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ORLY - Q3 2016 O'Reilly Automotive Inc Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2016 / 3:00PM GMT

OVERVIEW:

ORLY reported 3Q16 diluted EPS of $2.90. Expects 2016 total revenue to be $8.5-8.6b and EPS to be $10.58-10.68. Co. expects 4Q16 EPS to be $2.44-2.54.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome to the O'Reilly Automotive Incorporated third quarter earnings release conference call. My name is Adrian and I will be your operator for today's call.

(Operator Instructions)

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

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

Thank you, Adrian. Good morning everyone, and thank you for joining us. During today's conference call we were discuss our third-quarter 2016 results and our outlook for the fourth quarter. 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 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, considered, 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 reason SEC filing's. The Company assumes no obligation to update any forward-looking statements made during this call. At this time I would like to introduce Greg Henslee.

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

Thanks Tom. And good morning everyone and welcome to the O'Reilly Autopart's third 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.

I'm once again please to begin our call today by congratulating Team O'Reilly on another solid quarter and strong year to date results. Our team, made up of over 74,000 dedicated team members, now across 45 states, continues to earn our customers' business and gain market share by consistently providing unsurpassed levels of customer service. This unwavering commitment to customer service drove our third-quarter comparable store sales increase of 4.2%, which continues to significantly outpace our industry.

These solid results were in line with our guidance of 3% to 5%. And were on top of last year's excellent third quarter comparable stores increase of 7.9%. Representing this year's most difficult comparison to the prior year.

For the first three quarters of 2016, our comparable store sales increased 4.8% or 12.2% on a two-year stacked basis. And this consistent, market leading performance is a testament to the quality of our team in the commitment we've made to providing incredible levels of service to our valued customers.

In total, we grew sales for the quarter by 6.8%. And our ongoing focus on profitable growth and expense control translated this solid top line performance into a record third-quarter operating margin of 20.2%. Our diluted earnings per share for the third quarter of $2.90 is a10% increase over our reported EPS for the third quarter of 2015, of $2.64.

As a reminder, last year, our third-quarter EPS results included a larger than typical tax benefit of $0.11 from the resolution of certain historical tax positions. As we called out on the call last year, this benefit, while very positive for Company, was not representative of our expected tax rate going forward or our ongoing operating performance and is appropriate to focus on our EPS excluding this benefit from last year. On this basis, our third quarter 2016 EPS grew 15%, compared to adjusted EPS for the third quarter of 2015, representing our 31st consecutive quarter of adjusted EPS growth of 15% greater.

Our teams' track record of strong earnings growth over such a long period of time, is a reflection of the effectiveness of our customer service oriented culture, dual market strategy, and focus on profitable sustainable growth. The composition of our comparable store sales growth in the third quarter was very balanced with our professional and DIY sides of our business contributing equally to our comparable store sales growth.

We saw solid increases in both comparable ticket average and transaction count with a slightly larger contribution from our professional ticket count, although our DIY ticket count continues to be solid. As has been the case for several quarters, the increase in average ticket has been driven by increasing parts complexity, rather than inflation or pricing which has remained very static in our industry.

On a category basis, we saw strong performance throughout the quarter in weather related categories, such as batteries and air-conditioning, as a result of the hot summer weather. We also continue to see solid performance in key hard parts categories such chassis and brakes. Against very difficult comparisons for these in the third quarter of 2015.

Moving onto the cadence of our comparable store sales growth in the quarter, our monthly results in 2016 were impacted by a shift in the number of Sundays, our lightest volume day. Both in July and August as compared to last year. Adjusting for this calendar shift, our monthly comparable store sales increase was consistently solid throughout the quarter.

Overall, the macroeconomic environment continues to be a positive contributor to demand for our industry. And was a factor in our continued steady comparable store sales growth for the third quarter. Unemployment levels have stabilized over the last year. At around 5%. And the associated commuter miles, along with the continued low gas prices have benefited total miles driven in the US. Which are up 3.1% year-to-date through August.

We expect the current stable macroeconomic environment to continue to be a positive for the health of our industry. However, is we continue to lap the strong year-over-year 2015 benefit from these tailwinds, we are also cautious as we look for to the fourth quarter when our business can be variable based on the holiday season and weather volatility. In light of these factors, and the very tough comparisons we again face in the fourth quarter, we feel it is appropriate to set our fourth quarter comparable store sales guidance at a range of 3% to 5%.

We are focused to finish the year strong. And are off to a good start in the fourth quarter, as the solid business trends in the third quarter have continued thus far into October. We are also tightening our full-year comparable store sales growth guidance to a range of 4% to 5%. Which reflects our year to date results and our fourth quarter expectations.

