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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

Alan Rifkin *BTIG - Analyst*

Seth Sigman *Credit Suisse - Analyst*

Matthew Fassler *Goldman Sachs - Analyst*

Scot Ciccarelli *RBC Capital Markets - Analyst*

Greg Melich *Evercore ISI - Analyst*

Dan Wewer *Raymond James - Analyst*

Seth Basham *Wedbush Securities - Analyst*

Mike Baker *Deutsche Bank - Analyst*

Simeon Gutman *Morgan Stanley - Analyst*

Mark Carden *UBS - Analyst*

PRESENTATION

Operator

Welcome to the O'Reilly Automotive, Incorporated second-quarter earnings release conference call. My name is Richard and I'll be your operator for today's call.

(Operator Instructions)

Please note that this conference is being recorded. I'll now turn the call over to Mr. Tom McFall. Mr. McFall, you may begin.

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

Thank you, Richard. Good morning, everyone, and thank you for joining us. During today's conference call we will discuss our second-quarter 2016 results and our outlook for the third quarter and remainder of 2016. After our prepared comments we will host a question and answer period.

Before we begin this morning I'd 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 estimate, may, could, will, believe, expect, would, consider, should, anticipate, project, plan, intend, or similar words.

The Company's actual results could differ materially from any forward-looking statements due to several important factors described in the Company's latest annual report on Form 10-K for the year ended December 31, 2015, and other recent SEC filings. The Company assumes no obligation to update any forward-looking statements made during this call.

At this time, I'd like to introduce Greg Henslee.

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

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

It is once again my pleasure to begin our call today by congratulating Team O'Reilly on another solid quarter and a strong first half of 2016. Our Team's proven ability to provide superior value and service drove our industry leading second-quarter comparable store sales increase of 4.3%.

These solid results were in line with our guidance of 3% to 5% and we are pleased with our Team's ability to generate this level of comparable store sales growth on top of last year's excellent second-quarter comparable store sales increase of 7.2%. Our Company's consistent, market leading performance is the direct result of our outstanding Team of over 74,000 dedicated Team members and their unwavering commitment to providing consistently excellent levels of customer service.

In total, we grew sales for the quarter by 7% and combined with our Team's relentless focus on profitable growth and expense management we generated a quarterly operating margin of 19.5% driving a 16% increase in earnings per share to $2.65. This represents the 30th consecutive quarter we have grown EPS in excess of 15%, and this remarkable track record of strong earnings growth over such a long period of time is a testament to the effectiveness of our dual market strategy and the unwavering commitment of Team O'Reilly to providing the best customer service in the automotive after market.

The composition of our comparable store sales growth in the second quarter was very similar to the first quarter. Both our professional and DIY sides of the business were contributors to our comparable store sales growth with professional being slightly higher.

We saw solid increases in both comparable ticket average and transaction count with a larger contribution from our professional ticket count, although our DIY ticket count continues to be solid. The increase in average ticket continues to be driven by the secular industry driver of parts complexity with no help from increases in selling price as inflation on an individual SKU by SKU basis remains muted.

When we look at the cadence of our sales performance for the quarter, results were steady throughout the quarter and within our guidance expectations for each month. We did experience some pressure in April and May due to the wet, cool weather from the slow start to summer as well as pull forward of some business into the first quarter as a result of the mild winter, especially in our stores in the middle of the country. However, hot weather benefited our business as summer took hold in June and has continued into July with comparable store sales trends on a two year stack basis improved from the results we experienced in the first two months of the second quarter.

On a category basis, we continued to see solid performance in key hard parts categories such as brakes, chassis, and drive line, especially in our stores in the western and southeastern US which were not impacted by the timing of the weather fluctuations in first half of the year. As one would expect, weather related categories such as HVAC and batteries also performed extremely well in the back half of the quarter across the Company as temperatures rose.

Looking at the broader after market. We continue to benefit from positive tailwinds from modest improvements in total employment, low gas prices, and continued solid growth in miles driven which are up 3.3% year-to-date through May. We feel these positive macroeconomic trends have been an important factor in fueling our steady comparable store sales growth, although to a lesser degree compared to the significant year-over-year tailwinds we experienced in 2015.

Considering all the factors driving our comparable store sales performance, and in light of the very tough comparisons we face on a two year and three year stack basis, we feel it is appropriate to set our third quarter comparable store sales guidance at a range of 3% to 5%, in line with our full year guidance. While we have our toughest comparable store sales comparisons from the third quarter last year in the month of July, we are off to a good start and are currently comping within our guidance range for the quarter. We feel our industry is in a very stable, healthy condition, and more importantly, we remain very confident our Team will continue to take share and generate results which outperform the overall market.

