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ORLY - Q2 2014 O'Reilly Automotive Inc Earnings Call

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## CONFERENCE CALL PARTICIPANTS

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**Matthew Fassler** *Goldman Sachs - Analyst*

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## PRESENTATION

**Operator**

Welcome to the O'Reilly Automotive Inc. second-quarter earnings conference call. My name is Daniel and I will be your operator for today's call. At this time all participants are in a listen-only mode. During today's call prepared comments will be presented followed by a 30-minute question-and-answer session. Please note that this conference is being recorded. I will now turn the call over to Mr. Tom McFall. Mr. McFall, you may begin.

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

Thank you, Daniel. Good morning, everyone, and thank you for joining us today for our second-quarter 2014 conference call to discuss our earnings results and our outlook for the full year. Before we begin this morning, I would like to remind everyone that our comments today contain certain forward-looking statements and we intend to be covered by and we claim the protection under the Safe Harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995.

You can identify these statements by forward-looking words such as expect, believe, anticipate, should, plan, intend, estimate, project, will or similar words. The Company's actual results could differ materially from any forward-looking statements due to several important factors described in the Company's latest annual board on Form 10-K for the year ended December 31, 2013, and other recent SEC filings. The Company assumes no obligation to update any forward-looking statements during this call.

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

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**Greg Henslee** - *O'Reilly Automotive, Inc. - President and 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; Ted Wise, our Executive Vice President of Expansion; and David O'Reilly, our Executive Chairman, are also present.

It is once again my pleasure to congratulate Team O'Reilly on another excellent performance in the second quarter and to thank each member of our team for their unwavering commitment to our Company's culture of providing excellent levels of customer service to each and every one of our valued customers. The sales momentum we experienced in the first quarter carried forward into the second quarter as the wear and tear on vehicles caused by the harsh winter weather contributed to demand for our products, resulting in a robust 5.1% comparable-store sales increase, exceeding our guidance expectations of 2% to 4%. Our ability to deliver this strong comparable-store sales performance on top of a very robust 6.5% increase in comparable-store sales from the second quarter of last year is a testament to our team's commitment to serving our customers.

In total, we increased sales 7.7% to $1.8 billion and we were especially proud of our team's ability to grow sales profitably as we improved our operating profit by 94 basis points to 18.2%, which is a record second-quarter operating margin. As a result of our team's relentless focus on excellent customer service and expense management over the long-term, we generated a 21% increase in earnings per share in the second quarter, which represents our 22nd consecutive quarter of EPS growth of 15% or greater.

As we discussed on our last call, we expected the harsh winter weather would provide a tailwind in the second quarter as repairs were made to fix the excessive wear and tear on vehicles driven on weather-damaged roads. We definitely saw this play out in our Northern and Eastern markets, where under-car categories such as breaks, ride control, driveline, and chassis performed very well. Our comparable-store sales performance was consistent throughout most of the second quarter, but we did see trends soften somewhat at the end of the quarter, as we have yet to see the typical stretch of extreme heat and the associated seasonal demand in categories like temperature control and cooling. In addition, the drought in the Western half of the country has not been favorable.

Our sales performance to our professional customers was again the bigger driver of our comparable-store sales growth as we continue to grow this business more rapidly chain-wide in both existing and expansion markets. But our DIY business was also a very strong contributor to the growth in the second quarter and we are pleased with the market share gains we are realizing on this side of the business.

Average ticket continues to be the more meaningful driver of our comparable-store sales growth. As we have seen now for the past several quarters, inflation on an individual SKU by SKU basis was flat and did not significantly impact average ticket in the second quarter. The trend in average ticket growth continues to be the result of increased parts complexity and cost of repairs, and during this quarter this trend was further driven by the high mix of under-car repairs, which typically are more costly and result in a higher ticket.

Now I would like to move on and provide a little more color on our guidance for the third quarter and full year. We are increasing our full-year comparable-store sales guidance to a range of 3.5% to 5.5% to reflect the outperformance we delivered in the first half of the year. For the third quarter we are setting our comparable-store sales guidance at a range of 3% to 5%. At the midpoint of this range our expected two-year comparable-store sales a stack is 8.6%, which is below this second-quarter two-year stack of 11.6% but in line with our year-to-date two-year stack of 9.3% through June.

In establishing our sales guidance for the third quarter we expect to see a continuation of the current strong business trends and a solid demand partly driven by damage done to steering, suspension, and ride control components during the harsh winter. However, we remain cautious in our outlook for categories typically driven by extreme summer heat such as air conditioning, refrigerant, and cooling, as temperatures have remained relatively mild, even chilly in some areas, so far in the third quarter.

From a macroeconomic standpoint we are encouraged by modest gains in miles driven as unemployment very gradually improves. But our average consumer has been under pressure for a long time as a result of the slow recovery and we would not anticipate this pressure to significantly abate in the near-term, particularly as consumers face a headwind from gas prices, which appear to be holding at an elevated level above $3.60 per gallon on average.