Finally, I would like to make a few comments about our announcement in yesterday's press release regarding our definitive agreement to purchase the assets of Bond Autoparts. Bond is a very high quality auto-parts company headquartered in the State of Vermont. And operates 48 stores throughout Vermont, New Hampshire, Massachusetts and New York.

Bond was actually founded one year before we were in 1956. And for the past 60 years, we have known them at the premier parts supplier for their markets in New England. Their company stands out for their knowledgeable parts professionals, and a culture of excellent customer service. And we are excited about the opportunities we will have together to continue our growth in the Northeast.

We expect this transaction to close before the end of the year. And I want to take this opportunity now to express how excited we are to welcome the Bond team to Team O'Reilly.

Before I finish up my prepared comments and turn the call over to Jeff, I would like to again thank our team for another outstanding quarter. And for their continued hard work and commitment to driving the success of our business.

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 outstanding service to our customers every day. I'll now turn the call over to Jeff.

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 also congratulating Team O'Reilly on another strong quarter. This quarter is just another example of our teams' steadfast commitment to out-hustling the competition, to earn our customers' business by providing the best service in our industry.

Our comparable store sales growth of 4.2% on top of an incredible 7.9% last year, once again easily led the industry. And I want to thank each of our team members for their dedication to our ongoing success.

Now I'd like to spend a few minutes discussing our SG&A results for the quarter. For the third quarter, we delevered 12 basis points. Which, similar to the second quarter, was primarily the result of the tough comparisons to the robust sales growth we generated in the comparable quarter of 2015, in a few specific items I'll address in a moment.

Average per store SG&A for the third quarter increased 2.8%. Based on our results so far in 2016, and looking forward into fourth quarter, we now expect our full year average SG&A per store guidance to a increased slightly to approximately 2.5% over 2015. Versus our previous expectation of 2% growth. As a reminder, this average store SG&A comparison excludes the headwind in the second quarter of 2015 from an adverse legal judgment.

As we have discussed many times in the past, our expense control focus is a key component of the Team O'Reilly culture. And each of our managers is held accountable for the profitability of their individual store. However, and I know I'm a broken record on this one, we will always manage our store level staffing expense for the long-term and won't jeopardize the excellent customer service that develops and maintains long term relationships.

In addition to the complexities of managing store payroll, we've seen pressure from healthcare costs, as well as higher credit card costs. Which should abate when we're fully rolled out with the chip and pin technology in the first quarter of 2017. We will continue to closely monitor our sales volumes and will make appropriate adjustments as needed to prudently manage SG&A expenses both up and down, to match business trends and the opportunities that we see the marketplace.

We successfully added 52 new stores during third quarter. Bringing our net new store count two 141 for the year. And we continue to be pleased with the performance of our new stores. So far this year, we've opened or acquired stores in 35 different states including our first two stores in Rhode Island, our 45th state during third quarter.

Also included in our year to date new store additions was our acquisition of Frank's Auto Supermarket, a five store chain in Western Pennsylvania, which gives us a jumpstart as we begin to open in the Pittsburg market. Being able to open stores effectively across our national footprint allows us to balance our growth in our expansion markets in Florida, the Northeast, and the mid-Atlantic region, with backfill markets in Texas, California, the Great Lakes and throughout our other existing markets.

This flexibility gives us a great advantage in selecting new sites. And more importantly, identifying, hiring, and training outstanding store teams to provide excellent customer service in our new stores.

As Greg discussed earlier, we have entered into an agreement to acquire the 48 stores of Bond Auto-Parts in New England. Assuming Bond closes prior to the end of the year as we anticipate, we expect our full year addition to store count for 2016, to be approximately 258 net new stores. Which reflects our previous new store target of 210 stores, plus the addition of the Bond stores.

We've known the Bond family for many years and have a tremendous amount of respect for the quality of their people and their business. Their team members are truly professional parts people. We are extremely excited to welcome them to Team O'Reilly, as we look forward to growing on the outstanding foundation they've established in the Northeast.

Over the course of our history, we've proven our ability to very effectively acquire existing store chains, implement our dual market strategy, and instill the O'Reilly culture in the new store teams. However, as we've discussed repeatedly in the past, we are very disciplined buyers. And will only deploy our shareholders capital when we can identify companies that are a good fit with our culture. And can be acquired at the right investment.

This means that although we work hard on an ongoing basis to identify potential acquisitions, we often pass on potential deals which just don't fit our profile. Which make us that much more excited to have reached an agreement this year to at such an outstanding business to Team O'Reilly.

As we look forward to 2017, we will continue to execute our profitable new growth strategy. And have established a target of a 190 net new store openings for the year. Which is below our typical new store target, as we plan to devote significant resources to converting the Bond stores.