As we discussed during our first quarter earnings conference call when we provided our gross profit and earnings per share outlook for the second quarter, our second quarter results included LIFO headwinds totaling $23 million, primarily driven by a specific second quarter deal. Tom will discuss this in more detail in a moment, but this headwind to margin was in line with our expectations, and we remain confident we will achieve our previously stated full year gross margin range of 52.3% to 52.7%.

As the result of our solid performance thus far in the first half of 2016, we are increasing our full year 2016 operating profit guidance from a range of 19.3% to 19.7% to a range of 19.5% to 19.9% of sales. For earnings per share, we are establishing our third quarter guidance at $2.77 to $2.87, which at the midpoint would represent a 7% increase over EPS of $2.64 in the third quarter of last year.

As a reminder, our EPS results in the third quarter of 2015 including an $0.11 per share greater than typical benefit from the resolution of certain historical tax positions. On a comparable basis the midpoint of our earnings per share guidance range would be an 11% increase over the prior year adjusted earnings per share of $2.53 absent this tax benefit.

We are increasing our full year earnings per share guidance from a range of $10.10 to $10.50 to a range of $10.30 to $10.70. Both of the third quarter and full year this updated guidance includes the impact of shares repurchased through this call that excludes any potential additional share repurchases.

Before I turn the call over to Jeff, I would like to again thank our Team for another outstanding quarter. We remain very confident in the long term drivers for demand in our industry, and we believe we are very well positioned to capitalize on this demand and lead the industry by consistently providing exceptional service to our customers every day.

Again, congratulations Team O'Reilly for a very strong start to 2016. 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. I'd like to begin today by echoing Greg's comments and congratulating Team O'Reilly on another strong quarter. I'm extremely proud of our Team's execution and the level of consistent top-notch service that we continue to provide to our customers day in and day out.

Our comparable store sales growth of 4.3% on top of 7.2% in the prior year again out paced the market. And this industry leading performance is the direct result of our Team's commitment to out-hustling and out-servicing the competition each and every day. I want to thank each of our Team members for their continued hard work and dedication to making O'Reilly Auto Parts the destination location for all of our customers' auto parts needs.

For the quarter, we levered SG&A by 80 basis points. As a reminder, included in SG&A in the second quarter of 2015 was a headwind of $19 million from an adverse judgment in a long term dispute with a former service provider, and our leverage in the second quarter of this year benefited 93 basis points from the comparison to this item.

Excluding the adverse judgment in 2015, we delevered 13 basis points as a result of the tough comparisons to the robust sales we generated in the second quarter of 2015. As always, our Teams remain very focused on expense control, but we will be judicious in managing our store staffing levels to ensure we don't jeopardize the excellent customer service that develops and maintains long term relationships.

Average per store SG&A for the second quarter increased 2.9% over 2015 excluding the adverse judgment in 2015, which was within our expectations and driven by expected higher medical costs, and a comparatively more aggressive advertising campaign as we discussed when we established our full year guidance at the beginning of the year. We continue to expect our full year average SG&A per store to increase approximately 2% over 2015 average SG&A, excluding the adverse judgment. However, we'll closely monitor our sales volumes and will make the appropriate adjustments as needed to prudently manage SG&A expenses both up and down to match business trends and the opportunities we see in the marketplace.

We successfully opened 89 net new stores in the first half of 2016, and we continue to be pleased with the performance of our new stores. We continue to see heavier concentrations of growth in our expansion markets in Florida and the Northeast but we're also capitalizing on great growth opportunities across our footprint. And as a result, our store growth so far in 2016 was spread across 28 different states. Our ability to effectively enter new markets while also selectively expanding our presence in existing markets continues to give us a great advantage in choosing new sites, and more importantly, identifying, hiring, and training outstanding store Teams to provide excellent customer service in our new stores.

As we've discussed in the past, Texas is one of our long time markets where we continue to see strong growth opportunities and where our new store growth had stretched our distribution capacity. To this end, we're very pleased to announce the seamless opening in May of our newest DC in Selma, Texas, a northeastern suburb of the San Antonio market. This new DC will allow us to improve our parts availability in the rapidly growing San Antonio metro market, and will also enhance our service in the Austin market, another strong market for us just an hour drive up the interstate from our new DC. The San Antonio DC has the capacity to service approximately 250 stores, and has ramped up extremely well by transferring [neither] replenishment for 166 stores from our existing Texas DCs in Dallas, Houston, and Lubbock, creating capacity for new growth across the state of Texas.

