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ORLY - O`Reilly Automotive at Gabelli Automotive Aftermarket Conference

EVENT DATE/TIME: NOVEMBER 04, 2014 / 10:15PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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Tom McFall *O'Reilly Automotive - CFO*

PRESENTATION

Unidentified Participant - *Gabelli & Company - Analyst*

When we think about how great an industry the aftermarket is, our next presenters certainly indicate that, both with their own performance from a sales perspective, an earnings perspective and a stock price perspective. The guys at O'Reilly certainly know how to drive value for the shareholders, and they've shown that over the course of the last 10 years or so, but specifically within the last six after acquiring CSK Auto.

This company has 104 million shares, 102.4 million common at the end of the quarter, so about 105 fully diluted, trades around $170 for a just under $18 billion equity cap, about $1 billion in net debt for about $19 billion total enterprise value.

We are delighted to have Greg Henslee, the Company's Chief Executive Officer, along with Tom McFall, the Company's Chief Financial Officer, and Jeremy Fletcher, the Company's VP of Finance here, so we're going to get into a Q&A with them, and welcome, guys.

Greg Henslee - *O'Reilly Automotive - CEO*

Thank you. Just so you know, we decided not to bore you with our deck because it really hasn't changed the last five or six times we've shown it.

Unidentified Participant - *Gabelli & Company - Analyst*

That's kind of the beauty of your story, right? You've got -- you've shown a tremendous ability to grow comps in excess of the underlying market over the past five years, and part of that could probably be attributable to you bringing your former CSK stores on, but I think that there's more to it. I think that it's more that you're gaining share in local markets through your distribution capabilities. Talk about how that's really O'Reilly's core competence from an upgrading standpoint and why you think that that lends itself to continued success within the US aftermarket.

Greg Henslee - *O'Reilly Automotive - CEO*

Well, like you said, having bought CSK six and a half years ago, converting those stores to a format -- to the (inaudible) strategy format has been, obviously, accretive to our comps on the commercial side, so that's been a good thing for several years. But on the other side of that, I think that most that look at our Company would be very pleased at how our -- what we would consider the core O'Reilly stores do, both the DIY and the commercial side, when it comes to comp store sales.

And I think, like you said, it's something that plays into our business model from a parts availability standpoint, where we have distribution that touches every store at least once a day, but most stores are touched multiple times a day. They would be stores in cities where we have a DC would be able to have access to a distribution center inventory six to eight times a day in some cases, 16 the more common.

Having that kind of parts availability has always been a good thing in our business, and we've done it forever in our business, but it's more important today as cars stay on the road longer and it takes more parts to cover the car part, and I think having that kind of availability makes it possible for us to penetrate deeper into a market without having to have the inventory in each store that it would take to get the penetration that we have.

So the distribution centers, super-hub stores, hub stores and then just the management system that we have that helps us deploy inventory and decide what parts are most fitting to a market I think serve us well.

Unidentified Participant - *Gabelli & Company - Analyst*

By year-end, you'll have just under 4400 stores, about 4350, give or take. You've set out a goal, roughly speaking, at about 200 new stores per year. Realistically speaking, how long a runway do you think you have until you reach saturation in the US?

Greg Henslee - *O'Reilly Automotive - CEO*

Well, we think based on the way things exist today -- and things will change over the next nine or ten years, but based on the way things exist today and the way we look out, we think we can operate around 6500 stores in the US, Alaska and Hawaii. Things will change as we move forward.

There will be smaller companies that are bought by larger companies, as has been the case over the past several years, and the consolidation of the aftermarket will continue, although there won't be as many large acquisitions, obviously, but there are still several small companies that will be acquired, so that will change. But based on what we know today as far as who exists and who we think will be around nine or ten years from now, we would estimate that we would have about 6500 stores in the US.

Unidentified Participant - *Gabelli & Company - Analyst*

Now, you're entering some fairly new markets for the Company, having opened Lakeland and now extending into New England. Talk about the size potential of both the New England and Florida markets. And along with that, just talk about the kind of competitiveness in those markets that you think you need to compete against.