Finally, before I close my comments, I'd be remiss if I didn't acknowledge the incredible offer's of our supply chain groups to support our new store growth, while also continually enhancing our industrial leading parts availability. And I'd like to thank these teams for the great service levels they provide to our stores.

As we discussed on the last call, these teams very successfully opened the San Antonio Distribution Center earlier this year. And are on track to complete the expansion of our existing DC in Greensboro, North Carolina in the first half of 2017. This expansion will add approximately 200,000 square feet to this facility. And allow us to service an additional 125 stores from this location, as we continue to add stores in expansion markets in the mid-Atlantic.

Our ability to incrementally add capacity to our supply chain network, and provide high levels of inventory availability to our expansion markets, is a critical component of our growth strategy. And I'm very proud of the great work these teams do to support our growth.

Before I turn the call over to Tom, I want once again thank Team O'Reilly for their continued dedication to our Company's success. With one quarter left in 2016, we've had a solid year so far, but won't rest on our laurels as we push to finish the year strong.

As always, the key to our success is providing unwavering customer service that surpasses expectations, and continues to earn our customers' business. And I'm confident we have the team in place to out hustle and out service the competition and keep taking market share. Now I'll turn the call over to Tom.

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

Thanks, Jeff. I'd also like to begin today by thanking the O'Reilly team for another very profitable and successful quarter. Now we'll take a closer look at our third-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 $54 million increase and non-comp store sales. A $3 million increase in non-comp non-store sales. And a $1 million decrease from closed stores.

Based on results for the first nine months and our expectations for the fourth quarter, we now expect our total revenue for 2016 to be $8.5 billion to $8.6 billion. For the quarter, gross margin was 52.7% of sales. A 32 basis point increase over the prior year.

This was in line with our expectations for the third quarter, as continued strong POS margins offset a higher than anticipated LIFO charge of $10 million. Which was 23 basis points higher than last year. But significantly lower than the second quarter.

As we have discussed many times 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. However, these cost reductions benefit our POS margins on a go-forward basis. Excluding the impact of LIFO from both years, gross margin increased 55 basis points year-over-year, and 30 basis point sequentially from the second quarter.

Year to date, gross margin was 52.3% of sales. However, excluding LIFO from both years, gross margin increased 50 basis points. For the year, we will tighten our gross margin guidance from a range of 52.3% to 52.7% to a range of 52.4% to 52.6% of sales. With the expectation that our strong POS margin improvement will continue during the fourth quarter, as result of the cost decreases we've secured throughout 2016. And that pricing in the industry will remain rational.

Our effective tax rate for the third quarter was 35.5% of pretax income which is slightly below the 35.8% we expected for the quarter. Our third-quarter effective tax rate this year was significantly above the 33.6% we saw in the third quarter of 2015, which, as a reminder, benefited from a larger than typical tax reserve adjustment of $11 million related to a previous acquisition. We expect our fourth quarter return to a more normal rate of approximately 37.3% of pretax income.

Moving onto our free cash flow results. I will provide some color to our results and our updated full-year free cash flow guidance. Free cash flow for the third quarter was $234 million. Which was a which was $21 million less than the prior year. Year to date we generated $812 million in free-cash flow. Which was $46 million more than the prior year.

The year to date improvement was primarily driven by our net income growth and continued successful management of working capital. Specifically, net inventory, partially offset by higher year-over-year capital expenditures. Capital expenditures, for the first nine months, were $356 million. In line with our expectations, and resulted from our continued store growth and distribution expansion projects as Jeff discussed earlier.

We continue to expect capital expenditures will finish the year in the range of $460 million to $490 million. Based on our strong year to date free-cash flow performance, we're increasing our full year free-cash flow guidance to a range of $850 million to $900 million. Reflecting an increase of $50 million at both ends of the range.

Inventory per store at the end of the quarter was $592,000. Which was a 3% increase from the end of 2015. This growth rate was in line with our expectations for the quarter. But above our full-year expectation of inventory per store growth of approximately 1.5%. Driven by normal seasonality.

Our ongoing goal is ensure we grow per-store inventory at the lower rate than the comparable store sales growth we generate. And we expect to continue our success of effectively deploying inventory. Our [AP] to inventory ratio finished the third quarter at 107.5% which exceeded expectations. And once again, represents a new high for this ratio.

Our AP percentage continues to benefit from incrementally improved terms and strong sales guidance over the last 12 months. We expect our AP to inventory ratio will moderate somewhat during the fourth quarter from its current level. We expect to finish this year at a ratio strongly above 100% as we incrementally improve our vendor terms, but face the headwinds of seasonality.

