventories during the year.

The cost to move this inventory into a sale position in the stores is capitalized on our balance sheet at our overall distribution rate. However, the stock up inventory -- excuse me, moving the stock-up inventory into place is more efficient than normal orders. So we saw a benefit in our gross margin of approximately 15 basis points for the quarter.

For 2013, we expect gross profit as a percent of sales to be 49.9% to 50.3% of sales versus 50.1% in 2012. We expect the mix of professional sales to continue to grow faster than DIY sales, which will put downward pressure on our gross profit as a percent of sales, but we expect to offset this pressure with incremental gains in acquisition costs.

We expect to continue to drive improved distribution efficiencies that will offset the year over year headwind as we calendar the 2012 benefit from capitalized distribution costs. And our DC and store teams have established a great track record of controlling shrink, and we are expecting to maintain our solid shrink results next year. SG&A for the quarter was 35.4% of sales versus 35.3% in the prior period. SG&A for the full year of 2012 was 34.3% versus 34.1% in the prior year. The 2011 SG&A excludes the benefit from the former CSK officer claw-back. Average SG&A per store for 2012 increased 2.2% over 2011, primarily the result of customer facing store costs Jeff discussed earlier. Looking forward to 2013, we expect to see per store SG&A excluding the acquired VIP stores which will require some time to convert to the O'Reilly business model, to increase between 1% and 1.5%, as we expect to leverage our existing payroll infrastructure and drive market share gains that outpace the growth in SG&A.

Operating margin for the quarter was 15% of sales, representing a 31 basis point improvement over our 2012 adjusted operating margin, as we saw strong gross margin improvements more than offset the deleverage in SG&A. For the year, we achieved an operating margin of 15.8%, which represents a new record for our Company and the achievement one year earlier than expected of the 15% operating margin goal we set when we acquired CSK in 2008. Our operating margin guidance for 2013 is 15.8% to 16.2% of sales, with the improvement expected to come from leverage on SG&A, particularly leverage on store payroll and occupancy costs in the acquired CSK stores. The tax rate was 37.6 % of pretax income for the fourth quarter, and 37.8% for the full year of 2012. For 2013, we're expecting the tax rate of approximately 37.4% of pretax income, based on tax planning strategies we currently have in place.

Diluted earnings per share for the fourth quarter, was $1.14 per share, which represents a 23% increase over adjusted EPS of $0.93 in the fourth quarter of 2011. For the year, EPS was $4.75 per share, which represents a 25% increase over the prior year. As a reminder, adjusted diluted earnings per share for 2011 excludes the onetime charges from our financing transactions in the first quarter of 2011, and the benefit from the former CSK officer claw-back in the fourth quarter of 2011.

Moving to the balance sheet, we continue to make great progress in improving the productivity of our inventory net of payables. For the year, our inventory turnover net of payables was 7.4 times, versus 3.4 times in 2011. At the end of 2012, our average inventory per store is up 8% to $573,000 versus $531,000 at the end of last year. In 2013, we project inventory per store to be flat, as we continue to identify opportunities to redeploy our investment into more productive inventory.

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Our vendor financing program has been extremely successful as the catalyst to reducing overall supply chain costs, and improving the productivity of our net inventory investment. At the end of 2012, our accounts payable to inventory ratio was 85%, which is another great improvement over the prior year ratio of 64% and our expectation from the beginning of the year to finish 2012 in the 70% to 75% range. In 2013, we expect our gains in AP percentage to moderate, as we expect to continue to make more incremental improvements in vendor terms, but also face a headwind from the payments for the store level inventory build in 2012. As a result, we'd expect our AP'd inventory percentage to be relatively flat in 2013.

Capital expenditures for 2012 were $301 million, a reduction of $27 million from 2011 primarily due to the opportunities to lease more existing sites for new store growth versus owned stores. In 2013 we expect a higher CapEx spend in the range of $385 million to $415 million driven by a planned increase in new store openings from 180 new stores in 2012 to 190 stores in 2013, including the higher mix of owned stores, the construction of a DC in Lakeland, Florida, and the conversion costs associated with the acquired VIP stores.

