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ORLY - O'Reilly Automotive Inc at Gabelli Automotive Aftermarket Symposium

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CORPORATE PARTICIPANTS

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

PRESENTATION

Unidentified Participant

So for our final aftermarket retailer and distributor, we have O'Reilly Auto Parts. O'Reilly, headquartered in Springfield, Missouri is one of the largest retailers and distributors of parts, generating about $8 billion in revenue. In 2015 about 15% of that revenue is derived from do-it-yourself customers and 42% from the do-it-for-me customers. Speaking today is Tom McFall, Chief Financial Officer and an O'Reilly key member since 2006. Thanks for being here with us, Tom.

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

Thanks for having us. We are the last one?

Unidentified Participant

So I think for me, following your Company for a while now, the big question here is just your outstanding ability to out comp your peers. And just can you kind of elaborate on some factors that you believe have helped you to do that up above 5% year-to-date, probably (inaudible) as of last quarter, but pretty tremendous given some of other peer comps?

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

Well, for a tangible item, this is not all that families developed over time, they do a market strategy, the distribution model has been the model that most people have tried to emulate. So we have a big head start in how we distribute products and we figure what products go where, but the biggest driver for us is the leadership in the teams and the stores and the service that they're able to provide and our culture of excellent customer service that drives our business ourselves.

Unidentified Participant

Terrific. And then, I know that a few -- almost five years ago now, the CSK stores were a big point of conversation being able to drive those stores, and accelerating that growth, is that still an opportunity there?

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

Well, there's a tremendous amount of do-it-for-me business on the West Coast that CSK was not doing, that's a model that's very relationship driven that takes a while to build those customer relationships. So we continue to have a big opportunity to further grow our do-it-for-me business and the West Coast.

Unidentified Participant

Perfect. You talked about West Coast opportunity that I believe is this past call, you talked about an acquisition in the North East. Can you talk a little about that?

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

Well, we bought Bond Auto, which has been a company that's actually been in business a year or longer than ours. We have a long history with Bond through the alliance we're both members of the alliance as young company. They have a business model similar to ours, but more do-it-for-me focused and a very family-driven business that has produced very good results. Obviously, we haven't closed on that transaction, so we can't speak to the specifics because the bond's still on. But we're excited about the markets that brings us into the customer relationships they have and primarily the people that they have that run their business, we run a -- we have a very technical business, it requires a wide depth of knowledge about cars and how cars work, and what parts go in cars, to provide that service to customer, so acquiring a chain where service was the driver of their business and being able to grow on that footprint (inaudible) an opportunity for us.

Unidentified Participant

And in line with that, you had entered Florida a few years ago. You did a -- lot of us know you did a tremendous job penetrating that area. Do you see a similar path in the Northeast?

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

Well, we feel like our business model can work everywhere. We still have a long way to go, we really focused -- really grown through primarily the middle part of Florida, we're just starting to open in the tip of Florida, where there's obviously a lot of people in South Florida. From the Northeast, there is a tremendous amount of vehicles. There is a tremendous amount of markets that are on path for us and we expect to continue to grow it out of the Devens DC. We have a lot of capacity there, even after we buy, even after we close on bond and convert those stores over to Devens, but eventually, we talked about it in our call last week, we'll need additional distribution centers that service stores in the New England, New York area.

Unidentified Participant

Can I ask a follow up about Bond? It was a family run company. How long did it take to the negotiation process to come from, hey, we're interested in adding you too, let's get this done?

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

That's a fine question. So what we found in our industry is that the weak players have primarily been driven out of the business. So the chains that are left are well run, typically very well capitalized family-owned. So the driver there is more -- whenever those changes willing to itself. And so until -- if you run a family business and generating good income, you are competitive with the other folks on the street and have a stable market share, growing market share. you're probably cashing a good check. So it's when the right for the family to sell the business. So once that occurs, and we have the Bonds, we've known forever and ever back that day (inaudible) Mr. Bond, but keeping around this one, but they know that we're an acquirer of business. So it's a combination of proximity, a chain has less value for us once we start opening stores in the market, this is regarding the Floyd capital.

So it's a combination in case we are going to start overlapping more what do the family want to do, they were open to the idea of teaming up together and having (inaudible) where they could cash out on their inventory, but still have a great opportunity for their shareholders continue to grow within O'Reilly. So once -- say you're out of time. Once we get to a willing seller and evaluation that make some sense for us, it happens relatively quickly. Jeremy did all the work on the financial side for us this time. But the goal would be to close as soon as possible because we're buying a book of business, and we're buying a technically proficient labor source and leadership team, we need to keep those hose. So the best way to keep them hose is close as soon as possible and let people know, okay, here's what's going to happen. So the day that we announced, so is our earnings day, we have Greg Henslee, CEO, Jeff Shaw, Head of Store Operations, Brad Beckham, who is the Senior VP of that area of the country, they were all there. As soon as that release happened, we had meetings with Bond folks to say, hey this is why this is going to be great for you. So we want to make sure we maintain that momentum, so it happens pretty quickly.