Moving onto debt, we finished the third quarter with an adjusted debt to EBITDA of 1.66 times. Down from the 1.69 times at the end of the second quarter, driven by a strong trailing 12 month operating income performance, but up from the 1.57 times at the end of the third quarter last year. We're still well below our targeted range of 2 to 2.25 times. However, we continue to believe our stated leverage range is appropriate for our business and we will move into this range when the timing is appropriate.

We continue to execute our share repurchase program. And during the third quarter, we repurchased.4 million shares of our common stock at an average price of $281.04 per share. Year-to-date through yesterday, we have repurchased 3.9 million shares at an average share price of $262.32, for total investment of $1 billion.

We continue to view our buyback program as an effective means of returning available cash to our shareholders after we take advantage of the 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.

We're establishing our fourth quarter Earnings per Share guidance at a range of $2.44 to $2.54. Based on our year to date results, and the additional share repurchases since our last call. For the full year we are tightening our Earnings per Share guidance to a range of $10.58 to $10.68. Which represents a $0.13 increase from the midpoint of the previous annual guidance we provided on our second-quarter earnings release in July, driven by our stronger than expected third-quarter operating results and the incremental share repurchases.

As a reminder, in-line with our normal practice, our guidance includes all the shares repurchased through this call, but does not include any future share repurchases.

Before I turn the call over to or analysts for questions, I would once again like to thank the entire O'Reilly time for their continued hard work, dedication and unrelenting focus on providing consistently superior levels of customer service. Your ongoing efforts continued to drive our profitable growth, and we cannot thank you enough.

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

QUESTIONS AND ANSWERS

Operator

Thank you. We will now begin the question-and-answer session.

(Operator Instructions)

And our first question comes from Chris Bottiglieri from Wolfe Research. Please go ahead.

Chris Bottiglieri - *Wolfe Research - Analyst*

Hi Greg. Thanks for taking my question. I was hoping you could maybe talk little bit more about the Bond acquisition that you made. Do they have any DCs, do they own their stores? Generally speaking, does this signal your intention to accelerate growth into the Northeast?

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

Yes, sure. This acquisition is one that we overlap very little. They have a distribution center located in Berry, Vermont. Which we will utilize for some period of time. And we're talking about right now whether or not we would utilize that facility for anything in the future. But the plan is that we would further leverage our distribution capacity in Devens, Massachusetts. And supply those stores from there. While not sacrificing the benefit they have of availability by having as many parts as they have available in Central Vermont.

So we would, over time, alleviate the need to have availability by putting in a big hub or something like that. But ultimately the replenishment would come out of Devens. From a real estate standpoint the Company doesn't actually own the real estate. We have entered a lease agreement with the family members to lease the locations that they own. And then we have other third-party leases that we would takeover those leases and run the stores as leased properties.

Chris Bottiglieri - *Wolfe Research - Analyst*

Okay cool. And then just a question generally on the Northeast as a new territory for you obviously. Could you talk about your experience thus far? Has the delivery model been as efficient and cost-effective as elsewhere in the country? How are you ramping in DIY versus DIFM? Are you leading with DIFM? Just given your track record of buying VIP. Any additional commentary there would be helpful.

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

I think is, would typically would be the case in a new store, our DIY business generally comes on a little faster. With the VIP stores up in, primarily Maine, those stores were heavy DIY stores. They really want a supplier on the do-it-for-me side because of the conflict they had with the shops that the previous owner had.

So what I would say is that our DIY business has come on a little faster. We're doing a good job on the do-it-for-me side, as we progressively established what our Company is about and the availability model and the service model and those kinds of things. So it continues to build.

We see a lot of opportunity in the Northeast. There's a lot of high population areas that we're not in. We have a lot of capacity in Devens that we've not yet used. So our plan would be to continue to build out that area of the country. And become one of the dominant parts suppliers on the professional side. But then also put a big dent in the DIY business up there.

Chris Bottiglieri - *Wolfe Research - Analyst*

Great. Really helpful. Thanks for the time.

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

Thank you.

Operator

Our next question comes from Chris Horvers from JPMorgan. Please go ahead.

Christopher Horvers - *JPMorgan - Analyst*

Thanks. Thanks and good morning.

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

Good morning.

Christopher Horvers - *JPMorgan - Analyst*

Wanted to get your thoughts on the Amazon risk. We're getting a lot more questions about the risk relative to the industry. So would love to your thoughts on how you think about the competition.

What structural advantages do you see on your side from availability and service? What's the relative risk between commercial and DIY? And then how do you think about the risk of competitive pricing encroachment?

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

Okay. Well, what I would say is, that we've had pretty strong competitors on the e-commerce side. In the DIY business for quite some time. With some other suppliers that do a pretty good job there. Our DIY business is doing really well.

