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ORLY - Q3 2017 O'Reilly Automotive Inc Earnings Call

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OVERVIEW:

Co. reported 3Q17 EPS of $3.22. Expects 2017 EPS to be $11.82-11.92 and 4Q17 EPS to be $2.65-2.75.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome to the O'Reilly Automotive, Inc. Third Quarter Earnings Conference Call. My name is Allie, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to Tom -- Mr. Tom McFall. Mr. McFall, you may begin.

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

Thank you, Allie. Good morning, everyone, and thanks for joining us. During today's conference call, we'll discuss our third quarter of 2017 results and our outlook for the fourth quarter of 2017. 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, 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, 2016 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.

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts Third Quarter Conference Call. Participating on the call with me this morning are our co-presidents, Greg Johnson and Jeff Shaw, as well as Tom McFall, our Chief Financial Officer. David O'Reilly, our Executive Chairman, is also present.

I'd like to begin our call today by thanking Team O'Reilly for their continued dedication to providing consistently excellent service to our customers. This unwavering commitment to going above and beyond to meeting our customers' needs or was on full display during the third quarter in our team's response to Hurricane Harvey and Hurricane Irma. Jeff will touch on our team's effort in more detail in a few minutes, but I want to thank each member of Team O'Reilly for their hard work and commitment they showed to provide great service to our customers during the recovery from these storms.

We did see some headwind during the quarter as a result of store closures caused by the storms. However, thanks to our team's amazing commitment to getting their stores back open as soon as possible, we estimate we were able to make up most of the lost volume prior to the end of the quarter, and more importantly, we were able to generate incredible goodwill with our customers that will benefit us for years to come.

Our comparable store sales results for the third quarter were in line with the guidance expectations we established on last quarter's call, as we saw a continuation of the business trends we experienced in the first half of the year. Clearly, our results this year have been below our robust long-term track record as a result of challenging market conditions in our industry, driven by several factors I discussed in detail on our last conference call. These include the impact of 2 consecutive mild winters coupled with a mild summer in 2017, the impact to the addressable vehicle population from depressed new vehicle sales totals during the period from 2008 to 2011 and the significant economic pressure and uncertainty faced by many of our customers. None of these factors reflect a structural shift in the dynamics of our industry, and we remain very confident in the long-term outlook for the automotive aftermarket.

We operate in a very stable industry and expect to continue to see steady increases in total miles driven, along with growth in the total vehicle population in the U.S., and will continue to benefit as the high-quality vehicle engineering and manufacturing supports demand for parts late into a vehicle's life cycle. As we look forward to the fourth quarter and 2018, we remain diligently focused on executing our proven business model and consistently providing excellent service to our valued customers and fully expect to continue to lead our industry and generate robust profitable growth. Our confidence in our business is reflected in our continued reinvestment in new store growth. Jeff will provide his normal updates in a few minutes, but I'll steal some of his thunder to report to you that we are extremely proud to open our 5,000th store last week in Norwich, Connecticut. Our outstanding track record of extremely successful organic growth is the result of an amazing amount of hard work by so many of our team members throughout our history, and we continue to be very excited about our future growth prospects.

I'll now turn the call over to Greg Johnson for some more detailed comments.

Gregory D. Johnson - *O'Reilly Automotive, Inc. - Co-President*

Thanks, Greg. Good morning, everyone. I'd like to begin my comments today by thanking our team for their continued commitment to outstanding customer service and their hard work in the third quarter, which allowed us to generate respectable results in a tough environment. Team O'Reilly has consistently demonstrated that we will respond to market challenges by working even harder to take care of our customers, and that commitment to our customers has us well positioned to profitably gain market share moving forward.

I would now like to provide some additional color on the third quarter comparable store sales results and the fourth quarter guidance. Our results were within the expectations as we began the quarter on a similar trend line to the results we posted in the second quarter. As Greg previously mentioned, our month-to-month cadence for the third quarter was impacted by some headwind in the middle of the quarter as a result of store closures caused by the hurricanes, but we estimate we were able to make up for the lost volume in the affected regions as we saw demand increase for recovery-related activities. Excluding the timing impact of the hurricanes, our results for the quarter were relatively steady, with September finishing as the strongest month of the quarter.

On a category basis, our results in the third quarter were very similar to what we saw in the second quarter. We experienced continued softness in hot weather categories such as cooling, HVAC and refrigerants, particularly in the Central and Southern U.S., where mild summer conditions persisted throughout the quarter.

In addition to the pressure in hot weather categories, we saw continued headwinds in other weather-related categories, such as ride control and driveline, which did not experience the typical wear and tear this past winter in the absence of harsh weather, which drives the damage for these categories. While it is difficult to quantify the specific impact of any particular market factor has on our business over short periods of time, it is very clear to us that weather has created a short-term headwind to our business.

Our comparable store sales increase was driven by increases in average ticket size offset by pressures on ticket count for both DIY and professional customers. Our comparable store sales growth was evenly balanced between DIY and professional customers for the third quarter, and our comp results for the first 9 months were similarly balanced. We believe the parity on both sides of the business speaks to the impact of overall demand for auto parts being soft rather than isolated pressure resulting from a channel shift in the industry.