Unidentified Participant

And this is my last one, with that turn back to Caroline. When you buy an established business and you are in the process of doing the changeover, but what's the kind of friction between brands that they have already in the store, or maybe the brands that you want to carry out at Devens and your move to private label, talk about that process?

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

That's a fine question. Converting the store is much harder than opening a new store. We open a new story and find a site, we build with our spec, we put our products in and we put our systems in and we're off to the races, we open the door day one and hope we have some customers.

When you buy a business that already exists, you need to do those conversions, you need align products, you need to figure out are there products that they're carrying that we don't carry that we should carry. We've got to get out and talk to their customers, and say, hey, you used to be buy brand A but now we have brand B which is a hard conversion process and then you got to convert the product in the store and realign the stores while you're still provide great customer service, because those customers have other options. So it is a very detailed and extensive project.

Anytime that we buy a chain we continue to update the playbook, we get this playbook out, every department gets their playbook out of what they need to do to convert these stores, what went wrong what went right last time and actually that occurs after we close the deal we'll get back the other day and say, how do we need to adjust the playbook or we have a playbook ready to go for how we're going to convert all those stores, and we don't acquire other companies until we have a plan of how we're going to convert them, that's part of our evaluation from evaluation standpoint.

Unidentified Participant

Terrific. And then recently, I believe that was at your Investor Day, you mentioned that your propriety brands are going faster than your national brands. Can you talk a little bit about benefits of private label and where your opportunity there?

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

So they're growing faster in -- because some -- two items, one, they're well-accepted, two, when we decide to go private label, we may take a branded product line and go to house brand. So you see that growth of converting. The things that we like about them are, one, we control the product that goes in the box and that means from a quality standpoint, but also a supplier standpoint. Supplier A might have 85% coverage in a line, but we need to have 100% coverage, so we may put supplier A in for 85% and supplier B for 15%. Supplier A might be better on imports, supplier B might be better on domestics, so it allows us a lot of control of the form, fit and function of those parts, control the cost.

And then the last thing, and most importantly, we have taken some brands that were dormant in our industry, acquired the right (inaudible) and made them our house brands. And when we build that brand and then following behind that brand, it can be sold and we can't have a supplier that says hey, you did a great job building our brand and now we're going to sell our brand to your competitor. And that's happened in the few instances and we weren't very appreciative. So we like the control.

Unidentified Participant

Terrific. And then just before, I don't know if there are any questions, please feel free to ask, but what we did hear a lot about today was Amazon. I'm sure you've heard of them.

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

You haven't even spilled any Amazon questions in the last 15 minutes.

Unidentified Participant

So obviously, online -- the idea of online retailing is growing. Can you talk about what you have done want to combat that trend, but also to enter it yourself?

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

Yes. Certain parts are going to get sold online. There is a number of lines in our industry that make a lot of sense to buy online. When you're looking at items that are to dress your car up, from an appearance standpoint, when you look at performance items where I want to take perfectly good part off the car and put a new shinier part on, it makes a lot of sense. But when we look at our core business and the value proposition that our customers are looking for, they're looking for same day availability and maybe multiple times same day availability if I didn't get all the parts I need, from a DIY standpoint, they're looking for technical assistance, they're looking for somewhere that they can bring their part back and get credit for it or if it doesn't work, get the right part because they need to get their vehicle on the road today. They are not -- the DIY customers don't have three cars sitting at home, they just decide which one to pick to drive. They're DIY customer because they're trying to save money and they're economically challenged, which means that vehicle is their transportation mode. Once they get the wheels off, they need to get it back on the road. And typically the do-it-for me customer doesn't know all the parts they're going to need, they typically need advice on how to repair their vehicle.

So if you spend time in our stores, you'll see that the value proposition they're looking for is one of service, and availability, because they need to resolve their issue now. If you have a bad battery, your car doesn't start, you either got to keep jumping it or you've got to get a new battery right away. So those items make what our customers are looking for something different than satisfied by buying online. If you look at tirerack.com (inaudible) tirerack.com, it's a great service. You ordered a tire, it goes to a shop, you go there, your get the car put on, now the key there is that you got a spare tire, nobody's got a spare alternator in their trunk, that they slap on for a period of time. So you need that part right away, so the value proposition that they're looking for is different.

Now when we talk about Amazon, we see there -- we would be foolish to ignore them, but there are other people that have been doing this for a while. I think at 9:30 this morning, you had US Auto Parts and they've been offering online low cost parts for 10 years almost, 10 years. There's Rock Auto, it's a private company, there's eBay Motors that have offered the service for quite a period of time.