We remain very confident in the long-term outlook for our industry, as we expect to see better engineered and manufactured vehicles stay on the road longer.

Moving on from the top line, we are pleased to deliver gross margin of 51.5%, a 64 basis point improvement over the prior year. On a sequential basis the second quarter margin improved 68 basis points over the first quarter. This sequential improvement was driven by a significantly lower headwind impact from LIFO accounting which Tom will discuss in more detail later in the call. This impact was partially offset by the favorable mix benefit we experienced in the first quarter. For the full year we are leaving our gross margin guidance unchanged at a range of 50.9% to 51.4%. As in past quarters, this guidance assumes expected continued limited selling price inflation and rational industry pricing.

Thanks to the dedication of our 67,000 team members, we continued our strong momentum from the first quarter into the second quarter and we are well-positioned to deliver another outstanding year in 2014. Through our hard work and commitment to providing outstanding customer service levels we continue to gain market share, generating an increase in comparable-store sales of 5.1%. More importantly, we translated topline market share gains into profitable growth, increasing our operating profit by 94 basis points to an all-time second-quarter high operating margin of 18.2% and an EPS increase of 21% over the prior-year to $1.91.

Finally, we remain confident in the long-term drivers in the automotive aftermarket and most importantly in our team's ability to execute better than anyone else in our business and to profitably grow market share. Based on our continued confidence and year-to-date results we are increasing our full-year operating profit guidance from a range of 17% to 17.4% to our range of 17.1% to 17.5%. We are also increasing our EPS guidance for the full year to a range of $7 to $7.10, which includes shares repurchased through yesterday.

Again, I would like to thank Team O'Reilly for the outstanding second-quarter performance. Great job, everyone! I will now turn the call over to Jeff.

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

Thanks, Greg. And good morning, everyone. I would like to begin today by echoing Greg's comments on the dedication of Team O'Reilly. Because of the hard work and commitment of each of our store and DC team members, we were able to once again produce results that exceeded our expectations.

During the first quarter our team battled the elements to keep our stores open under very harsh conditions with the sole purpose of taking care of our customers when they needed us to be there for them. That level of commitment continued in the second quarter as we were once again there for our customers as they worked to repair the wear and tear to their vehicles resulting from the extreme winter weather.

O'Reilly's long-term success is the direct result of our team's relentless focus on providing consistent top-notch customer service daily to every customer who calls or walks into our stores. And we cannot thank our team enough for their continued contributions and commitment to providing the highest level of customer service in the industry.

I would like to take a few minutes to add some color to our operational results from the second quarter, including the progress of our distribution expansion activities and our new store expansion. Starting with SG&A, we were able to leverage our expenses by 30 basis points in the second quarter due to our strong comp performance. As Greg mentioned, our team generated a 5.1% increase in comparable-store sales during the second quarter, which was on top of a very strong 6.5% increase during the second quarter last year. Average SG&A per store increased 2.4% during the second quarter, which was higher than our expectations and was the result of higher than expected team member costs and negative outcomes on certain litigation that is inherent in the normal course of our business.

We are very proud of our ability to relentlessly control expenses over the long-term, but under no circumstances will we sacrifice our customer service. I know I sound like a broken record on this, but our ability to consistently provide top-notch customer service is critical to our long-term success. We manage our store staffing levels to control expenses with adjustments to support current business fluctuations; but, just as importantly, we staff our stores to provide them with the tools they need to grow their business in the future. This long-term perspective on store staffing levels has been instrumental to our past success and is critical to our ongoing future profitable growth.

As we look forward to the second half of the year, we would expect that our average SG&A per store would not increase at the same level as the first half of the year. However, due to our higher than planned results in the first half of the year, we now expect that full year average SG&A per store will increase by approximately 2%.

Before I provide an update on our distribution expansion projects I would like to congratulate our DC team for their continued ability to provide the best parts availability in the aftermarket. Our knowledgeable and dedicated store teams worked tirelessly to provide our customers with top-notch service, and our DC team works relentlessly to ensure our stores are properly stocked and have same day or overnight access to all of the parts our stores need to take care of our customers.

I cannot stress enough the vital role that our robust regional tier distribution system plays in our long-term success. Nightly store replenishment and same day or overnight access to over 145,000 hard-to-find parts is critical to providing unsurpassed levels of customer service. It is a key driver of our comparable-store growth, which is consistently lead our industry. Along with the support of over 270 strategically located hub stores, our comprehensive distribution system provides our stores with the access to inventory necessary for continued success. And I want to thank our DC team for their ongoing hard work.

Okay, now back to the specific distribution expansion projects. Our newest distribution center, in Lakeland, Florida, continues to ramp up nicely and is now providing nightly service to 87 stores, up from 76 stores in April. As I mentioned last quarter, it takes time for a new greenfield DC to build the critical mass of stores that is necessary to operate at maximum efficiency and optimal productivity, but our Florida DC team is focused on daily improvements, and we are very pleased with the early productivity results we have seen so far.