As we've said many times in the past, opening a new DC is a long process and is much more difficult and complex than our DC Leadership Teams make it seem. Opening a back fill DC in such a strong existing market is an especially challenging test since the store serviced by San Antonio and our customers in those markets have high service expectations because of the great track record we've established over a long period of time. Well, the San Antonio Team did an amazing job getting up and running without missing a beat, and we're extremely proud of the excellent Team we have in place providing outstanding and enhanced service to our customers in central and southern Texas.

As I close my comments I want to thank Team O'Reilly for their continued dedication to our Company's success. We've had a solid year so far. We're also well positioned to continue to provide our customers exceptional service and the best parts availability in the industry, and we intend to finish the year strong.

That said, we will never rest on our past successes. We know we have to go out and win the business each and every day by out-hustling and out-servicing our competitors, and I'm very confident in our Team's ability to do just that. Now I'll turn the call over to Tom.

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

Thanks, Jeff. I'd also like to begin today by thanking Team O'Reilly for another successful quarter. Now we'll take a closer look at our second quarter results and update our guidance for the remainder of 2016.

For the quarter, sales increased $141 million comprised of an $85 million increase in comp store sales, a $56 million increase in non-comp store sales, a $1 million increase in non-comp non-store sales, and a $1 million decrease from closed stores. For 2016 we continue to expect our total revenues to be $8.4 billion to $8.6 billion.

For the quarter, gross margin was 51.8% of sales, a 23 basis point decrease from the prior year. The decrease was driven by a larger than typical LIFO headwind of $23 million, which was in line with our previous guidance, and as we've discussed previously, related primarily to a supplier renegotiation for a specific major hard parts line.

As we discussed in the past, our success at reducing our acquisition costs over time has exhausted our LIFO reserve, and further cost decreases require us to reduce our existing inventory value to the lower cumulative acquisition cost, creating non-cash headwinds to gross margin. Excluding LIFO from both years, gross margin increased 31 basis points year-over-year.

Moving forward, we will realize improved gross margins from the lower acquisition costs, and we're reiterating our gross margin guidance of 52.3% to 52.7% of sales for the full year. This assumes pricing in the industry continues to remain rational.

Our effective tax rate for the quarter was 36.9% of pretax income. For the full year we expect our pretax rate to be 36.8%. As is typical for us in most years we anticipate our third quarter tax rate to be lower as we adjust for the expected totaling of certain historical tax periods. We expect our third quarter rate to be approximately 35.8% of pretax income, which is significantly above the tax rate of 33.6% we saw in the third quarter of 2015 due to the large, positive, non-typical tax reserve adjustment in the third quarter of 2015 relating to a previous acquisition. We expect the fourth quarter to return to a more normal rate of 37.3% of pretax income. These estimates are subject to the resolution of open audits and our success in qualifying for existing job tax credit programs.

Now I'd like to provide some more color on our free cash flow results and provide updated guidance expectations for the full year of 2016. We generated $194 million in free cash flow for the quarter which was relatively flat with prior year. Year-to-date we generated $578 million in free cash flow compared to $512 million in the prior year. And based on our successful management of working capital, primarily net inventory, we're raising our full year free cash flow guidance from a range of $750 million to $800 million to a range of $800 million to $850 million.

Inventory per store at the end of the second quarter was $588,000 which was a 2.2% increase from the end of 2015. This growth rate was in line with our expectations for the quarter and we still expect our full year inventory per store to grow approximately 1.5% based on normal seasonal differences. Our ongoing goal is to ensure we grow per store inventory at a lower rate than the comparable store sales growth we generate and we expect to continue our success of effectively deploying inventory in 2016.

Our AP to inventory ratio finished the second quarter at 106% which exceeded our expectations and represented a new high ratio. Our AP percentage continues to benefit from incrementally improved terms and strong sales volumes over the past 12 months; however, as we move into the back half of 2016, we expect our AP to inventory ratio to moderate somewhat from its current levels to a number slightly above 100% as we incrementally improve our vendor terms, but face the headwinds of seasonality and the lower expected increase in sales based on our current comparable store sales guidance for the remainder of the year.

Capital expenditures for the first six months were $220 million, which was up from 2015 and in line with our expectations. We continue to forecast CapEx at $460 million to $490 million for the full year of 2016. Moving on to debt.

We finished the second quarter with an adjusted debt-to-EBITDA ratio of 1.69 times, down from 1.72 times at the end of the first quarter driven by our strong trailing 12 month operating income performance. We're still well below our targeted ratio of 2 to 2.25 times, however we continue to believe our stated leverage range is appropriate for our business and will move into this range when the timing is appropriate.