At the end of the fourth quarter, our adjusted debt to adjusted EBITDA was 1.83 times, which ranks below our long term targeted leverage range of 2 times to 2.25 times. While we've incrementally increased our leverage over time, and expect we'll enter our leverage range this year, we remain very committed to maintaining and improving our investment grade ratings.

For the year, free cash flow improved 20% to $951 million, versus $791 million in 2011. This strong improvement was driven by increased net income, an improvement of $359 million in net inventory investment, and reduced capital expenditures. While we expect to maintain the working capital gains we've made over the past two years, we do not expect to generate the same dramatic improvement in our net inventory investment. As a result of this headwind to free cash flow for 2013 combined with a planned CapEx increase in spend of $100 million, we anticipate generating free cash flow of $450 million to $500 million in 2013. With free cash flow this year of $951 million and the net proceeds from incremental borrowings, we were able to aggressively and opportunistically execute our share buyback program. During the fourth quarter and through the date of our earnings release, we repurchased approximately 5.5 million shares, with an average price of $88.45. This brings our cumulative share repurchase since the inception of our program in January of 2011 through yesterday to 34 million shares with an average price of $76.28. We continue to believe that the best use of our free cash flow is to reinvest in our business by maintaining and growing our store base, and consolidate the industry through accretive acquisitions.

To the extent these opportunities do not use all of our available cash in 2013, we intend to continue to prudently execute our share buyback program with the $248 million of cash in the balance sheet at the end of the year, and additional free cash flow generated during the year. Our guidance for both the first quarter and full year takes into account the shares repurchased through yesterday, but does not reflect the impact of any potential future share repurchases. For the first quarter, our diluted earnings per share guidance is $1.30 to $1.34 a share. For the full year, our diluted EPS guidance is $5.50 (sic-see press release "$5.57") to $5.67 a share. At this time I'd like to ask the operator to return to the line, and we'll be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Colin McGranahan, Bernstein.

Colin McGranahan - *Sanford C. Bernstein & Company, Inc. - Analyst*

First question just on the expansion. You know, moving into Florida, opening up the Lakeland DC and pushing farther south it's obviously a newer market for you, and then moving into the northeast, as well. Can you talk a little bit about what you're seeing in Florida so far as you expand there and expectations for the northeast just in terms of store performance, difference in the competitive environment, things like that?

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Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, it's still early in central Florida. We're not into southern Florida yet. We are in, you know, the northern Florida, panhandle and have been for a while. And our stores there do very well. It's a pretty good real estate market for us. Our exploration so far has yielded good results from a location standpoint. And we've got several stores going in down there.

And we expect to do really well in the Orlando and Tampa markets, and several small markets around that area. So yes, we're excited about it. We think it's a great opportunity for us. And we look forward to having the facility in Lakeland that will allow us to get further south into Florida. In the northeast, it's way early. You know, we've done a lot of looking around up there as we've contemplated acquiring a company or two up there. As you know, we acquired VIP.

You know, a lot of cars, a lot of traffic. You know, the real estate market obviously is a little more difficult. But for the most part, where we would locate the majority of our stores outside of the major-- the major metro areas, you know, we wouldn't put parts stores in downtown Manhattan for instance. It looks pretty good, we're excited about the opportunity to expand up there, and we'll use the VIP acquisition as a means for us to expand south out of the far northeast, and then we'll continue to use our existing store base to expand up into the northeast. And at some point in the future we'll be expanding our distribution capability in that area.

Colin McGranahan - *Sanford C. Bernstein & Company, Inc. - Analyst*

Okay. That's great. Thank you. Then just a quick followup on CSK. Can you talk a little bit about the relative performance differential, the stores in the middle of the country versus the west coast, and how that contributed to the overall comp?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

You know, I really don't have a -- the west coast obviously performs very well. And they -- they performed better than the core O'Reilly stores, although the core O'Reilly stores performed well. The upper Midwest stores were our poorest performing stores. And as I said in my prepared comments, that, the 25% of the stores that we comprise as maybe being the weather affected stores, you know, caused about a 200 basis point decrease in our overall comp performance. We would say that maybe the disparity between the non weather related stores and the weather affected stores would be somewhere above 700 basis points, something like that.