More importantly, we are excited about our ability to provide enhanced service levels to our stores in the growing Florida markets and we continue to view Florida as a market where we can open a large number of successful stores. I would also like to mention that our Lakeland DC team is very excited to host our analyst day next month and is looking forward to showing off their beautiful new facility.

I'm proud to say that our distribution projects in Naperville, Illinois and Devens, Massachusetts are progressing well and remain on track to begin operations during the back half of this year. As we previously mentioned, the Naperville DC is a new greenfield facility and is needed to better penetrate the large and competitive Chicagoland market and to free up growth capacity in our northern Midwest DC. When our Devens DC opens we will relocate all operations from our existing DC in Lewiston, Maine to this new facility and will immediately service our 56 stores in the upper Northeast.

Just as important, this larger state-of-the-art facility will provide us with the capacity necessary to expand in those markets beginning with new store openings next year. We are very excited about the opportunities for enhanced customer service our current distribution projects will provide, and we look forward to their completion in the coming months.

I would like to finish up today with an update on our store expansion for the first half of 2014 and our plan to finish up the year. In the second quarter we opened 41 net new stores across 17 states. This brings us up to 91 net new stores year-to-date across 28 different states and just shy of 50% of our planned 200 net new store openings for the year.

As we mentioned on last quarter's call, the harsh winter weather pushed several of our store opening projects back. But we are confident in our ability to hit our target of 200 net new openings this year with a good number of the remaining openings occurring during the third quarter. Not surprisingly, Florida leads the pack with the largest number of new stores so far this year at 14, followed by Texas with 10, and California with nine.

As I mentioned earlier, the Florida markets present great expansion opportunities for us and California is a huge market which offers great backfill potential as our dual market strategy continues to gain traction. In Texas, our operations teams continue to execute our model very well as that market continues to expand year after year. The remaining openings are spread throughout 25 other states.

We remain very pleased with the success of our new store openings, and we attribute this success to our ability to be very selective in our new store site selection process as well as our ability to develop and train outstanding teams of professional parts people who are eager and ready to provide consistent top-notch customer service in every new store. Our robust distribution infrastructure has capacity from coast to coast, allowing us to choose optimal sites in any market with the confidence that the new store team will have all of the support necessary to be successful.

Now, before I turn the call over to Tom, I would once again like to congratulate and thank our store and distribution teams for another record-breaking quarter. Your commitment to providing consistent top-notch service to all of our customers each and every day continues to be the key to our long-term success. I will now turn the call over to Tom.

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

Thanks, Jeff. Now we will take a closer look at our results and provide updates to our guidance. Comparable-store sales for the second quarter increased 5.1%, which exceeded our guidance of 2% to 4% as we benefited from the strong demand in under-car categories as customers repaired vehicles damaged during the severe winter.

For the quarter sales increased $132 million, comprised of an $86 million increase in comp store sales, a $45 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. This strong sales performance combined with solid expense control resulted in a 21% increase in diluted earnings per share to $1.91, which exceeded the top end of our second-quarter guidance range by $0.08.

Now I would like to update you on gross margin and the impact LIFO accounting had on our margins. As we discussed on our last three calls, our success at reducing our acquisition costs over time has exhausted our LIFO reserve with the result that additional cost decreases create one-time non-cash headwinds to gross margin as we adjust our existing inventory on hand to the lower cost. During the second quarter our gross margin of 51.5% included a LIFO headwind of $3.4 million as we continued to be successful in reducing acquisition costs.

Looking at the third quarter, we expect to see a similar LIFO headwind as we saw in the second quarter. As a result, we expect a comparable gross margin percentage in the third quarter as we achieved in the second quarter. Our full-year gross margin guidance range remains unchanged at 50.9% to 51.4% and includes the expected LIFO headwinds in the third quarter but none in the fourth quarter.

Our effective tax rate for the quarter was 36.7% of pretax income and benefited from $2 million more than we expected in job tax credits. For the full year we now expect our effective tax rate to be approximately 36.6%.

Moving to the balance sheet, inventory per store at the end of the second quarter was $579,000 versus $570,000 at the beginning of the year. This increase is consistent with the seasonality of our business, and we continue to expect inventory per store to be flat for the full year as our teams diligently at the right inventory, leverage our existing investment, and minimize nonproductive inventory.

At the end of the second quarter our AP-to-inventory ratio was 93.5%, representing an improvement of 690 basis points from the end of 2013. While the seasonality of our business yields a higher AP-to-inventory percentage in the second and third quarters, 93.5% exceeded our expectations. We will give some of this gain back by the end of the year as sales and replenishment volumes seasonally decrease, but based on the current support we are getting from our vendors we now expect our AP to inventory percentage to be slightly above 90% at the end of the year.