We continue to execute our share repurchase program, and during the second quarter we repurchased 2.1 million shares of our stock at an average cost of $262.17 per share. Year-to-date through yesterday we've repurchased 3.3 million shares at an average share price of $259.19 for a total investment of $861 million.

We continue to view our buyback program as an effective means for 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 our shareholders.

Based on our results during the first half of the year and the additional share repurchases since our last call, for the full year we're raising our earnings per share guidance to a range of $10.30 to $10.70 per share, representing an increase of $0.20 per share from the annual guidance we provided during our first quarter earnings release. In line with our normal practice, our guidance includes all of the shares repurchased through this call, but does not include any future share repurchases.

Before I turn the call over to our analysts for questions, I would once again like to thank the entire O'Reilly Team for their continued hard work and dedication to providing consistently high levels of service to our customers. Congratulations on another solid quarter.

This concludes our prepared comments. At this time I'd like to ask Richard, the operator, to return to the line and we'll be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question online comes from Mr. Alan Rifkin from BTIG.

Alan Rifkin - *BTIG - Analyst*

Thank you very much, gentlemen. Congratulations on a nice quarter.

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

Thanks, Alan.

Alan Rifkin - *BTIG - Analyst*

Maybe you should have kept talking. The stock is up 10 points during the duration of the call. But my first question is you raised the earnings and EBIT guidance for the year while maintaining the revenue and comp and gross margin.

Obviously incrementally you must be seeing something on the expense side of the equation which coupled with your SG&A per store being up 2.9% in the first half and your goal is 2% for the year, which would imply 1% in the back half. So my first question is what incrementally are you seeing on the expense side of the equation that gives you the greater confidence?

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

Alan, our increase of $0.20 is comprised primarily of share repurchases, and the increase in operating profit expectations primarily driven by a higher gross margin percentage through the remainder of the year. As a result of improved acquisition costs as we take these LIFO charges we end up with a higher ongoing POS margin.

Alan Rifkin - *BTIG - Analyst*

Okay and my second question is--

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

Alan, I could add just -- and the third piece as you stated is we're expecting to see a little better SG&A than we've seen in the first half of the year.

Alan Rifkin - *BTIG - Analyst*

Okay, thank you, Tom. My follow-up if I may is on the LIFO charge. It's predominantly from one vendor, which would imply that obviously you've exhausted the LIFO reserve with this one vendor. And based on their size we can glean that this is a pretty large vendor.

I guess my question is if you're seeing such additional clout with a very large vendor, would it be reasonable to assume that your clout with even smaller vendors is as great if not greater than what you're recently seeing with this one particular vendor?

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

Well Alan, a slight difference in what you said is our LIFO calculation is based on our inventory as a total pool. It's not based on supplier by supplier, so the elimination of our LIFO reserve and going into a debit position over time has been the [culmination] of many, many suppliers.

Alan Rifkin - *BTIG - Analyst*

Okay, thank you Tom, I appreciate it.

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

Thanks, Alan.

Operator

Thank you. Our next question online comes from Mr. Seth Sigman from Credit Suisse.

Seth Sigman - *Credit Suisse - Analyst*

Thanks guys, good morning. You guys have done a really good job navigating some of the seasonal volatility in the last couple quarters. I'm just wondering there's a bigger battle between industry tailwinds and weather. I realize comparisons are getting quite difficult, but the question is are you seeing any evidence that maybe the industry tailwinds are fading or how should we be thinking about that?

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

Seth, I think our industry is really healthy. I think all of the things that I mentioned relative to gas prices, miles driven, employment rate, those are all great things. I think that what our industry has experienced is all of us having reasonably tough compares from last year's great performance and the tailwinds we had last year, but then also this weather issue we are talking about.

It's an issue. We had a mild winter and then we had a late start to summer, so April and May. Our May two year stack was pretty notably down from what we did in April and June, so I would relate it to that more than anything. I think that the industry tailwinds continue as the overall macroeconomic conditions contain or continue to be well.

Seth Sigman - *Credit Suisse - Analyst*

Okay, understood. And then my follow-up question is just on the market share dynamics in the business. That's been obviously a nice part of the story. Based on the comp in the quarter it does seem like you outperformed. Can you maybe speak to the market share and competitive dynamics, and if you're seeing any major change in where that share may be coming from? Thanks.

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

I don't think there's been any major change. We had a lot of great competitors, and a lot of them are companies that don't publicly report and there are people that we compete with regionally that are great companies and are publicly traded companies that we compete with. They are all well-run companies, but I don't think anything has really changed.

I think that we go out there every day realizing that we've got a big job ahead of us and that if we want to gain market share we've got to out-work and out-hustle our competitors like Jeff said, and that's our store operations guys' operating mode every single day. We never take the position that we're in for granted and we know that we have to earn it with each customer every time we receive a call from them as a professional shop or when they walk into our store, so -- but I think we're in a good position to continue to do what we've been doing.