As I said in my prepared comments, are both our DIY and our do-it-for-me business were pretty well even contributors to our 4.2% comp-store sales. So we're doing pretty well in DIY.

Obviously, we see these e-commerce players that sell at prices below the brick-and-mortar companies online. There's a lot of elements that play into auto parts that I think differentiate us from many other retail channels. But primarily, it's about, and speaking just on the DIY side, many times when a DIY customer walks into our stores they're really needing help figuring out how to solve a problem that they have. And we provide that help.

Not only do we provide the help, but we are able to tell them the tools they need to fix the car. A whole array of things. And we even loan them tools. We've got a very significant loaner-tool program. Where a customer will put a tool they might otherwise not be able to buy because of the expense of a specialty tool or something. They can put it on a credit card and use it to install the part to fix their car and bring it back for a full refund when they're done. And we put it back on the shelf and reuse it again for the next customer that needs to use that. Those kinds of services are pretty hard to quantify. But they're incredibly valuable when servicing the DIY customer.

On the B2B side I speak from having done this for 32 years. And previously being in the repair business. None of the shops, or very few of the shop stock parts. They may stock a small array of filters, or maybe a few belts, or a few batteries and stuff like that. Almost every repair that they make, the parts have to be delivered. And it's just so incredibly important that they're able to turn their bays over quickly and keep their technicians busy. In order to provide gainful employment for the technicians, but also maximize the revenue and the profitability of the shop.

And most shops nowadays know that they can get 30 to 45 minute service out of a Company like ours that has a wide array of parts. And our competitors in many cases, have these wide array of parts. It's just hard for me to see a company like Amazon being a significant player on the do-it-for-me side.

And I would tell you on the DIY side, where there is some people that are going to buy some parts and some accessories over the Internet because they can wait and because they know what they're doing in making the repair. The vast majority need help and appreciate the advice, recommendation and the help we give them in repairing their cars.

Christopher Horvers - *JPMorgan - Analyst*

Thanks. That is very helpful. And then I just wanted to ask about the inter-quarter trend. A couple peers of yours talked about some acceleration in August and/or September, while you spoke to consistent trends in the quarter. And obviously you've been the most consistent operator out of any of your peers.

But I was curious if you had any thoughts on why they saw some acceleration versus you being more consistent. Is that perhaps geographic exposure? Is it the balance in the business? Is it share acquisition and so forth? Thank you.

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

Well there could be differences for all the things you said. In my prepared comments, I spoke to August and July on a monthly basis being Sunday affected which Sunday is our lowest volume day. And probably a more from a trend standpoint a more meaningful way to look at our comp cadence throughout the quarter would be to look at it on a weekly basis. I've got that in front of me now and I can tell you our sales on a weekly basis, we're pretty darn consistent throughout the period.

And that consistency is continued to this point in the quarter. And this quarter, our toughest compares to last year are this month and December. We have a softer comparison in November. And we have carried this healthy strong trend that we were on into this point in the fourth quarter.

It's hard to say what our competitors represents from a comparison standpoint on a weekly basis, what they're up against from just a geography standpoint. Because I know some are more exposed to the weather-affected areas in the Northeast. And again, this quarter we saw a difference in the areas that we would consider to be weather affected versus not.

And taking into consideration the maturity of some of the stores or maybe the lack of maturity in some of those stores, we still would look at somewhere in the 400 to 500 basis point difference in comp performance between the weather-affected stores and the non-weather-affected stores.

Christopher Horvers - *JPMorgan - Analyst*

Thank you very much.

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

Thank you.

Operator

And a next question comes from Alan Rifkin, BTIG. Please go ahead.

Alan Rifkin - *BTIG - Analyst*

Thank you very much for taking my question. So Greg just as a follow-up to your commentary you just gave. So the solid trends of Q3 have continued in Q4 despite October being one of the most difficult months. Is that correct?

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

That's correct.

Alan Rifkin - *BTIG - Analyst*

Okay. And on the DIFM side of the business, can you maybe add a little bit more color as to where you're seeing the growth come from? Are you seeing some new account additions or our current accounts of yours just spending more? What are you seeing there?

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

Well that varies a lot by store, by market. In new markets where we work to get that first call, not first call status but simply the first interaction with the shop, of course, those in newer markets is new customers. In existing markets is just taking more of the business that they're doing.

Most shops don't have just one parts provider. They share that business among a few. And although the first call provider can be 70% or 80% or maybe even more of the parts provided, our work with those customers is to take more of their purchases. And I think we did a pretty good job on both.

I feel like we are gaining market share on the do-it-for-me side. And I feel like we're gaining market share pretty significantly on the DIY side. But it's hard to quantify whether our improvements in do-it-for-me are coming from new customers or improvements in the purchases from existing customers. Because it's a mix of both. And that's just something that's hard for us to fully quantify.