Year-to-date capital expenditures were $195 million. This is slightly behind where we thought we would be at this point in the year, but we still expect our 2014 CapEx to be within the range of $390 million to $420 million. This leads us to free cash flow, which was $461 million for the first six months of the year versus $263 million in the prior year. The increase was driven by higher income, slower growth of trade receivables, and a better net inventory position. Based on the above-plan income and our increased year-end AP-to-inventory expectations we are raising our full-year free cash flow guidance to $625 million to $675 million.

Moving on to debt, we finished the second quarter with an adjusted debt-to-EBITDA ratio of 1.81 times. We continue to believe our targeted leverage range of 2 to 2.25 times reflects our optimal capital structure and we will move into this range when additional borrowings will not create significant negative carry. Over the long-term we will be extremely prudent in managing our debt levels to ensure we maintain our investment rate rating, continue our robust vendor financing program, and have the flexibility to support opportunistic acquisitions.

We continue to execute our share repurchase program, and from the beginning of the year through the date of this press release we have repurchased 2.6 million shares of our stock at an average cost of $149.07 per share, for a total investment of $389 million. We continue to view our buyback program as an effective means of returning available cash to our shareholders after we take advantage of opportunities to invest in our business at a high rate of return. And we will prudently execute our program with an emphasis on maximizing long-term returns for shareholders.

For the third quarter we are establishing diluted earnings per share guidance of $1.91 to $1.95. Based on our above-plan results in the first half of the year and additional shares repurchased since our last call, for the full year we are raising our guidance to $7 to $7.10 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.

Finally, I would like to thank the entire O'Reilly team for their continued dedication to the Company's success. As Greg and Jeff mentioned earlier, your hard work and commitment to providing unsurpassed levels of customer service is the reason for our record-breaking results.

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

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Seth Basham from Wedbush Securities.

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**Seth Basham** - *Wedbush Securities - Analyst*

Congrats on a great quarter. My question revolves around, first, trends to date. It seems like trends slowed a little bit in June you spoke to. How is July trending to date?

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

It's doing fine. And we spoke to June being a little softer than the first two months of the quarter, but it wasn't like a cliff or anything; it was just the softest month of the quarter. But July we are doing fine.

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**Seth Basham** - *Wedbush Securities - Analyst*

So it's within your guidance range of 3% to 5% for the quarter?

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

Yes.

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**Seth Basham** - *Wedbush Securities - Analyst*

Got you. And then secondly, as we think about some of the new DCs you are opening -- I know Lakeland recently opened and then a couple more on track for later this year -- can you give us a sense what kind of lift you are seeing from those 87 stores in Florida with the overnight service there, or service from that Lakeland DC and what we should expect from Naperville?

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

Well, Florida is a new market for us, at least central and southern Florida is a new market for us. And we are doing very well down there. And I think it goes without saying, as you have implied, Seth, that stores that are supported by a distribution center have the ability to better penetrate a market than stores that are supported by a hub or maybe without the support of either a hub or a distribution center on a same-day basis.

So to be frank, the Southeast and the Northeast think some of our newest markets and being markets that were affected to some degree by weather but more than anything just the fact they are newer stores and they are supported in the South by a new DC, are some of our best-performing markets. So we would expect to do much better in Chicago and then again in the far northeast, where we had the VIP stores, once we have a larger DC and more access to SKUs, because right now the stores that we have converted as part of the VIP acquisition are supported by distribution center that does not have the number of SKUs that we would typically put into a DC because of space constraints. So we will be in a much better position up there once we do that.

But yes, they are performing well. And we would expect the Chicago stores to perform well. I don't really have a number for you. But they will perform better with a DC then they do without.

**Seth Basham** - *Wedbush Securities - Analyst*

Got it. Thanks so much.

**Operator**

Matthew Fassler from Goldman Sachs.

**Matthew Fassler** - *Goldman Sachs - Analyst*

My first question relates to gross margin. Thanks a lot for the clarity on LIFO; appreciate it. If you think beyond LIFO and you think about the intrinsic drivers of margin in the business, I know you had started to talk about coming up on the five-year anniversary of the CSK deal and some of the vendor renegotiations that were going to commence along with that. So can you give us a sense as to the status of some of the longer-term margin drivers and how do you see those playing out, gross margin drivers, that is, how you see those playing out over the second half of the year and then into 2015?

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

Well, our renegotiations with vendors are pretty much complete and we are happy with the results. Obviously, our gross margin improved significantly, as you know, as part of the CSK acquisition and some of the deals that were made. And as we've anniversaried those deals, we are happy with the position we are in now. And as a growing and, we think, a successful company, we are a company that suppliers want to have in their camp. And we feel like we will continue to have incremental gains, although we wouldn't expect our gross margin to continue to grow much in the coming years by a large extent. It will be maybe small incremental gains but nothing like what we've seen the last couple years, I would guess. Tom, you may have some additional comments on that.