Seth Sigman - *Credit Suisse - Analyst*

Thank you.

Operator

Our next question online comes from Mr. Matthew Fassler from Goldman Sachs.

Matthew Fassler - *Goldman Sachs - Analyst*

Thanks so much guys, and good morning. If you could go into a little more detail on category performance to the extent you saw deceleration in a couple places, what you could trace to the winter weather, what if anything you could trace to the summer weather, and how much that might have changed? I know it's been quite hot in different parts of the country and curious what parts of the business are responding to that and what parts might not be?

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

Well, I think that the most notable thing that we would have seen is in April and May is typically the HVAC and cooling business starts to do really well. Those businesses of course didn't do as well early in the quarter and they really picked up late in the quarter.

The things that are comping best for us right now in addition to some of the hard parts categories that I mentioned that would be weather related would be like batteries that can fail during hot weather, at least get damaged and kind of conditioned for failure in the winter time but maybe fail in the hot weather. Cooling is always a big category and it's doing well, and then climate control and HVAC is currently doing well.

Matthew Fassler - *Goldman Sachs - Analyst*

Is there anything that's lagging on account of last winter, and if so when does that kind of rust come off the purchase cycle and you start fresh again?

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

The things that you would expect to lag would be things like chassis, but our chassis business has been really well. We really haven't seen anything that has been a major lag relative to winter weather last year or during the winter.

I think that had we had winter weather some of these categories would be doing better, but I think the overall macroeconomic backdrop is driving some of these categories that might otherwise be notable poor performers to not be as notable.

Matthew Fassler - *Goldman Sachs - Analyst*

Great. And then a very quick follow-up, Tom, if you would. Your conservatism on the payables ratio over time has been admirable, but you've continued to beat your targets pretty consistently. Is there any reason why this would have to be the peak?

I know you talked about coming off a bit as you make your way through the year. I guess you're not quite at the top of the sector yet so there's precedent for moving higher. Is there any reason why you'd want to hold that back rather than driving that cash conversion cycle further?

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

We would like to raise it as high as reasonably possible with our suppliers. The reason, all things equal, the difference in the rate for us has a lot to do with the sales volume. And when we look at the middle of the year we have the highest sales volume. So we're in the summer selling season, so we're going to churn our inventory the fastest and generate the highest AP to inventory, so as we go into the fourth quarter into the slower part of the year we're naturally going to see some decrease.

Also we kind of have a nine month look back to look at the sales churn to see how rapid that was. And if we look back to the previous nine months have been very good at sales and have helped raise that. We're expecting to come down, but not below [100].

Matthew Fassler - *Goldman Sachs - Analyst*

Got it; thank you so much, guys.

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

Thanks, Matt.

Operator

Thank you. Our next question online comes from Scot Ciccarelli from RBC Capital Markets.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Good morning guys. A bit of a broader question here. It seems to us that the commercial segment of your business should be relatively insulated from e-commerce competition due to the extremely quick delivery times that your industry requires. But in your view what prevents e-commerce from becoming a bigger factor over time in the DIY segment of the business?

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

Well, I think there's a lot of factors on the DIY side that would cause it not to be as penetrating into our business as it would be some other portions of retail. Mainly the immediacy of need, when a car breaks you need the part. Some of the maintenance stuff you could of course order online and maybe wait for a weekend or something, but you always risk getting the wrong part or the application not being correct or not being able to have something that you might need that a parts specialist would recommend.

Plus across the US there's 35,000 parts stores, so there's very few places geographically that there's not a parts store fairly close. And I think we're all pretty price competitive. While we wouldn't be selling at prices that some of the online retailers would, I don't think we're that far off and wouldn't be that far enough off that it would make sense to pay freight and buy the parts online, so I think that's part of it. But a big part of it is just advice.

A lot of DIY customers that walk into our stores are doing repairs on their cars not because they're hobbyists. They are doing so because they have economic drivers in their household that require that they work on their own car. And we're able to help them fix their car in the most efficient, expedient way, and online retailers just aren't able to do that. So they risk putting parts on their car they may not need, putting parts on their car that may not fix their car, and it always helps to get advice when you're working on a car and we have a lot of guys that give great advice.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

So basically speed and complexity. One other quick question, hopefully. What was the magnitude of the gap in comp growth that you guys saw between let's call it weather impacted regions of the country versus areas that saw more consistent weather patterns?