Colin McGranahan - *Sanford C. Bernstein & Company, Inc. - Analyst*

Okay. Great. Thank you very much.

Operator

Dan Wewer, Raymond James & Associates.

Dan Wewer - *Raymond James & Associates - Analyst*

Just to follow up on that comment about the gap between the cold and warm weather markets of 700 or 800 basis points. Did you also indicate in your prepared comments that by the end of the quarter those upper Midwest markets were performing in line with the Company average?

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Greg Henslee - *O'Reilly Automotive Inc - CEO*

They were comping better. You know, they weren't -- they would have been -- you know, it varies by region. If you put them as a whole, they would have been comping under the average. But they had sequentially improved significantly into December.

Dan Wewer - *Raymond James & Associates - Analyst*

Do you think that we have crossed the hurdle where the weather issues that have been impacting those markets are now behind us? And you know, when you look at 2013, are you expecting those markets to perhaps outperform your southwestern and western stores given that you see comparisons?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

You know, I -- Dan, it's hard to -- it's hard to really fully get our arms around the effect of the unusual Winter we had last year. To some degree, in many markets, a little bit of a soft Winter this Winter. You know, there's no question that extremes put pressure on automobiles. And there are some hardware failures that result from the cold and hot weathers and the roads that get potholes in them and so-forth. To answer your question, yes, I would expect those stores that have not performed well as the weather normalizes to perform much better on the easier comparisons. So yes, I think they will.

Dan Wewer - *Raymond James & Associates - Analyst*

Okay. And then just my followup question for Tom. You noted that you're not expecting any improvement in your payables inventory rate in 2013. I would certainly understand that the rate of increase could slow, but I'm surprised that you're not expecting any improvement. Could you again maybe, you know, walk us through the reasons for that?

Tom McFall - *O'Reilly Automotive Inc - CFO*

Well, the primary reason is -- is we're going to have to have some substantial gains to stay where we are. When we look at the math and we talk about the store level inventory build this year of $150 million, that when you add additional parts to the stores and that kind of mask, we're able to get special dating on those orders. You know, if we have year dating on those orders, that's come in through the numerator and the denominator at 100%, and they're going to come due this year. We're going to have to continue to make progress with our vendors through the financing program, and through other avenues to maintain that percentage. You know, and if we look back to the beginning of the year, our guidance was 70 to 75. You know, those stock-up orders helped us surpass that level this year. So we've got some work to do to stay where we are.

Dan Wewer - *Raymond James & Associates - Analyst*

It would not if your inventory per store is flat year-over-year in 2013, that would lead to faster inventory turns, right, and that mathematically would benefit the payables inventory rate?

Tom McFall - *O'Reilly Automotive Inc - CFO*

Well, you know, if you look at our days in payables, it's starting to get beyond where our turns are. It's more -- bigger drivers, when do those payments come due for non typical orders.

Dan Wewer - *Raymond James & Associates - Analyst*

Okay. Thank you.

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Operator

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

The commercial business has always been competitive. But just given the continued focus on the segment from Advanced and Auto Zone, are there any noticeable changes on the competitive front? And alternatively to that, is there a point where O'Reilly may have to accelerate some investments whether it's newer systems or more labor to continue to gain the kind of share that you have in that part of the business?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, yes, it's a competitive business. As I've said to many of you several times, you know, it's -- I've been doing this for a long time, I think it's always been a very competitive business. There's -- I can think of only a few markets over the years where we didn't have a competitor that was just tough and quality and did a good job. So you know, we're -- our role has always been to go out and identify the markets where there's a lot of commercial business and try to take market share. And it's not easy. So yes, I think the newer players in that -- in the commercial business coming in, you know, certainly adds another element of competition.

It hasn't really changed the way that we would go to market because the fundamentals that drive the relationship between a commercial customer and the parts store remain exactly the same. You know, the expectations are the same. We've always been able to build our business by meeting those expectations better than many of our competitors. And I think that -- I think we'll continue to do that.

From an investment standpoint, or the things that we can do to improve that, you know, it's -- over a number of years we've kind of transitioned the way we do that business. We were one of the first companies, I think, to allow our customers to electronically order from our stores.