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

We are starting to anniversary some of those deals. When you look at the impact of LIFO, we have a number of big deals that happened in the third, fourth, and first -- third and fourth quarter last year, first quarter of this year. So we haven't lapped those deals. But once we do, we would expect to get back to a more normal growth margin -- gross margin, growth rate in the 10 to 30 basis points a year.

**Matthew Fassler** - *Goldman Sachs - Analyst*

And Tom, just following up on that and thinking about the cadence of renegotiation by category in vendor, which you guys have visibility to, and also the pace of the inventory turnover, which varies a lot by category but on the whole is, I guess, about two times a year, at what point does that really start to make its way through the P&L for maximum impact? Is it late this year? Is it early 2015 that you start to see them all kind of marshal their impact on the margin?

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

Because we are on LIFO and we utilize last buy, we see the reduction in cost across dollar inventory, day one. And that second day, the first part you sell you are selling at a lower cost. So it's not based on turns. Mathematically we need to trend inventory one time to offset that first write-down, but sequentially the margins improve right away.

**Matthew Fassler** - *Goldman Sachs - Analyst*

Got it. And then very briefly, following up on the SG&A, I know there was a small litigation item that probably distorted the numbers a little bit. How much variable expense would you say there is relative to the base guidance that you gave, relative to your sales guidance, such that if sales were a little bit better maybe the expenses inch up for bonus comp or what have you?

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

When we look at these litigation items outside of normal, because we have some -- we were $2 million or $3 million higher this quarter than we would be on an average run rate.

**Matthew Fassler** - *Goldman Sachs - Analyst*

Got it. Thank you so much.

**Operator**

Greg Melich from ISI Group.

**Greg Melich** - *ISI Group - Analyst*

I just wanted a quick follow-up on the gross margins and then touch on SG&A. If you look at the second half, it was helpful to know about the LIFO there. Are there any uniqueness in terms of the new distribution centers coming online that could be impacting gross margin in the next couple quarters as well that we should be aware of? Then I had a follow-up.

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

The effect of the new DCs coming online will be minimal and I don't think it will be noticed in our gross margin. They are levered pretty well and we have some offset from our Indianapolis distribution center, which is really beyond capacity and not operating as efficiently as it should be and will benefit from the offload of some of the stores. So we wouldn't expect that to be a factor in the second half.

**Greg Melich** - *ISI Group - Analyst*

And then on SG&A per store, I guess it was up about 2.5%. How should we expect that to play out in the second half? Is this a good run rate or was there something tweaking that in a certain direction?

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

We have been above 2% in the first half of the year. Our guidance is to be 2% for the full year. So we should run a little less than 2% in the third and fourth quarter.

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**Greg Melich** - *ISI Group - Analyst*

Is there anything special around that or is it just that weather early in the year added more costs?

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

We are relatively close. These are relatively small percentages. The beginning of the year obviously had some payroll and maintenance costs associated with all the cold weather and utility costs. But there's nothing that sticks out as a real issue in the second quarter. And we should be pretty close to plan in the third and fourth quarters.

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**Greg Melich** - *ISI Group - Analyst*

And Tom, on AP to inventory you said part of the free cash flow increase included a new number for that, a new target. Do you have a number you could give us?

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

Slightly above 90.

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**Greg Melich** - *ISI Group - Analyst*

Thanks a lot. Good luck, guys.

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**Operator**

Alan Rifkin from Barclays.

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**Alan Rifkin** - *Barclays Capital - Analyst*

Greg, you mentioned that the winter weather continued to be a tailwind in the quarter. I was wondering if perhaps you could quantify what the benefit was. And when do you expect this tailwind to exhaust itself?

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

Well, Alan, I wouldn't really be able to quantify it. I can tell you that the categories that we would most apparently see is categories that would benefit from the harsh winter that we had were some of our best-performing categories. And I mentioned some of those. But they are chassis, ride control, driveline, brakes. Automotive batteries did real well, which are sensitive to weather extremes. So it was a factor. To quantify it, I don't know what we would have done, had we not had the weather. But these are the categories that are a big part of our business. So we expect to perform well in those categories ongoing, and our comp percentage is driven by our success in these categories.

So the portion of our performance here that's incremental related to weather is hard to determine. I think that when we have weather extremes there are some things that people have to fix right away. When you've got maybe a tie rod end coming loose and your car won't pass state inspection as a result of being jarred around on rough roads, that has to be fixed right away. Things like shock absorbers, ride control that may fail earlier than normal because of being driven on bad roads -- those are not something you have to replace right away, but you eventually will because the ride of the car changes in the handling of the car changes. So there's some ongoing benefit, but it will start waning as we go through the summer. But again, it's hard to determine how much of it was related to whether and how much of it is just pent-up demand and just the solid aspects of the business that we are in.