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

That's a little bit hard to measure because it's hard to draw a line as to where the weather impact began and where it ended, but we would -- based on our analysis we would say it's between 400 and 500 basis points if you compare the southeast which is not as weather impacted, and the western states which were not as weather impacted to how we performed in the central and central southern we would say 400 to 500 basis points.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Got you, very helpful. Thanks guys.

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

Thanks, Scot.

Operator

Thank you. Our next question online comes from Mr. Greg Melich from Evercore ISI.

Greg Melich - *Evercore ISI - Analyst*

Thanks. I have a couple questions. I just wanted to get a little more color first on what put the comp together, the pro versus DIY. I think you mentioned that traffic and ticket were up for both and that DIY ticket was also solid. Does that mean DIY traffic was down? Just an update there, and also on the loyalty program, and then I have a follow-up.

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

I'll answer the first part. Our DIY traffic was positive for the quarter. Just professional was up more.

Greg Melich - *Evercore ISI - Analyst*

Got it. And it's true the ticket was the bigger portion of the comp for the Company?

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

Slightly bigger, yes.

Greg Melich - *Evercore ISI - Analyst*

Great. And then I guess a bigger strategic question just given the balance sheet and the free cash flow is stronger than you expect, obviously help with the working capital and maybe it moderates a bit, but we've been below that two times target for so long now, I mean how do you guys think about that?

Is there a certain point where you would consider special dividends, or is it a certain amount that you always want to keep just in case there's an acquisition that makes sense? How do you think about that?

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

Well, we raised some debt in the first quarter, and we've deployed -- returned a lot of capital to shareholders for the first half of the year, but we remain with cash on our balance sheet. So we're going to continue to deploy that in ways that make sense from a long term return standpoint. At some point we may consider a special dividend, but that is not on the table right at the moment.

Greg Melich - *Evercore ISI - Analyst*

In terms of acquisitions, is it -- do you see the opportunities out there, is it still more along the lines of bolt on with the existing US business, or do you think there are markets that you could expand in North America or elsewhere that you guys could really leverage?

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

I think that it's both. I think there's some bolt on acquisitions in the US, I think there's is some potential targets in North America that are outside the US. We're exploring what our acquisition opportunities are right now.

We never don't do that except for when we are acquiring a big company when we do the work to integrate that company and we might stand down for awhile. But we're always in the process of evaluating what might make sense for us. And I think we're in a good position right now to acquire some of these smaller bolt on companies here in the US, and I think we're looking outside the United States for potential targets that would be in North America, Caribbean and those areas.

Greg Melich - *Evercore ISI - Analyst*

That's great. Good luck.

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

Thank you.

Operator

Thank you. Our next question online comes from Mr. Dan Wewer from Raymond James.

Dan Wewer - *Raymond James - Analyst*

Thanks. Tom, your guidance for the third and fourth quarter implies the gross margin ramp accelerates a lot during the fourth quarter. Is there anything happening with a third quarter margin rate perhaps another LIFO charge that we need to take into account?

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

For the third quarter we're expecting a small LIFO charge, not a very large one, but we see that acceleration as we significantly reduce the LIFO charge from the second quarter and benefit from these lower acquisition costs.

Dan Wewer - *Raymond James - Analyst*

And would the momentum that we're going to see in the fourth quarter of 2016, would you expect that to roll through the first three quarters of 2017?

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

Well, we haven't given guidance for 2017, but the way the numbers work when we take these LIFO charges for the next 12 months after that charge is incurred we would have a year-over-year improvement in acquisition cost. Obviously the pricing in the market can change during that period, but from a purely acquisition standpoint we should have a year of tailwind.

Dan Wewer - *Raymond James - Analyst*

Greg, one question for you. When the industry environment becomes more challenging as it did in April and May, does it become easier or more difficult for O'Reilly to grow market share? And then just one other quick question. With a lot of the changes taking place with your competitors, is it becoming easier to recruit seasoned salespeople from other competitors?

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

Well, what I would say, Dan, is that our effort to gain market share really doesn't change that much in bad times versus good times or when we're under pressure from weather or whatever the case may be. I think that the market share gain gap we may have with competitors, I would say that that probably, at least from our view, would stay about the same even though the total market share gain might be less. But I think that we're able to maintain that gap right now.

From a recruiting standpoint, I think that things have improved. I think that we're in a pretty good position to recruit from a competitor or two that may not be doing as well as what some of their team members might like. And we're always looking for good parts specialists and individuals that can prosper in a great Company, and we feel like we have a great Company here that's created a lot of opportunity for existing team members and we'll certainly continue to create opportunities for those that come on board as new recruits that have skills and talents that would help us continue to gain market share.

Dan Wewer - *Raymond James - Analyst*

Great, thank you.