What we have to make sure that we do is that we're providing the availability and service that drives people into our stores and makes them feel good about that purchase that they're getting a good value. And that's the key for us. When we look at our online presence, what we want to be is a good resource for our DIY customers, how to repair, what parts I need, what availability is. When we look at our online business, it's a much more pronounced to be the order online, pick up in store, because they need that availability and that's the DIY side of the business.

The professional side of the business a totally different thing, they're expecting to get their parts in 35 minutes to 40 minutes. They're expecting if they forgot one nut for a job that we run it out there right away because if they don't have enough jobs not done, they don't get paid. And they they're passing that cost on along to the customer so they are even more service-oriented that requires many, many deliveries, you have a busy shop, you might be out there for four or five times in a day. So that's just a totally different service. So we are very cognizant of what Amazon does, but we are more cognizant in making sure that our service levels are what make us a choice to buy our products.

Unidentified Participant

Hey, Tom. I mean, this year, you are a 50% gross margin business with no inflation for the past five years, but if not necessarily Amazon that the online model that I think about as a threat it's the Expedia, Travelocity, you mentioned 35 minutes, 40 minutes for a part to come at garage and I have access to a window when that 35 minute to 40 minute radius and look around and have a tool that allows me to see what your store Advanced AutoZone is offering the same part for, isn't that somehow a potential threat to gross margins as you look toward the future? And does that exist in any form today?

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

Well, it sure does, they're spawned and you would be surprised on expensive DIY business. DIY fixes, the customers (inaudible) do you have the part? What's the price on the part? And if your way out of whack and somebody else got the part, you're not going to make the sale, but we are supporting a huge inventory basis, slow moving process. So you got to make a good margin to make the right TMRI. We have locations with inventory closely available, but there's also an SG&A cost for that. So we are already a very price competitive business for people that have invested all of those dollars to have apart and technical assistance available in local markets. So I don't see people aggregating costs and figuring out that zone significantly lower cost than we are and (inaudible).

Unidentified Participant

Just I think this question has been answered similar ways for all the auto parts retailers, I think you've done a good job of explaining why it's not an existential threat. That being said, there is some threat that you've identified knowing that not all the customers are going go to Amazon or anything like that, what percentage of your products or revenues or whatever it is, would you classify as exposed to the do-it-yourself, can wait a few days, appearance performance related type products?

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

I would tell you it's a pretty small percentage, there have already been these avenues to buy their part if you're willing to plan and wait and hope that you get the right part, they've already been to avenues to purchase those. When you look at the items that really are good fit, they were catalog items back in the summit racing days, you get some racing catalog, and you look through it and you'd find these items and order. Call in and -- JC Whitney, which US Auto Parts owns now and you place an order and then they come into mail, if they weren't right and ship them back -- you'll -- so our business has already been built around things that are service driven. So I wouldn't tell you it's a huge percentage.

Unidentified Participant

And it looks -- just to talk about what was talked about over the last couple of days, including Nina, it looks as if gas prices may begin to creep up after some below years of below average prices. Can you talk about how that might affect the business and what point -- what gas price might we get to that actually?

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

So gas prices are a factor what drives our business. If we have the ultimate statistic, we would look at miles driven on cars outside of warranty. That would be the ideal stat that predict our business. So to the extent that gas prices go up, we don't like this when gas prices spike up and then people cognizantly try to minimize how much they drive, when people drive less there is less wear and tear. But you ultimately if gas prices go up and people continue to be employed and have money in their pockets and continue to drive, there will be demand for our product. So what we do get concerned about is that we have raising gas prices and it hits the employment and then we see commuter miles go down, that is a headwind for us. But it's worth that second derivative that this is a derivative of milestone.

Unidentified Participant

And then I guess, as I was talking about Amazon, what I think sometimes gets surpassed when people think that isn't how many parts you need to keep in a distribution center distribution center. How many distribution centers you have to have invested then to really be able to grit all the parts across all the different vehicle mix and models, but O'Reillys done an exceptional job managing that inventory.

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

Thank you.

Unidentified Participant

How were you handle to manage their inventory. Seems like you're kind of the best in class here.

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

Luckily for us, there are tremendous number of vehicles, nameplates, age of vehicles out there and part specific to a specific vehicle that creates a huge myriad of skews unique. So that's been one of the drivers in the consolidation industry. It's expensive and it's hard to manage. We have -- because of our do-it-for me and our regional distribution centers and our heavy reliance on the do-it-for me customer and their demand for parts in a very short period of time around and I'm going to call (inaudible), we build a very robust network from a physical standpoint, but also within -- just having that physical standpoint doesn't work. You've got to have the systems to determine what parts go where, when they should get added, when they should get taken back and what should be stocked at the store. And that's something that we've developed over time and it's proprietary to our business, but the folks that run those systems, and their knowledge and history in the auto parts business is critical to making all that work.