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**Alan Rifkin** - *Barclays Capital - Analyst*

Okay, thank you. And just a follow-up, if I may. You have talked about the opportunities in Florida, and certainly we are in agreement with you. And if you look at Florida together with California, those are certainly two of the more lucrative states in the country. Obviously, you have more experience operating in the state of California since the CSK acquisition. But if we were to drill a little bit deeper and if you compare and contrast California specifically to Florida, what is your assessment in terms of the opportunities in Florida relative to California? Is it as good? Is it even better?

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

Well, I don't think we will ever have as many stores in Florida as we have in California, just because of the size of the states, the populations and stuff. But it's really good. Florida has been the state that has been one of our best new store opening states that we've had in a while. And we are really happy with how our stores have done down there and happy how they've done once we opened the Lakeland distribution center.

So I would rank it right out there. Last quarter California and Florida led our new store openings. And we are happy with the performance of the stores in both those states.

When we came into California, CSK already had those stores almost up to put we did average in most states across the country. So, we really didn't see it from the ground up like we are in Florida. We are really impressed with Florida as to how quickly we are getting to what we would expect to do in a store. And in California we have incrementally grown beyond what CSK has done. But it would be hard to compare the two because there's differences in both. Rents are obviously higher in California, so you have to do more volume per store. Wages tend to be a little higher in California, so you have to do more volume per store. Litigation in California -- there's a lot of rules in California that don't exist in some states, so you have to be wary of that.

On balance we like Florida a lot. But we do a ton of business in California. So they are both good states for us.

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**Alan Rifkin** - *Barclays Capital - Analyst*

Are the commercial opportunities in Florida greater than the commercial opportunities in California?

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

The only difference that I would be able to point out, Alan, would be that in Florida you have what I think would be an older population that would be less likely to work on their own cars. So I think that it's just a mix of business; I think the commercial business is really strong down there. I think in California you would have more people that would be apt to work on their own cars, so the DIY business is probably a little stronger than what it is in Florida.

**Alan Rifkin** - *Barclays Capital - Analyst*

Okay, thank you. That certainly makes sense. Thanks, Greg.

**Operator**

Mike Lasser from UBS.

**Mike Lasser** - *UBS - Analyst*

Greg, where would you normally transition from some of the hot-weather products to more fall-related merchandise? So, at some point you are going to -- the lack of hot weather won't matter as much. At what point do you get there?

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

You start getting there in like September and October in most markets. It varies on geography, of course. But generally you make that transition after school starts. In our business we see a little bit of a dip in the shops that we supply. We see a little bit of a dip in business when school starts because people start spending money on school supplies and getting their kids ready for school and stuff that in many cases they don't plan to spend but then they do because they need to. And they will delay some repairs and other things that they need to do.

And typically, once someone makes it to the point that school is starting with something that they can avoid fixing like an air conditioner or something, they may just hold on and wait to fix it next spring. So it would push forward. And then we would transition into doing more fall and prep for winter type stuff.

**Mike Lasser** - *UBS - Analyst*

So during those months weather becomes less of an influencer on the business? Is that fair to say?

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

I think that's fair to say.

**Mike Lasser** - *UBS - Analyst*

The other question is we will soon get to the point where the cars that were sold in 2008 become a bigger portion of the seven-year-old vehicles. Typically, what categories are first sold into a car when they reach this sweet spot of the aftermarket? And I ask that because the weather benefit is fading, the smaller cohort is going to become a bigger portion of the total. So there is going to be a lot of debate in the six months in the industry to the extent that trends remain below where they were in the first half of the year -- is that the simple fact of weather, or is it because of the change in the vehicle population?

So I guess what I'm trying to frame is, where will you see it? If there are some impacts from smaller cohorts of seven-year-old vehicles, where will you see it first? And what are you going to be watching for? Thank you.

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

Well, Mike, we are talking about six-, seven-year-old vehicles. So that age of a car would typically -- I know it varies by geography and by individuals. But let's say it's a 100,000-mile vehicle. What you are going to have is brake failure, some chassis part failure. The cars today that are so closely monitored by a computer that has multiple sensors that detect all these different things -- you may start having problems with some of those sensors, so the check engine light comes on and can cause some drivability problems so you start having some of those things.

So primarily I think what we would watch would be brakes, chassis, ignition, emission. Cars of that age need tune-ups and so forth, belts and hoses, timing belts especially on cars that have belt driven camshafts. That's about the point that the belt gets replaced. So we will watch those. Like I said, right now those categories seem to be doing pretty well. And it's hard to quantify what's weather and what's just normal maintenance.

Tom, do you have something to add?

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

Michael, what I would add to that is during the short term, quarter to quarter the weather impacts our business. And it's noticeable in certain categories, driven by what type of weather events we have. When we look at the car population with [240 billion-plus] light cars and trucks, changes in the population occur slowly over time. And those changes, when you look at go over a long period of time, are identifiable. But on a quarter-to-quarter basis the change of a 240 million-vehicle population -- it's hard to track specific items related to that.