Alan Rifkin - *BTIG - Analyst*

Okay and one last one if I may. Obviously Bond pales in comparison to CSK or even earlier acquisitions like Mid-State. Does the same potential present itself to increase the EBIT margins at that business? As what you have realized in some of the other acquisitions you've made?

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

I think it'll be a great acquisition. I think any time we buy a company that is, from a size standpoint, as much difference as what exists between our Company in Bond, there's very significant opportunities from just a merchandise cost perspective. They run a very good business. And they've built it over number of years and the Bond family are great operators and have a great team there.

So, we would look more for the opportunity to be on the cost-of-goods side and the advertising and marketing we can do to help them build a better DIY business. And some of the efficiencies that we have through systems and better product selection. Through some of the science and tools we use to deploy inventory and make sure we have exactly the right inventory. And the breadth of inventory it takes to gain market share. We're just a Company that's very well-capitalized to make sure that the stores are in the very best position they can be to compete and take additional market share.

Alan Rifkin - *BTIG - Analyst*

Okay. Thank you very much.

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

Okay thank you, Alan.

Operator

And your next question comes from Bret Jordan, from Jefferies. Please go ahead.

Bret Jordan - *Jefferies LLC - Analyst*

Hey good morning guys.

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

Good morning Bret.

Bret Jordan - *Jefferies LLC - Analyst*

On the Bond deal, I mean obviously they're a member of the Alliance so they're pretty heavily skewed to branded parts. One of the levers you pull there, do you expand the hours and put in the more of the direct-sourced mix? And when you think about the geography distributing up to Bond out of Devens, how far west can you go as to get out towards Franks? Do we need to build more distribution into the expansion markets?

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

From a product standpoint, we will be very sensitive to the brands that they have built, and the products that they carry to make sure that, if and when we transition brands and products, we do it with a lot of forethought and a lot of selling to the customers to make sure they have confidence the brands will change.

But again, we feel like we've got an incredibly good lineup of products and they do too. There's a lot of overlap. Our history with the Alliance has led us to continuing to do business with a lot of the same suppliers the Alliance does business with. So I think we will be good there.

From a distribution standpoint, we will definitely need more distribution up in the Northeast. We will need distribution and probably what Greg would you say two or three distribution centers up there? We'll end up with two or three additional distribution centers up in the Northeast. While working now to fill out the capacity that we have in Devens, for us to move further west we would need additional distribution capacity just to make sure we were in the position from a geographic reach standpoint to do what we do as far as at least overnight service but in many cases multiple times a day same-day service out of a big distribution center inventory.

The Frank stores in Pittsburgh, they actually get serviced out of Detroit. So as we grow, that is still quite a distance as we grow mass, we will have to look to see where we position our additional distribution centers.

Bret Jordan - *Jefferies LLC - Analyst*

Okay thanks. And just one to follow up as you look at the Alliance members, would you think about picking up an eastern or somebody who's more of a WD to get some market share and distribution and then building in a store base around that? Or is that too far from a retail model?

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

We are opportunists. We would look at any opportunity to acquire a company that fits the profile that Jeff described in his prepared comments. So we would look at any and all companies that might be for sale. And that our decision would be made based on fit, geographic overlap, price, multiple factors that come in to consideration when we acquire companies.

Bret Jordan - *Jefferies LLC - Analyst*

All right thank you.

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

Thank you.

Operator

And a next question comes from Greg Melich, Evercore ISI. Please go ahead.

Mike [Montoni] - *Evercore ISI - Analyst*

Morning this is Mike Montoni on for Greg. Just wanted to ask if I could on the expense control side, Greg and Tom can you talk about some of the initiatives you have there to take costs out and to manage around potentially FLSA, rising minimum wages that we're seeing across retail and healthcare costs? How do we get comfortable that you guys can get back towards 2% SG&A per store?

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

What I would tell you is that when we look at third-quarter SG&A, it was pretty much on our expectations. When we look at delevering, when we look at last year, obviously we had a big, big comp number at 7.9%. So it's hard to lever against those sales.

And if we look at the third quarter of 2015, there was 87 basis points year-over-year leverage. So very a difficult compare from a dollar standpoint we ended up where we thought we should end up for the third quarter.

When we look at the items you're talking about, FLSA is a big focus of ours. And we've adjusted our compensation policies to retain our entrepreneurial focus, while minimizing the overall impact. But we want to continue to focus our store managers on growing their business, building a great book of business, and growing it and compensating them for that. We think we've made some changes that keep the essence of our program while complying with the laws.