Pre-Internet, or before the internet was mainstreamed as it is today, we put terminals in our customers' shops and had them electronically order parts from us. And I think we've been pretty innovative in the way that we managed those relationships over the years. And yes, I think that we'll continue to invest in innovation. I don't see any big game changer on the horizon that would require a significant investment by us to maintain those relationships.

I think the things that we see that we need to do, for instance 2012 where we increased our weekend deliveries. You know, some of our professional customers are open on weekends now, whereas back several years ago, maybe there weren't as many open on weekends. Or the national account type customers are open on weekends, and by increasing our weekend service out of our hubs and DCs to stores, it makes us a more effective supplier. And then just increasing the number of stores that are touched every day by a hub store or by a distribution center. And when I say by a hub store, many times the hub store itself is touched by the DC on a daily basis and the hub store touches the store. So in effect, the store has access to a distribution center breadth of inventory, and that's been very effective for us. So no, I wouldn't see anything that would change significantly. But we will continue to incrementally make investments as we see fit.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Got it. Thanks.

Operator

Daniel Hofkin, William Blair & Company.

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Daniel Hofkin - *William Blair & Company - Analyst*

Just a question about the comp outlook effectively doing the math, the full year guidance would imply something in the range of a 4% to 6% expectation across quarters two through four on average. Just wondering how much of that fairly substantial acceleration is due simply to the considerably easier comparisons, how much is due to either current or potential additional initiatives?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, it certainly -- we don't ignore the comparisons when we come up with our annual guidance. And having the easier comparison the second and third quarter will allow us to generate a little better comp than we would assuming that our comp trend continues to be what we think it will be. So, I think the things that we've done from an inventory deployment standpoint, by increasing our hub store count, product availability, all the things we can do to drive our business are going to be helpful. But certainly the comparisons in the second and third quarter are a consideration.

Daniel Hofkin - *William Blair & Company - Analyst*

Okay. And then from a gross margin standpoint, could you just review again sort of the maybe the biggest puts and takes in terms of obviously you've had really substantial gross margin improvement over the years including 2012. What, you know, kind of at the mid point would make you think about flat versus moderate improvement again in 2013?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

We look at big puts and takes, we would tell you, we kind of laid out why we came up with a flat gross margin. We're looking to really maintain the run rates we're at. We have some switch in distribution costs, some switch between professional business and acquisition costs. You know, our expectation is that pricing is going to remain rational within our industry, and there's not going to be a large, dramatic shift in how we and our competitors have priced over the last three, four, five years.

Daniel Hofkin - *William Blair & Company - Analyst*

Okay. And I mean as far as like the former CSK stores, obviously you're seeing the strongest growth in the commercial business there, as well. But, that said, is there a gross margin benefit to kind of the increasing the mix of hard parts within the business compared to what it was a couple of years ago?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

That's definitely the case. In general, hard parts carry a better margin as commodities are on the low end of our margin spectrum. So as we've added more hard parts both on the professional and the DIY side at CSK, that's helped to offset the pressure from giving professional shops volume discounts.

Daniel Hofkin - *William Blair & Company - Analyst*

Got it. Thank you very much. Best of luck in the first quarter.

Operator

Michael Lasser, UBS.

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Michael Lasser - *UBS - Analyst*

The spread between your comp and that of your competitors that have reported in the last several weeks seem to have expanded quite a bit. Do you have a view or a hypothesis on what drove the expansion? How much do you think it was due to the geographic differences versus some of the initiatives that you laid out?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

You know, it's really hard to quantify for us, Michael. You know, we're -- we're out there, and I've got Jeff sitting across the table from me. He manages a lot of, you know, great team members that wake up every day trying to take market share from our competitors. And I feel like we're pretty effective. It's -- you know, we work hard at it. I think this fourth quarter we worked extremely hard at focusing on growing quality sales.

You know, we could grow our sales faster if we were not as prudent when it comes to maintaining the price at which we sell products for and which we're very cognizant of the gross margin at which we sell products. So what I would say is we're -- we're out there pedaling as hard as we can and trying to gain as much market share as we can. And you know, I think our competitors are doing the same thing. You know, it's just hard for me to speak to their results compared to ours. And you know, the causes of maybe their comp softness as compared to ours.