QUESTIONS AND ANSWERS

Unidentified Audience Member

NA

Unidentified Participant

We have a question down here.

Unidentified Audience Member

Yes. Thanks, Tom. I apologize in advance for a nit on the last quarter, but it was uncommonly volatile. So I feel like it's fair game. I don't know if people really understood the shape of comps correctly and how the industry -- there is this kind of muddiness and very specifically on a year-over-year basis, on a monthly basis, not weekly or anything like that, was September better than July?

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

We were pretty consistent throughout quarter. To address your question, I think head-on, we had competitors that said that their business improved throughout the quarter, fair. I guess our question would be why were their businesses not that are early in the quarter? And we are a company that is very focused on providing top notch excellent, consistent customer service to drive consistent results. So we are very happy with how our quarter went, so we're above the midpoint of our guidance. The fact that every month was good and we didn't rely on one month to drive our comps, we think speaks to the strength of our business. When we talk to October, we talked about we have tough compares, and we continue to do very well.

So we saw that as a positive and I think that a lot of people out there, clearly, if you look at our stock price, they didn't see that as a positive but our job is to deliver consistent results and for us to have negative comps in a month, that would be a problem. Definitely there will be a problem with our PE. So we need to deliver consistent results, so I guess maybe that's a glass half full as opposed to half empty, but we'll take 4.2% versus negative 1.5%.

Unidentified Participant

Since we're talking about last quarter, we saw some SG&A creep. can you discuss the factors that you talked about then?

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

Well, we talked about a couple of different factors, one was on the leverage, if we look back in the third quarter of last year, best SG&A month, it's amazing how SG&A leverage when you do a 7-9 comp. So we talked a few specific items on the de-lever, we talked to healthcare costs, we talked to credit card costs and how much we basically do delever? 12 basis points we delivered. When we talk about increase in average SG&A per store quarter-over-quarter, that's the more relevant item to us and mostly of it comes down to how much we decide to spend on store payroll. That's our biggest variable cost in our SG&A and we looked hard at how we're going to staff the stores to provide excellent customer service and take opportunities to grow market share.

So given where our publicly traded competitors have reported comps, we feel like it was a good investment to drive a better comp and continue to gain market share, but it's something that we look at very closely and I think something that people don't understand -- when we look at our store payroll, yes we talk about it on a macro basis, but it is really managed at the district manager, regional manager level to make sure that we're investing in the right hours each and every store what hours are going to work it , who's going to work, I mean how we're going to drive the business.

Unidentified Audience Member

Perfect. And since we talked about SG&A, just going to your gross margin, I know that because of your improving acquisition costs, you're taking these gross margin or your LIFO charges. Can you talk about that and if that does reverse in the following year?

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

Finally, a Jeremey question. I knew that was coming. And we've been in this situation and talked through it several times in the past. We just hit a point in our -- in evaluation of our inventory on LIFO, where to maintain LIFO accounting, we would have a debit balance, we'd actually write up our inventory, because of the way our costs have declined over the course of time. So when we negotiated DO and CO reduction in our costs, it creates headwind as we take a charge to write down our inventory to the new lower cost, which we've talked about.

To the extent that we see that in a period like we have recently, it's a headwind to gross margin, but obviously as we sell through those products and on an ongoing basis with that new lower acquisition cost that benefits gross margin going forward. So we've -- we had those pressures over the course of the last few years, but obviously the positives have also helped us to achieve gross margins where they're at, and we would expect, as we move through the remainder of this year and in the next year, we'll ill benefit from those or acquisition costs, and this is -- and I'm the -- over the course of the time, to the extend we continue to do better in buying world have some of these pressures.

Unidentified Audience Member

Perfect. Thank you and that -- we are out of time, but obviously 4% comp over 7% last year is pretty impressive. So thank you so much.

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

We appreciate it and can I just give one pitch here before we go? So to be successful in our business, we have that good partners, and all of our partners talked yesterday, Standard Motor Products is an excellent company, very big partner of ours, very well run company. So I would listen close to what they have to say because I think that they've done a great job and this acquisition of (inaudible) Cable, which also was a supplier of ours, something a lot of times supplier A buy supplier B and not that excited about it, but this is one of those that they have run such a good business for such a long time. (inaudible) was a good partner of ours, but when that happened we were pretty excited about it. So hopefully everybody sticks around and listen to Eric and Jim. I think they've got a great story. We're happy that they are our partners.

Unidentified Participant

Thank you, for taking your time.