When we look at minimum wage, there are certain areas where minimum wage is going to be some pressure on expense. For those geographic regions, we will monitor pricing very closely and try to maintain our profitability.

Mike [Montoni] - *Evercore ISI - Analyst*

Okay. And can you talk about your ability potentially to raise price and pass through any costs that you might incur or that you can offset directly. And then also if you could, some of the initiatives you might have around omni-channel, whether it be the loyalty program, the private label. Talk about some of the offensive things you might have going on to build out the business and serve consumers regardless of channel?

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

Like Tom said in these markets, where costs are going up as result of minimum wage changes and so forth, we work every day looking for opportunities to increase price while remaining competitive. Knowing that our competitors are under the same pressure that we are, over time, I think this plays out. And the fact that costs go up ultimately result in higher consumer prices. Auto-parts would be no different.

As far as our opportunity with omni-channel and just the various opportunities we have in businesses, we have an opportunity on the Internet. We're not a big B2C e-commerce player. We could do more. And were working now to re-platform our website to do little bit more of that business.

Private label we continue to be a very powerful Company when it comes to building these private label brands. As you know our strategy is not to have a single private label brand that's viewed as being a private label. Our brands are really national brands that may have been retired by a supplier, or whatever the case may be. And we picked them up and reestablished the brand.

And many of our brands are now recognized. Even though they are what we would be considered as we discussed, here is private label, they're really viewed by our shops as being a national brand. Even though they are in our proprietary brand. And there are brands that we put products of equivalent quality to a branded product in the box. So we feel like we have a lot of opportunity there to continue to grow market share in the brands that we own. And that growth is accretive to our gross margin as you know.

Mike [Montoni] - *Evercore ISI - Analyst*

Great. Thank you.

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

Thank you.

Operator

And our next question comes from Simeon Gutman, from Morgan Stanley. Please go ahead.

Simeon Gutman - *Morgan Stanley - Analyst*

Thanks good morning. Greg you mentioned the 400 to 500 basis point spread I think between weather and non-weather. Can you share what percentage of the markets are affected? And then looking back at these years in which weather has had an impact. The nuances tend to resolve themselves.

You hinted that we haven't seen any signs yet of that because the trends have been somewhat consistent. But is that usual? Or do we have to wait for the next big weather trend to break? Meaning colder temps? Or should we have started to see some of that change already?

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

I think we're starting to see some of the change already. When we start getting the freezing weather in these markets is when I would say okay we've got to call the weather thing to an end.

Because having come off of a very hot summer, when cold weather gets here, there will be a lot of battery failures and electrical system problems and things like that. That will be attributable to the winter weather. So really once we anniversary into winter, and start the freezing weather is when I would consider the effect of the 2015, 2016 winter to be over.

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

On the regional question, we're providing some color for just different performance in markets. But to further quantify it goes beyond our level of comfort in communicating regional performance.

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

In addition it's hard to draw a line. When Tom and I talk about this, it's very difficult for us to draw line and say okay well these are weather affected, these are not. Generally speaking, the center part of the country up in the upper Midwest and then also the Northeast are generally the weather-affected markets. The South and Southwest and so forth aren't so much.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. And then my follow-up on Bond. Have you talked about or can you disclose revenue for an annual basis and then implications for accretion or dilution next year?

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

We're little uncomfortable talking about the specifics of that pre-closing. We won't close until sometime before the end of the year. And we'd rather not get into the specifics about their financial performance at this time.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. Thanks.

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

Okay thank you.

Operator

And a next question comes from Seth Basham, Wedbush Securities. Please go ahead.

Seth Basham - *Wedbush Securities - Analyst*

My question is around price competition. Whether or not you're seeing any signs of increased competition in the slower growth industry right now? Either by customer, segment, region, channel et cetera?

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

Well Seth, I'll tell you, there's never been a time in my 32 years here that we haven't felt price competition. We feel it every day. Generally speaking, it's on the professional side of our business. Where companies that are trying to gain market share and in the most recent entry of some of the larger retail-type companies into the wholesale business is what's talked about most now. But for years we've had competition from a number of companies on the professional side.

So there's always promotions, specials, new ideas. Something that's happening here recently is kind of the kit idea. Where competitors, and us to now, we will put two brake rotors and a set of pads and give it a kit price rather than the individual piece price. So there's always a lot of competition. I would say that it's consistent with what I've seen in the last 30 years, but nonetheless there's a lot of competition.

Seth Basham - *Wedbush Securities - Analyst*

Okay thank you. And my second question, on the theme of gross margin. Just thinking about LIFO, Tom, what kind of impact you expect for 4Q and for 2017 (inaudible)?