Greg Henslee - *O'Reilly Automotive - CEO*

Well, in New England, we just opened the one distribution center, and it can supply 275 stores or so. We'll eventually have to have another DC up there to fully penetrate that market, so we would end up with more than that amount of stores up there. We would have another DC on further west to take advantage of the opportunity up there.

In Florida, Lakeland can service approximately 300 stores, and we would end up with approximately that many stores there, many of which already exist. We were servicing them out of our distribution center in Atlanta, Georgia, and we'll continue to expand down there, and we'll end up with somewhere in the area of 300 stores in Florida, I think.

Unidentified Participant - *Gabelli & Company - Analyst*

Now, one of the things, at least for me, on an operating perspective that kind of flies in the face of your mix is that you've been able to grow gross margin while, at the same time, increasing your do it for me mix. Just kind of, Tom, maybe you're the guy to talk to about that. Talk about how you've been able to do that over the course of the last several years.

Tom McFall - *O'Reilly Automotive - CFO*

Well, if we look at the do it for me mix and the do it yourself mix, we continue to grow do it for me faster, so it's increasing. But when you look at the percentages and the weights, it's not as dramatic of an impact on gross as you would think. But really the success has been through reducing acquisition costs, maintaining rational pricing, and as we've grown, especially in the CSK market, leveraging those new DCs and also making sure that we focus on having profitable relationships that -- our pricing is going to be competitive in every market, but we really want to win on service and we want to make sure that the pricing we start with a customer day one is the pricing that we can continue on because that's like the long-term relationship.

Unidentified Participant - *Gabelli & Company - Analyst*

Sure. And I hate to jump around, but thinking about CSK now six years after the fact, is it fair to say that the earliest stores that you turned there are now considered to be fully mature? And what's the kind of revenue per store for some of the stores that you converted early versus those that maybe finished towards the end of your process?

Tom McFall - *O'Reilly Automotive - CFO*

It really depends on the market we're in. We bought CSK out a number of years ago, but all those DCs and those systems didn't change right away. But we continue to have tremendous opportunity, especially on the West Coast, which were the last stores to convert to grow our do it for me market share. Those stores volumes tend to be -- those stores tend to be in more highly concentrated and populated areas, so they've edged above the average for the chain.

But as we talked about when we purchased CSK, our mix of -- our average store mix includes quite a bit of immature stores, and then also because of our dual market strategy, we'll go into smaller markets, more rural markets where the volume opportunity isn't the same, but the cost structure is a lot lower.

Unidentified Participant - *Gabelli & Company - Analyst*

Greg, one of the things that you talked about on your Analyst Day was proliferation of import parts and how you're choosing on an internal basis to take on the challenge of addressing changing car parts, so talk about your import part strategy and how you expect that to kind of play out over the next couple years.

Greg Henslee - *O'Reilly Automotive - CEO*

Okay. Well, the way that we look at parts for cars or inventory is really the same as we've looked at it really all the years we've been in business. Our Company has never been one to develop a set that works in a store and use that as a repeated set. We've always built customized inventory for our stores based on different things, and primarily the factors are expected demand that is affected sometimes by the climate. It's also the vehicles that exist in the market, the age of those vehicles, those kinds of things.

The way we look at import cars is, well, they're cars being driven in our markets, and they're cars that we have to have parts for, so I think we do a great job of covering the vehicle population with the parts coverage that we need to service import cars.

Now, to the extent that there are import specialists, I'll call them -- they're shops that primarily work on import cars, many of whom the owners of these shops are guys that used to work in dealerships. Maybe a BMW master tech decided that he had a better opportunity to own his own business and open an import specialty shop working on BMWs. Those guys can have a pretty good business, and some of those guys prefer a more OE-like import part, not that the aftermarket parts aren't OE-like, because many times they are.

Many times, they're made by the same manufacturer that made the OE part, but sometimes the packaging and the way you present it to an installer can make it seem as though it's more of an OE-type part, and sometimes it's just a difference when you buy a part from an import supplier. So we developed a private-label brand called Import Direct that we developed a few years ago, and we are changing our product line enough so that we have, in some product lines, parts for import cars in an Import Direct box.

And we pay a lot of attention to what's in the box when we put an Import Direct brand on it. We try to make sure it's a part that an import specialist would want to use, and that allows us to kind of take the position that Worldpac has taken over the years, and IMC to a much less degree and then SSF to a much less degree have taken with regard to relationships to these import specialty shops.