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

Okay, thank you.

Operator

Thank you. Our next question online comes from Seth Basham from Wedbush Securities.

Seth Basham - *Wedbush Securities - Analyst*

Thanks a lot, and good morning.

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

Good morning.

Seth Basham - *Wedbush Securities - Analyst*

My question is around the gap between DIY and DIFM comps. Can you comment on the relative magnitude of that gap this quarter relative to the last couple quarters?

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

The gap is pretty close. We don't speak to them individually, but the commercial has been better, but the gap is -- the difference between the two is pretty close.

Seth Basham - *Wedbush Securities - Analyst*

Got it. So the weather anomalies of this quarter didn't really drive outsized performance in one sector or the other, DIY versus DIFM?

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

It appears to have affected both about equally.

Seth Basham - *Wedbush Securities - Analyst*

Got it, that's helpful. And as a follow-up, you mentioned that you're tracking in line with your 3% to 5% comp guidance for Q3 to date. Can you just remind us of the monthly comparisons for Q3 2015? Were they relatively consistent monthly comps in that quarter?

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

July was our toughest comp in Q3, and then August and September were close to each other. But July would stick out as the toughest comparison that we have, so we're pleased that we're comping where we are now on the toughest compare month that we have for the quarter.

Seth Basham - *Wedbush Securities - Analyst*

Great to hear; thanks a lot.

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

Thank you.

Operator

Our next question online comes from Mr. Mike Baker from Deutsche Bank.

Mike Baker - *Deutsche Bank - Analyst*

Thanks. So I just wanted to ask about the SG&A and you said that if sales trends slow a little bit that there are levers you can pull to react. So I'm wondering what those are, is it things like marketing or labor hours and the like?

And then sort of related to that, do you -- how do you balance that? Do you run the risk of if you pull back on some of those things maybe you're not able to continue to drive the kind of comps that you're driving?

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

I'll make a couple of comments and then I'll ask Jeff to make a couple comments on this. Generally speaking, it's payroll.

Sometimes when business is really good we might work some overtime or allow individuals to work some overtime that would help cover the demand, but in down times we wouldn't have that over time and we work to manage payroll. And Jeff, you and your Team do such an excellent job managing this you might want to make a comment or two about this.

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

Well payroll, you run your business kind of store by store, market by market, and you adjust your staffing needs to whatever your business is doing. Whether it's seasonal issues coming out of summer going into fall and winter or just maybe business is a little slow and we would adjust accordingly.

There again over time is always one that you can pull back in if business slows down, and just really your ramp down going from a busy time to a slow time. You just adjust based on the needs on the professional and the retail side of the business.

Mike Baker - *Deutsche Bank - Analyst*

Is that something you look at weekly, monthly, daily even?

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

Daily. We look at payroll daily, and as I said in my prepared comments, it's something you have to be very careful of and very cognizant of. You can't cut staffing too far and jeopardize service levels. You pay for that long term, so we monitor and adjust accordingly thinking about the long term.

Mike Baker - *Deutsche Bank - Analyst*

Okay, makes sense. And then maybe somewhat related but maybe a different topic. Just wanted to ask about the same-store sales and still very strong, but they have slowed from last year. And I think some of that is weather, some of that is maybe some of the miles driven slowing a little bit from last year. Still very strong, but slowing.

But is there any way to figure out -- are you seeing any of your competitors maybe [seating in less] share than they have in the past, and so just not giving it up as easily maybe that's what causes the comps to still be strong but slow a little bit?

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

Well, I say this to be a little bit funny, but our competitors just don't tell us very much as you could imagine. But I don't think anything is really changed that much from a competitive standpoint. We have a lot of good competitors, and some of our larger competitors come into the professional side of the business and try to do more business with repair shops. They have good programs, they're competitive, and we view them all as competitors.

I would say that we haven't seen a lot of change. I feel like we continue to gain market share and the gap that we've been able to create from a market share gain standpoint. I think we've maintained that well through for some time now, and even though we're all comping a little less than we did last year on the tougher compares and the weather issues I think that we continue to maintain that gap as about to where we were last year during better comp times.

Mike Baker - *Deutsche Bank - Analyst*

Well, just to follow up quickly if I could. I think something did change in the industry or the competitive environment in 2015, right, with one of your bigger competitors going through some changes. But you're saying from 2016 versus 2015 you haven't seen much change?

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

That's correct. And what's been going on with them has been going on for some time. The acquisition has been -- that was a big undertaking, but I would speculate that there was some market share loss there prior to the acquisition that us and some of our other competitors were taking advantage of prior to the acquisition.

Mike Baker - *Deutsche Bank - Analyst*

Okay, understood. Very helpful, thank you.