So quarterly we will talk about weather. Long-term, that change in vehicle population, the engineering of the vehicles has the biggest long-term impact. But it's hard to identify on a quarter-by-quarter basis.

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**Mike Lasser** - *UBS - Analyst*

Okay, that's super helpful. Thank you so much.

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**Operator**

Mike Baker from Deutsche Bank.

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**Mike Baker** - *Deutsche Bank - Analyst*

Just curious -- did your back half comp outlook change at all based on what you are seeing in June? I know you raised the full year, but that's because of what you've seen year to date. But wondering if you've changed your back half outlook at all.

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

No. We changed our full-year to reflect what we've accomplished so far this year. But our back half outlook remain the same.

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**Mike Baker** - *Deutsche Bank - Analyst*

So this little bit of a slowdown in June doesn't change your outlook? Okay, thanks. And then I was curious if you could talk about the percent of your business that is from DIY versus DIFM currently and break that down, if you can still do it, how that makes down from that acquired CSK stores versus the stores that you didn't acquire.

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

Yes, right now we are about 42%/58%, 42% do it for me, 58% DIY. We really don't break down the CSK versus O'Reilly mix. The CSK mix on the do it for me business has incrementally grown as we have been effective gaining market share out there. But we really don't give the mix numbers for the different parts of the --

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**Mike Baker** - *Deutsche Bank - Analyst*

Well, how about this? I assume, then, that the CSK store is still under indexed to DIFM. But is there still an opportunity for that to increase more so than in other stores?

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

Yes. They under indexed compared to the core O'Reilly stores and our new stores. So there is more opportunity out there for us to continue to increase our do it for me business. And we have a lot of good competitors out there that are doing a lot of business on the do it for me side. So, we see that as an opportunity for us to incrementally work to gain market share in a profitable way.

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**Mike Baker** - *Deutsche Bank - Analyst*

All right. Okay, thanks. Appreciate it.

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**Operator**

Simeon Gutman from Morgan Stanley.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Greg and Tom, going back to the secular outlook, I know we talked little bit about. It sounds like, Tom, it's a slower moving process than some of the numbers look. But curious what your outlook is. How do you feel and how do you think we should think about that sweet spot of the fleet shrinking next year? Should industry growth continue despite some of those headwinds? It sounds like it should but I just wanted to get your thoughts.

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

Simeon, what I say -- and Tom may have some comments, too. But we are not that concerned with the change in the vehicle population age relative to the recession that we went through because of the size of the vehicle population and also the age of the vehicle population, having so many cars that are older and beyond what was previously considered the sweet spot and I guess maybe still is today, that are still on the road at high mileage is.

And I know I've said this probably too many times to different analysts. But there are cars being driven today at mileage is that just have not seen by us in the past because of the quality of the drivetrains and the bodies and the interiors and all these things that might have previously caused people to trade or scrap a car. Today cars just have the ability to stay on the road a lot longer. So I just think our industry is in for a good run as we continue to benefit from these cars that have been built over the last 10, 15 years that are of incredibly high quality credit comes to drivetrains and bodies and interiors and so forth, and that the automotive aftermarket is in a good position as a result of that.

And of course, we have to consider the vehicle population to some degree. But we don't pay a whole lot of attention to that part of it. And the way we look at it is there's a lot of market share out there to gain. When we have our internal meetings here we don't spend much time on the vehicle population. We spend time on how much market share we have that we are not -- how much market share we have that we can gain that our competitors are currently doing. And I think we have a lot of opportunity out there. Tom?

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Is that age of -- I'm sorry. Tom?

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

From a macro standpoint for our industry looking into next year, we don't think that 2008's low SAAR number is going to have a huge impact, just because of the continuing age of vehicles can stay on the road and size of the population. From a macro standpoint when we look forward for the next 18 months, the biggest driver is going to be the health of the consumer and what happens with miles driven and how much, how many people go back to work and start commuting to work and what that adds to the potential for parts failure.

From an overall profitability standpoint, when we look at the top line we have run the last couple years without much inflation. We would like to see not a lot of inflation but a little bit of inflation to help drive higher top-line sales and more gross margin dollars to offset the increases in cost you see. But that's an item that could also have an impact on comps for the industry.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

And is the age of vehicles that you're servicing, to the best you can track it, is that changing in any way that gives you more or less confidence in the outlook?

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

It's hard to track, of course, because many parts fit different vehicles. So you have to track it based on the lookup, assuming that the part is always looked up electronically. And we do track that. But yes, as the vehicle population gets older, yes, we are selling more parts for older vehicles, for sure.

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

And I think you see that in the SKU count for ourselves and what you need to be competitive in this industry. The SKU count continues to rise because new vehicles are coming with new SKUs and old vehicles are staying the fleet longer and you have to keep those SKUs on hand.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Okay. And then my follow-up -- regarding inflation, Tom, is there any early signs of cost creep from the supplier side that you can look down the road and maybe get some inflation?