So as we've looked at these companies as everyone else has, the thing that was not a need for us was distribution. We have this great distribution model in the US. If you look across the United States, there's really -- it would be hard to find someone, I think, that could get a part quicker in a consumer's hand or a do it for me customer's hand quicker than we can.

So if we've got the inventory in our distribution system, we're in a really good position, and that's our strategy, is to leverage our distribution system with the right products for import cars, and I think we do a good job on it today. I think a lot of our comp store sales growth and market share gains are on imported cars.

Unidentified Participant - *Gabelli & Company - Analyst*

Greg, we're six months into the integration -- or the beginning of the integration of Worldpac and Carquest with Advance. Have you seen any disruptions in your core end markets? I know you've taken on some independents, but what do you think? What are your thoughts on how this is playing out in the market and where this ends up?

Greg Henslee - *O'Reilly Automotive - CEO*

We've not seen a lot yet. There have been a few stores close. The recent couple of brand changes recently are favorable to us and genuine parts, because we carry those brands. I think that as the integration strategy is executed, there might be opportunity for us. Today, there's just not a lot of integration consolidation work other than the stores that have been closed, which there aren't that many stores that have been closed yet, so I think it's yet to be seen. The opportunity for us, of course, is where a store is closed.

I read an analyst report the other day that was speculating that 85% up to 100% of that business can be retained when you close a store. Boy, that has not been the case in our history. We've done this kind of thing a lot, and usually when you close a store and try to consolidate any other store, you lose more than that.

And again, circumstances are always different depending on the specific market and who's running the store and all these other factors, but we would expect that as that consolidation happens where an Advance and a Carquest store exists together, that there will be some of that business that will go up for grabs and that we'll be one of the participants that take some of it, along with everyone else.

Unidentified Participant - *Gabelli & Company - Analyst*

This is my seventh conference. You've obviously been in the industry for far longer. One thing we haven't seen over time is part insulation and that being a net benefit to your bottom line. What do you think is preventing that?

Greg Henslee - *O'Reilly Automotive - CEO*

Do you want to take that?

Tom McFall - *O'Reilly Automotive - CFO*

Yes. So when we -- we haven't seen tailwind for comps from inflation since 2010, and when we look at the economics for our business, what we're really trying to do is continue to have comparable increases in gross margin dollars. So over the last three years, there hasn't been a push on inflation -- or push from inflation on input prices to raise prices.

But at the same time, ourselves and our competitors have been able to improve acquisition costs, so we've gotten those comp gross margin dollar increases -- not through the sales line, but through the gross profit percentage. And we need to see those increases to cover our increasing costs, so what we would expect to see as the economy improves is that there will be pressure on input costs and we'll get back to having a moderate amount of inflation in our industry.

We don't have the tailwind for those acquisition decreases that we've had over the last three or four, five years, as we've moved manufacturing of product to lower-cost markets, and the parts that have come out of those markets have improved and been able to be spread across more categories. So our expectation is that we're going to see the economy improve, we're going to see some moderate inflation, people will start to raise prices, and we'll continue to grow gross margin comp dollars and it will be a benefit to sales comp, which we haven't seen.

Unidentified Participant - *Gabelli & Company - Analyst*

That's a good -- actually, a good segue. And by the way, please raise your hand if you have any questions. You've taken -- you've grown your gross margin and your gross profit dollars through better purchasing, which to me, on the other side of the coin, means pressure on your supply base. Once you were able to get to investment grade, you've certainly been able to use your balance sheet to help return cash to shareholders and drive leverage. What's your sense now that the supply base can continue to handle payable terms where you've pushed them? And then if we get into a rising rate environment, what happens to that?

Tom McFall - *O'Reilly Automotive - CFO*

When we talk about acquisition cost decreases, throughout the industry we've seen a reduction in the cost to manufacture.

Unidentified Participant - *Gabelli & Company - Analyst*

I'm not saying it's just you, by the way.

Tom McFall - *O'Reilly Automotive - CFO*

Right. Well, I didn't want you to think that we've squeezed --

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Unidentified Participant - *Gabelli & Company - Analyst*

No. No, no, no, no, no, no. You are not alone.