Michael Lasser - *UBS - Analyst*

That's helpful. And the second question I had is over the course of the last few quarters, you've seen some particular weakness in some categories that are typically purchased out of replenishment. As the cold weather has set in, have those categories gotten better, and do you expect to see some pent up demand released over the next few periods?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Yes. I -- I've said in a few -- when I've met with a few analysts in just different venues that I would expect that some of the parts that didn't get replaced last winter that were parts that would typically fail in extreme weather would either fail, for instance, batteries that didn't fail in the wintertime, a lot of them failed last summer during the heat. They'll fail this winter. Our battery business in 2012 was really good. I would expect that some of the chassis parts that have lived a little longer life than they really should have based on them failing due to weather extremes, that we'll have maybe a little pickup there. Maybe some ignition and brake -- brakes has been a little soft with the -- they're not being as much weather affected corrosion type stuff as you might see otherwise. So yes, we would expect to see pickup in some categories as the weather normalizes.

Michael Lasser - *UBS - Analyst*

Just to follow up on that, in the colder weather market, are those categories -- are what improved?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, I think that everything has done a little better there at the end of the quarter. Yes, we saw -- the one that sticks out in my mind is we've seen a significant improvement in our performance on batteries.

Michael Lasser - *UBS - Analyst*

Okay. Great. Thank you very much and best of luck with the year.

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Operator

Alan Rifkin, Barclays.

Alan Rifkin - *Barclays Capital - Analyst*

It was mentioned that your operating margin in 2012 of 15.8 was achieved one year earlier than you had originally planned. Looking back at the last four years since you acquired CSK, and I'm sure it's a function of many things, but is your ability to get to that operating margin a year earlier more a function of revenues that are exceeding your plan or greater synergies, or greater expense reductions? Can you maybe just shed some color on that?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

There's several contributing factors. And I'll make a comment and, Tom, you may have some comments too. Obviously growing our revenue out there has been helpful. You know, but the synergies from a product acquisition standpoint and maybe a mixed standpoint and also some improvements that we've made in the way we deploy products and some of our private label branding, those things are significant contributors. Tom, I don't know if you have a comment on which one you think is the biggest contributor?

Tom McFall - *O'Reilly Automotive Inc - CFO*

When we look back at our model when we bought CSK, the opportunity from a scale standpoint to reduce our acquisition cost was quite a bit more than what we thought. We've done a little bit better on the expenses than we thought. And sales continue to be an item that we're very pleased with. But as Jeff mentioned in his prepared comments, we still have a lot of opportunity to improve our market share on the west coast.

Alan Rifkin - *Barclays Capital - Analyst*

Okay. On the last call, you guys were kind enough to give us longer term expansion opportunities out of Lakeland. Would you be able to shed some color on how many stores, two, three, five years you guys think you can have in the new market of the northeast?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

You know, I would rather not speculate on that. We've not planned our distribution strategy up there yet. You know, we'll have a lot of stores up there, but I really I would be completely speculating to give you a count. And considering that we've not planned our distribution strategy, and haven't done all the detailed market analysis that we'll need to do to define where we put DCs, how many DCs how many stores they'll service, I would rather save that for another day.

Alan Rifkin - *Barclays Capital - Analyst*

Okay. Hey, one last one if I may, Greg. If you take your commentary over the last four years in term of the CSK stores year in and year out, outperforming the legacy stores, our math would tell us that those stores today are doing 1.6 and 1.7. I know that in the past, your statement has been our goal is to get them to 1.8. Does there come a point in the not too distant future or maybe you revisit the longer term revenue on the revenue side for those former CSK stores?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, you know, we threw that 1.8 number out there early on just as a speculation as to where we thought those major metro market stores could get based on our experience in major metro markets in the core O'Reilly stores. You know, we've never felt like that we would rest when we got to

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1.8 because we obviously are going to try to gain as much market share as we can. Yes, we gained a lot of market share in the western CSK stores. The upper Midwest, Chicago, Detroit stores the gains there have been somewhat affected by the weather events that us and our competitors have talked about to some degree.