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

Well hard to know for 2017, when we look at 2016, will have a moderate headwind. Not as much as this quarter. This quarter was probably double what we thought it would be. We will have to get together with the merchants and see what they have cooking for 2017 as they continue to work on getting us the best acquisition costs we can get.

Seth Basham - *Wedbush Securities - Analyst*

Great. Thank you guys and good luck.

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

Okay thank you.

Operator

And a next question comes from Dan Wewer, Raymond James. Please go ahead.

Dan Wewer - *Raymond James & Associates, Inc. - Analyst*

Thank you. Tom you had exceeded the third-quarter earnings by $0.03 per share. But you took $0.02 off for the high end of your fiscal-year forecast. It looks like you're reducing your fourth-quarter outlook by about $0.05 a share I guess that the reason the stock is acting the way it is today. Can you explain what has changed in the fourth-quarter outlook? Is it a higher LIFO? I guess based on the previous question it doesn't sound like that's an issue.

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

I would tell you that our expectation for the fourth quarter is an inherent guidance in our net income have not changed from the last call. What I would tell you is that we had a wider range on the end of the last call because we had two quarters to go. Now we have one quarter to go, it would be hard to have a wider range on annual EPS than it is for the quarter. That would not be logical. So you see --

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Dan Wewer - *Raymond James & Associates, Inc. - Analyst*

No I understand that. I was just thinking reducing the high end. Of the year after --

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

What we would tell people and what we said on the script is, we would focus on that we increased the midpoint of our guidance by $0.13. Due to higher income in the third quarter and on additional share repurchases. And that's what we think is the important [deal].

Dan Wewer - *Raymond James & Associates, Inc. - Analyst*

And to follow up on the comments about the higher SG&A per store. In one of the, I think it was on page 9 of the release that indicates the total employment count grew about 2.6% year over year compared to a 4.6% increase in the number of stores. It looks like the employment per store has actually declined a bit. So if you could help reconcile that against the higher SG&A rate per store. Or the SG&A dollars per store.

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

That has to do with the number of full-time versus part-time people that we employ. So what that number is telling you is we have a higher mix of full-time people in that growth area. Which also has a higher cost because you're providing benefits. But we also feel it has a much higher productivity level, which you see in our top line.

Dan Wewer - *Raymond James & Associates, Inc. - Analyst*

So the implications are if you look at the actual payroll hours per store, it's growing faster than the employment number?

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

Yes. We report total team members versus FTEs.

Dan Wewer - *Raymond James & Associates, Inc. - Analyst*

Okay thank you.

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

Thanks Dan.

Operator

And a next question comes from Scot Ciccarelli, RBC Capital Markets. Please go ahead.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Hi guys how are you? I figured you guys would know it. Just a clarification on the LIFO commentary, Tom, it came in above what you expected. Is that a function of better price concessions than what you previously anticipated? Or is that better sales of that particular vendor's product? Can you help us understand why it was $10 million instead of $5 million?

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

It's fully based on the number of new deals we sign, and the impact of those cost reductions over the breadth of our inventory. So the short answer is, we got more, better deals than we anticipated.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Okay. Got it. And then shifting to SG&A. I know you guys talked about some of the reasons you didn't have leverage this quarter. And a lot of that make sense to me. And the street I think. But SG&A per store growth has been a bit elevated the last couple quarters. What I'm looking for is clarification on as we look out a little further, should we just assume SG&A per store growth will be up more like 2.5% rather than the 2% you have historically run at given the wage and healthcare pressures that you've cited?

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

Well we haven't given guidance for next year. And our guidance for the fourth quarter is a little slower growth. We've got a long process that we go through to plan, not just the upcoming year, but years to follow. And we're going to sit down, and healthcare continues to be a pressure item.

The big item for us is making sure we established payroll levels with enough help in the stores to provide great customer service and grow the business. So a lot about depends on what our outlook is for growth opportunities. So we're not going to comment right now. But what we will make sure to say is that we manage SG&A over a long horizon. Not just on a quarter or six-month basis. So we're going to have to get back to when we finalize our plan for next year.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Understood. Right thanks guys.

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

Thank you.

Operator

We have reached our alotted time for questions. I will now turn the call back over to Mister Greg Henslee for closing remarks.

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

Thanks Adrian. We'd like to conclude our call by thanking the entire O'Reilly Team for our outstanding third-quarter results. We're pleased with our solid third quarter, and remain extremely confident in our ability to continue to aggressively and profitably gain market share and are focused on continuing our momentum as we finish out 2016.

I'd like to thank everyone for joining our call today. And we look forward to reporting our 2016 fourth-quarter and full-year results in February. Thanks.

Operator

Thank you ladies and gentlemen, this concludes today's call. Thanks for participating and you may now disconnect.

THOMSON REUTERS