Tom McFall - *O'Reilly Automotive - CFO*

I've looked at P&Ls, and they still make money. So those efficiencies are kind of coming to an end. When we look at the dating, we really look at it separately from the pricing. So the suppliers are in a supply agreement because it gives them more access to capital quicker. They borrow at a better incremental rate. To the extent that we get back to interest rates that are more normal, it'll be a higher input cost for them, and that'll roll through costs of goods, which will give us some of that inflation that we would like to see on the top line, but it shouldn't impact the dating.

(Inaudible) is like the speed of light -- it's the same for everybody. It's that borrowing on investment grade, and it's the access to cash a lot quicker that entices people to be in a supplier agreement.

Unidentified Participant - *Gabelli & Company - Analyst*

Oh, over here.

Tom McFall - *O'Reilly Automotive - CFO*

Michael.

Unidentified Audience Member

(inaudible - microphone inaccessible) fabulous growth in the margin rate of the business over the last five years. Is there a finite limit that you see that you just won't be able to go above and beyond, if only because of the dynamics in the industry where there's too much power given to the distribution side over the vendor side, the vendors could push back and say -- you're earning too much at our expense? Or are there any other natural limits that you might see in your business where you don't want to push it further above and beyond what's possible?

Greg Henslee - *O'Reilly Automotive - CEO*

Well, I don't think we ever stop pushing as much as we can, although I wouldn't expect gains like we've seen the last six or seven years in the upcoming six or seven years. I think we're all reaching a point where we all benefit from really good gross margin. The suppliers -- many of them have felt the pressure of just the industry in general and some of the things that happened back when the OEs were having low car sales and things like that. There are a lot of suppliers that just didn't make it through that, to some degree.

And so I would not expect big gross margin gains in the future, although I would continue to expect incremental gains. We expect our suppliers to continue to look for means to operate more efficiently. They continue to move their production to low-cost countries and look for places where they can manufacture for less. We continue to try to work with them on ways that we can logistically better manage inventory and costs of transportation and things like this. I think there continues to be incremental opportunity, but not big wins like we've seen in the last six years.

Unidentified Audience Member

(inaudible - microphone inaccessible)

Unidentified Participant - *Gabelli & Company - Analyst*

On the SG&A side?

Greg Henslee - *O'Reilly Automotive - CEO*

Yes, the same thing on SG&A. Yes.

Unidentified Participant - *Gabelli & Company - Analyst*

So we shouldn't expect your business over the long term to have a 25% or 30% operating margin rate.

Greg Henslee - *O'Reilly Automotive - CEO*

I'm very hopeful, but I would think not.

Tom McFall - *O'Reilly Automotive - CFO*

I think the thing we'd add to that, when we look at our SG&A structure, we want to make sure that we've got the cost structure that not only supports the business now but continuing to grow the business for the long term.

Unidentified Participant - *Gabelli & Company - Analyst*

So one of the -- I guess tied to that question, one of the things that's helped private label and then brands that are -- or manufacturers that are finding cheaper ways to produce product, so the question is on national brands versus private label. There are some in the industry that think over time, national becomes more important. We talked about Import Direct and import parts. In a few years' time, imports will be the more dominant. The growth of Worldpac and IMC, right, the brand names -- the brands and OE brands become more important. So is that some tension point that the business reaches, where there is some shift back to the name brands? And if so, can you teach those brands maybe to manufacture cheaper so that the margins can keep going up?

Greg Henslee - *O'Reilly Automotive - CEO*

It's obviously yet to be seen, but I think that branded products play a very important role from a lot of perspectives, from the perspective that some of them are brands that installers have a lot of trust in. For manufacturers, they make a lot more profit on branded products, and they like them for that reason, and we like them because it is good for our manufacturers. We like them because it brings, generally speaking, more gross margin dollars to the transaction, not always at greater percentage, but more dollars.

And it's always great to have a product that you don't have to sell. If you call on a customer and you say -- I've got Wicks or Gates and they're familiar with those brands, you don't have to sell them a private label brand. They know what it is, and then it becomes a matter of relationship and service and stuff like that.