So if I carve those out and look just at the regular CSK stores, we've come a long way in getting to the average that we talked about. But yes, at some point we may talk about a different -- a different target. But again, the idea is there's -- this target is just early on was just to give us some idea for analysts as to where we thought we could take the majority of those stores. It's not an internal target by any means. Our internal target is to gain as much market share as we possibly can, and it's very -- there's a very detailed evaluation on a by store basis as to what we feel like our market entitlement should be. And our store managers and district managers and regional managers are out there today striving to get us to that point.

Alan Rifkin - *Barclays Capital - Analyst*

Okay. Thanks, Greg. And congratulations on an outstanding year.

Operator

Gary Balter, Credit Suisse.

Gary Balter - *Credit Suisse - Analyst*

Just a question Greg and David and Tom and everybody. Your results kind of in the middle of last year kind of slow down and joined the pack. And since then you've got them back to doing much stronger results than we've seen from the other public competitors at least. What changed in your mind? Like was there a refocus on maybe operational excellence or could you talk about what got you re-motivated and we're seeing in the results?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Well, we didn't -- we don't feel like we ever weren't motivated. But we've worked really hard to drive sales in the fourth quarter. We worked hard through the summer, too. You know, we're very consistent executors of our business model. And we've not really -- we didn't change anything in the fourth quarter. We have -- we did go through a process of evaluating some supply chain opportunities that we had as far as making inventory available on a same day basis to more stores.

And looking at some of the newer stores whose inventory could potentially yield better results if it was a little larger. And we went through this process of investing in inventory last year that we think is -- has generated some good results. So I would say -- I would say that we've tried no harder in the fourth quarter to drive sales than we did in the second and third quarter. I think some of the changes that we made from a supply chain standpoint and from an inventory availability standpoint have benefited us, and will for the long term.

Gary Balter - *Credit Suisse - Analyst*

Thank you.

Operator

Matthew Fassler, Goldman Sachs.

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Matthew Fassler - *Goldman Sachs - Analyst*

First of all, you alluded when you discussed gross margin to the capitalization of certain distribution costs associated with inventory accumulation. And I know we hear about this periodically. It feels like more in the auto parts sector than in some other industries. Can you just give us a brief refresher on how this accounting works? And I think you discussed this barrier or hurdle for you as you enter 2013?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Jeff, do you want to handle that one, or --? When we look at our merchandise, the cost of the product and we have the cost of getting the product into a saleable position. So as we move inventory into the DCs, it has a certain additional value that gets capitalized. As we move it into the stores it has even a higher value. And then as we sell that merchandise, we expense not only the cost of the merchandise but the cost to get it in place. So as the inventory in the stores rises, the value of the cost to get it in place rises on our balance sheet. To the extent that inventory and the cost to distribute stays the same over time, it has a net zero impact. When inventories go up, it reduced -- it is an offset to our distribution costs. When inventories go down, that -- or don't go up as much year-over-year, is a less of an offset to our distribution costs. So when we look at next year, we are going to have a less of a build of inventory, a less of a benefit from adding that value. So it will create a headwind.

Matthew Fassler - *Goldman Sachs - Analyst*

The 15 basis points you discussed for the quarter or for the year?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

That was the fourth quarter number, the third quarter number was larger than that. And that's versus 2011. When we look at our headwind for 2013, it's going to be a little more than that for total.

Matthew Fassler - *Goldman Sachs - Analyst*

A little bit more than that going the other way you're saying?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Correct.

Matthew Fassler - *Goldman Sachs - Analyst*

Okay. Just another followup on gross margin. Clearly as you've gained commercial share and CSK has achieved incremental commercial penetration, there's some headwind to your gross margin that's in part offset some of the other things that have gone right on that line item. Can you give a rough quantification of what that drag has been in any given year, whether that number's moved around a lot over the past few years?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

I will tell you that when we originally purchased CSK, when we looked at what the professional side was and what we thought the margin impact was going to be, we had a -- you know, our expectation was it was going to be a pretty significant number. What I'd tell you is over the last four years, it's really been a net zero. CSK was selling a lot of items that weren't hard parts that didn't create great margin. And as we've transitioned the business away from ancillary products to hard parts on both the DIY side and the professional side, those products in themselves generate a better POS margin. So we've seen that balance.