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

Thank you.

Operator

Thank you. Our next question online comes from Simeon Gutman from Morgan Stanley.

Simeon Gutman - *Morgan Stanley - Analyst*

Thanks guys. Good morning. I guess similar topic to a lot of this focus on the comp. And Greg, you mentioned you're comping within the range, and it sounds like if things stay the same the compares get a little easier so maybe you'll get an uptick. That's what I wanted to focus on.

What would it take at this point to get above the range? Is it simply weather? And you've made a lot of commentary on some of the secular dynamics, but if weather does become let's say more favorable, which for the third quarter would be what, seasonal temps, and then cold in the fourth quarter, could we see the comps maybe reaccelerate a little bit in the back half?

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

I think so. And this would be in an ideal world, and speaking specifically of the weather impact on our business, and this is very short-term thinking because overtime this all revolves itself. But if we continue to have this blistering hot summer that we're having, if that extends well into August and late into August.

And then we go through the back-to-school period where things slowdown and then in October, if many markets start having freezing temperatures where the batteries that were damaged by the heat start failing. Ideal for us would be a continued real hot summer, the little window that you have when school starts, and you kind of go through fall, and then an abrupt start to a real cold winter, that would be ideal and that would drive good comps for all of us.

Simeon Gutman - *Morgan Stanley - Analyst*

And then you mentioned in terms of expansion, you hinted some North American expansion, you'd look other places. I want to just focus on a second on the independence in the US market. And I know you've always had your eye and take advantage of appropriate opportunities.

Can you talk about the complexion of a lot of owners of these businesses, are they aging? Is that process happening in the next decade where you'll see it accelerate versus let's say looking backwards where there's going to be enough of that opportunity to continue taking advantage of that here in the US?

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

Well, Simeon, I'd say there's a lot of -- there's really every possible imaginable scenario out there with these owners. Some are just -- most are just really good operators that have survived a consolidating industry to this point.

Some have children or people to help them manage their business that are very capable of managing the business even if the owners aren't as involved as maybe they have been in the past, and for that reason they may want to continue to own them. Others, when faced with the prospect of us and AutoZone and Advance continuing to grow and become more powerful on the professional side in the case of some of our competitors, they may decide that their business may be worth more today than it would be in the future and they may decide to not continue to own their business and sell it.

So there's every possible combination out there, and we're currently looking at several of them to see if there's a fit for us. But like you said, sometimes the owners want to continue to run their business and in many cases they are very profitable business that don't have much debt and they may run them for years to come and be very successful.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay, thanks.

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

Thanks.

Operator

Thank you. Our next question online comes from Michael Lasser from UBS.

Mark Carden - *UBS - Analyst*

Hey guys, this is actually Mark Carden on for Michael Lasser today. Thanks for taking the question. So inventory per store has now declined in four of the last five quarters. Can this rate continue, and how does the enter of the new DC impact overall inventory levels for you guys?

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

Well, if we look at our average inventory per store, it's up from the beginning of the year. So we would expect inventory to be in a pretty narrow range on a per store basis for the remainder of the year. When we look at the end of the year that typically is our slowest time of business, so we have the lowest level of safety stock in the DC, so we see a lower number at the end of the year. But we're happy with where our inventory is and we'll be relatively consistent on a before basis.

Mark Carden - *UBS - Analyst*

Great, that's really helpful. And second, I wanted to get a sense of how satisfied you guys are with the returns you're seeing on your advertising spend these days?

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

Well it's always hard to measure. A wise man once told me that half your advertising spend is wasted and the art is figuring out which half you're wasting. But we're pretty happy and we're heavy on radio. I think we get a good return on radio, but it's very hard to measure.

We spend more on digital than we have in past years as most companies do, but we continue with a lot of sponsorships. But we're happy with it as you can be. I think that we have a great Advertising and Marketing Team, and they've done a good job of making sure that we invest in the right medias, and we're reasonably happy with it. But again, it's a very tough thing to measure, and we're as happy with it as we've ever been.

Mark Carden - *UBS - Analyst*

Great, thanks so much, guys.

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

Thank you.

Operator

We've reached our allotted time for questions. I'll now turn the call back over to Mr. Greg Henslee for closing remarks.

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

Thanks, Richard. We would like to conclude our call today by thanking the entire O'Reilly Team for our outstanding second quarter results. We are pleased with our solid second quarter, and remain extremely confident in our ability to continue to aggressively and profitably gain market share, and are focused on continuing our momentum through 2016.

I'd like to thank everyone for joining our call today, and we look forward to reporting our third quarter 2016 results in October. Thanks.

Operator

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