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

Through the end of the year at our expectation is that on SKU by SKU sale basis we are not going to see inflation.

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**Simeon Gutman** - *Morgan Stanley - Analyst*

Okay, thanks.

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**Operator**

Aram Rubinson of Wolfe Research.

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

Aram, are you there? Operator, we might go to the next question.

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**Operator**

Sure. Our next question comes from Chris Horvers from JPMorgan. Chris, please go ahead.

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

I also wanted to follow up on the gross margin. As you think about that 10 to 30 basis point outlook over the longer term, what's the driver of that? How much of that is volume synergies versus leverage on distribution centers that you are putting in versus, I guess, company-specific pricing type strategies?

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

Those are the three buckets it comes from. It depends on the year. We are going to try to chip away on all fronts. We do have quite a few newer distribution centers. And as the stores in those distribution centers reach higher volumes we would expect to see more efficiencies. We would expect to see some price optimization opportunities, especially when retails start to move a little bit, which they haven't really moved much in quite some time. I think the third leg of that is acquisition costs. And although we've gotten most of our benefit from that here recently, we continue to expect to continue to find incremental gains.

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

So pretty balanced, sounds like?

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

Yes.

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

And then just to clarify on the LIFO, as you lap the LIFO's pressures later this year and early into next year, do we get that back? Or how does that play out?

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

I would think of it more as an absence of the headwind.

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

Absence?

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

Yes. When we look at it, and we talked about it earlier, we take that hit all up front. And then from the next part we sell at the lower cost on a going-forward basis we make a higher POS margin on that part. So sequentially when we look at the quarters, that better pricing is factored into the gross margin.

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

Understood. And then finally, can you just remind us on the compares last year -- I seem to recall there was a heat snap in early July and the business started to pick up but then it moderated back down. How did your third quarter comparisons -- how do they play out?

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

Third quarter last year -- July was the best month of the quarter.

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

Any degree or any qualitative comment as to how much?

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

No. It wasn't a huge difference but July was definitely the better part of the quarter, and then we ended the quarter with the softest month of the quarter.

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

Perfect. Thanks very much.

**Operator**

Liang Feng from MorningStar.

**Liang Feng** - *Morningstar - Analyst*

Looking more granularly into your commercial performance, can you discuss how your small business accounts are performing versus some of your larger accounts? And when you enter into a new market like Florida, which customer base do you start off with?

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

Well, on the national accounts we have, we would have existing relationships and existing pricing set up. So we would be ready to do business with them. So we would start off with them pretty quickly. But our focus is typically on the just the up and down the street shops that exist. And we typically open the store and do a market blitz to make sure that all the shops knew we were open and what we were about, what kind of services we provide. And we would set up accounts and so forth.

So it's a mix of both. And it depends a lot on the particular market and who exists in those markets. Most shops are doing pretty well this year. The pickup in demand as a result of the weather -- I think that shops across the board are doing pretty well. Some of the chains appear to be -- you never get all the customers business so it's hard to know for sure how each one is doing in total. I saw Monroe reported this morning, and I think their comps -- they were hoping there be a little higher than what they were. Some shops, especially the national chains that sell tires -- and this may be the case with Monroe, too, where tire deflation has caused some pressure on the top line. That may be a factor for them, too. But from the parts supply standpoint I would consider them pretty equal. And I think most shops are doing pretty well.

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**Liang Feng** - *Morningstar - Analyst*

So when you enter into a new market, now that you have this national reach, do you have some of your larger account customers asking for you to come into Florida, for instance? And you mentioned that the Florida business is picking up faster. Could that be contributing to it?

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

Well, we put a lot of focus on having relationships and doing business with national accounts. Typically, we call on them rather than them asking us to be there supplier because there's -- really in the US there are no underserved markets when it comes to auto parts these days. When you go into a new market you have to go in and take the business from someone who is supplying them now.

So yes, we work hard to have relationships with national accounts. In Florida we have some. I'm unaware of that being a major factor in our success down there. And I would say that probably at least as big if not bigger factor is just our efforts up and down the street to develop relationships with shops, independently owned shops, maybe small chains of shops, and sell them parts and provide services to them.

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**Liang Feng** - *Morningstar - Analyst*

That's very helpful. Thank you, and good luck on your next quarter.

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**Operator**

We have now reached our allotted time for questions. Greg Henslee, I will turn it over back to you.

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

Thanks, Daniel. We would like to conclude our call today by again thanking the entire O'Reilly team. We have once again proven that committing ourselves to the O'Reilly culture values and taking great care of every customer are the keys to our record-breaking results. We continue to believe in the long-term demand drivers for our industry and are very proud of our second-quarter results and accomplishments and we are very confident in our ability to continue to successfully and profitably execute our proven growth model and to gain market share from coast to coast.

I would like to thank everyone for joining our call today. We hope to see many of you at our analyst day in August and we look forward to reporting our third-quarter 2014 results in October. Thank you.

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**Operator**

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