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Matthew Fassler - *Goldman Sachs - Analyst*

Okay. Thank you so much.

Operator

Christopher Horvers, JPMorgan.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Can you give a little bit of a retrospective and forward look as to how you think about inflation '11, '12, and '13?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Tom, you want to speak that?

Tom McFall - *O'Reilly Automotive Inc - CFO*

I will be glad to. You know, if we look at this year, we were pretty -- we would say we had a below average inflation year. You know, we'll expect just like any retailer to se a percent and a half inflation for the year. You know, as gross margins, percentage stays the same and acquisition costs go up, that helps to fund, you know, inflation and wages and inflation also. And occupancy costs. If we look at 2012, we saw larger than normal rate and was a helper for comps in 2011 and about average in 2010.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

So 2012's above the 1.5 -- 2011 is above the 1.5. 2012 was below. And then sort of back to normal in 2013?

Tom McFall - *O'Reilly Automotive Inc - CFO*

That would be our expectation.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Okay. And a couple followup, cleanup questions. On that headwind to capitalize inventory costs, should we think about that headwind in the back half as you cycle, or how does that play out?

Tom McFall - *O'Reilly Automotive Inc - CFO*

Well, we look at the flow of our gross margin, we would expect the last two quarters to be a tougher compare because of that.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Okay. And then Greg --

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Tom McFall - *O'Reilly Automotive Inc - CFO*

Slightly better in the first half of the year slightly below in the second half of the year. Of course with the backdrop of, you know, inflation and pricing environment. Being -- to be determined.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Yep. And Greg, you mentioned on the cold weather seeing a pickup in the batteries. Is it -- as you look out today, is it that the tough comparison -- you're seeing it in the underlying data, but maybe we shouldn't expect to see an overall comp because of the compare? But you're seeing the lift actually underneath in batteries and brake pad and some of those other areas?

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Yes. I'm simply -- well, we haven't seen it so much in brake pads. We have seen it in batteries. Batteries are something they have a very specific life. You know, when a battery dies, it's dead, and it's not going to work. You can charge it and make it start the car again or jumpstart it, but when it's dead, it's dead. Brakes are a different story. When a brake pad gets metal to metal, it's worn out and you're done. A lot of brakes in good times get replaced before they're worn out because as tires get rotated, people decide to go ahead and have their brake pads replaced at that time. And from a corrosion standpoint, some of the brake components fail quicker because of corrosion due to salt on the roads and stuff like that. So what I was saying is that some of the parts that didn't get replaced in -- that would be more weather related, those will be replaced. It's just been pushed a little further in time. And that we have seen an improvement in batteries. Some of that could be very well due to the batteries that didn't fail last winter that failed during the summer or this winter.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Perfect. And one final one. Would love to get your thoughts on how you're talking internally about the potential impact from the payroll tax increase, thank you.

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Tom, you want to take that?

Tom McFall - *O'Reilly Automotive Inc - CFO*

Well, you know, that's something that we, like any other retailer, want to see people walking around with money in their pockets. To date we haven't seen a significant change from that. But that will be a headwind this year as, you know, as our type of customer has less discretionary income to spend. So that's built within our comp expectations.

Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

But tough to see anything quite yet?

Tom McFall - *O'Reilly Automotive Inc - CFO*

Correct.

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Christopher Horvers - *JPMorgan Chase & Co. - Analyst*

Perfect. Thank you very much.

Operator

Ladies and gentlemen, we've reached the allotted time for questions. I will now turn the call back over to Greg Henslee, Chief Executive Officer.

Greg Henslee - *O'Reilly Automotive Inc - CEO*

Thanks. We would like to conclude our call today by again thank our 53,000 members of team O'Reilly for their commitment to providing the best customer service in our industry. 2012 was another record breaking year for our Company. And our continued success is a direct result of your hard work. As we look forward to 2013, I'm confident that we are well positioned to continue our strong record of profitable growth, supported by your dedication to the fundamental concept that taking care of every customer every day is the key to our long term success. I would like to thank you everyone for joining our call today. We're very proud of our performance in 2012. And we look forward to reporting our first quarter 2013 results in April. Thank you.

Operator

This concludes today's conference call. You may now disconnect.

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