See, on the import side, I don't see as much of a branded thing as what some may feel there is. If you walk through a distribution center of one of the import specialists like we've talked about, what you would see is a lot, a lot of brands, and some of those might be private label brands that that particular company has built, like an Import Direct, that installers over time begin to think that they're a national brand but really they're a private label brand.

A lot of our private label brands are recognized as national brands. We've, over time, acquired brand names that we put products in, and many of our professional customers would view some of our private label products as nationally branded products, not recognizing that we're the only ones that have them and it's our private label.

So I think it's yet to be seen. I think that there's no question that the branded products continue to play a very important role, and I think that today, as some of our more retail-inclined competitors in the past have tried to come into the professional business, that they've become more interested in branded products, and that's why it gets more attention than it has in the past.

We're very happy with the performance of our private label products, but only because we've been, I think, really good stewards of the product, of the quality in the box, and then also using brands that may have a history, that have been recognized in the past as national brands, like Murray air conditioning parts and stats and things like that, that we private label ourselves but we use a brand that used to be a national brand. We own the Precision brand, which used to be a Federal-Mogul brand for universal joints. We use that now on fuel pumps and some undercar things. But it's a brand that most professional customers would recognize as a national brand, a high-quality brand, but it's a private label that we own.

Unidentified Participant - *Gabelli & Company - Analyst*

Okay, Brett.

Unidentified Audience Member

And I guess just a follow-up to some of the hopes for inflation -- I can see it on the commercial side. Could you talk a little bit maybe about the potential for deflation on the DIY side as the Internet becomes sort of more of a disrupter from a price standpoint?

Greg Henslee - *O'Reilly Automotive - CEO*

When we look at our business and we look at the Internet, we're selling not just a part, but a service, and most DIY customers don't exactly know what they need, so they're coming to the store to get knowledge as well as the part. I'm not exactly sure what the make-model is. I might not even know what the part is. I might need to show you the part. I might get my car up on jacks and figure out that, gosh, I don't have all the parts.

The other thing that's different in our industry from a lot of industries that have become major Internet industries is the placement of inventory. So there is a lot of inventory out there. Typically, people have to make a repair on their car. Nobody -- the typical customer doesn't choose to make a repair. They have to make the repair, so they're doing it to save money and they're doing it to get back on the road, so they need to get their vehicle out there. So for those reasons, the Internet is important, but we're selling not just a part, but the service.

Unidentified Participant - *Gabelli & Company - Analyst*

You've been a bit of a victim of your own success. For the past year and a half, you've targeted at a 2 to 2-1/4 times leverage number, and you just keep comping better than expected and not being able to hit that. So should we just continue to think that, at least from a share repurchase standpoint, it's going to remain business as usual, or is there any mandate internally to try and get to that target leverage maybe sooner than (inaudible)?

Greg Henslee - *O'Reilly Automotive - CEO*

Well, just so you know, we don't feel very victimized over this. You know what I mean? We don't -- we gave that ratio and that target out there to communicate what our long-term expectations are. When we look at our AP-to-inventory ratio for this year, we're vastly exceeding our expectations, so we've generated more free cash flow. We're going to execute a buyback program over a long period of time. We don't feel the pressure to get to that leveraged range so that we can have more cash sit on our balance sheet and pay interest for it.

So a couple calls ago, I think we dropped that we soon expect to be within the range because we just keep generating more cash from the great results, and it's a Cadillac problem to have, but over time, we're committed to having the right capital structure, but we're not in a rush and doing foolish things to get there.

Unidentified Participant - *Gabelli & Company - Analyst*

My number is not yours. I mean, to get to that number, you're up close to $9 in earnings next year. Obviously, it's been a great accelerate of earnings, but it's also been a function of (inaudible).

Greg Henslee - *O'Reilly Automotive - CEO*

Sure. Well, ultimately it's like the icing on the cake, but it's not the cake. The cake is continuing to increase operating profit dollars. That's our focus.

Unidentified Participant - *Gabelli & Company - Analyst*

We have time for one quick one more. If not, then I'll move the agenda along. Guys, thank you so much. As always, congratulations on another great year, and best wishes for (inaudible).

Greg Henslee - *O'Reilly Automotive - CEO*

Okay, thank you very much. Appreciate it.