As we discussed last quarter, our tight connection to our professional customers gives us deep insight into the drivers of our comparable store sales results since we can identify changes in the demand from prior periods on a customer-by-customer basis. We continue to receive feedback that the sluggish demand we've seen in the first 9 months of 2017 is being felt across the industry as our professional customers report similar sluggishness in their business.

I would now like to spend a few minutes discussing the comparable store sales guidance we provided in yesterday's press release. As noted, we have established our fourth quarter guidance range at flat to 2%. While this range is lower than the guidance we provided for our third quarter, it does not reflect an expectation of a negative shift in the trend of our business. We finished the third quarter on a good pace, with September being the best month of the quarter, and that better pace has continued into October. One has to consider that we have our toughest fourth quarter comparisons in December, and that, coupled with the impact of the calendar shift in the fourth quarter, led us to stepping up our comp sales guidance down to flat to 2%.

This calendar headwind resulted from an additional Sunday in 2017 versus the fourth quarter of 2016 as well as the timing of the Christmas holiday, which falls on a Monday this year versus Sunday last year. Both of these calendar shifts create a headwind for us since most professional shops are closed on Sunday, and it represents our lightest volume day of the week. Based on historical experience, we expect the calendar shifts to represent a combined headwind of 50 to 100 basis points of comparable store sales growth in the quarter. As I mentioned, we have been reasonably pleased with the business thus far in the quarter, but remain cautious given the volatility we place -- we face in the fourth quarter due to the variability of the holiday shopping season and the timing of winter weather. This is especially true this year since we face difficult comparisons at the end of the quarter as we compare to strong business in December of 2016, when we benefited from the only harsh weather we saw last winter.

Taking these factors into account, our guidance range for the fourth quarter is consistent with our actual results in the first 9 months of the year on a 2- and 3-year stacked basis. Just to reiterate, the midpoint of our fourth quarter comp guidance of 1% is below our year-to-date results of 1.5% because of the calendar shift headwinds, and we continue to expect to see a continuation of the underlying business trends. We are leaving our full year guidance unchanged at 1% to 2% based on our actual performance for the first 9 months of 2017 and our expectations for the fourth quarter.

Looking at the broader automotive aftermarket, we have benefited from solid macroeconomic trends and the core underlying drivers of business in our industry. Total miles driven in the U.S. is up 1.5% year-to-date through July, and gas prices continue to remain stable at low historical levels. Overall employment levels and the economy continue to be solid, and the corresponding stable commuter mile underpins support for demand in our industry.

We feel our industry is facing normal cyclical short-term pressures, but it is very stable, and healthy condition will return to the long-term growth rates in the industry as the industry has historically experienced. More importantly, we remain very confident our team will continue to take share and generate results which outperform the overall market.

I would now like to discuss our gross margin results for the third quarter and our updated guidance for the full year. Our third quarter gross margin of 52.6% came in at the bottom end of our guidance expectation as we saw continued pressure to our gross margins from deleverage of fixed costs on low sales volumes as well as other factors Tom will discuss in more detail.

We expect sequential margins will improve in the fourth quarter as compared to the third quarter as we benefit from a more favorable product mix. However, we expect continued pressure for the fourth quarter from deleverage on fixed costs to result in a full year gross margin at the bottom end of our previously issued guidance. As a result, we are adjusting our full year gross margin to lower the top end of the range and now expect our full year gross margin to be within a range of 52.5% to 52.7% versus our previous range of 52.5% to 52.9%. We continue to see an absence of broad-based pressure to pricing in our industry, and we see no significant inflation -- and we assume no significant inflation in both our comparable store sales and gross margin guidance.

For the third quarter, we generated earnings per share of $3.22, which includes a $0.02 benefit from the change in accounting related to the tax benefits from stock option gains and is at the top of our previously guided EPS range for the third quarter. While our third quarter EPS performance is below the historical growth rates we have generated over the past several years as a result of the tough sales environment and corresponding leverage pressures on our business, it still represents a 10% increase over the prior year after adjusting for the accounting change. Our team's ability to provide excellent customer service, which drives long-term value for the company, while still producing solid financial results is a testament to their hard work and dedication.

Moving on to the fourth quarter. We are establishing a guidance range of $2.65 to $2.75 and increasing the full year guidance to a range of $11.82 to $11.92. Our full year guidance includes the previously discussed positive benefits realized in the first 9 months of the year from the change in accounting for taxes as well as the shares repurchased through today's call, but neither the fourth quarter nor the full year guidance includes any additional benefit related to the accounting change for taxes or additional share repurchases.

Before I turn the call over to Jeff, I would just like to echo Greg's comments and reiterate our confidence in the strength and fundamental drivers of our industry and our team's ability to successfully execute our business plan, drive profitable growth and generate exceptional returns for our shareholders. Our past successes and opportunities for the future are driven by the excellent experience we provide to our customers, which is the direct result of the quality of our professional parts people. This exceptional service provides a tremendous value for our customers and is extremely difficult to replicate.

I'll now turn the call over to Jeff Shaw. Jeff?

Jeff M. Shaw - *O'Reilly Automotive, Inc. - Co-President*

Thanks, Greg, and good morning, everyone. I'd like to begin my comments today by thanking our team for their relentless commitment to excellent customer service and their continued hard work every day to out-service and [out-hustle] our competition. Team O'Reilly's dedication was especially evident in those regions of our company impacted by hurricanes Harvey and Irma, and I want to provide a little color on the impact of these storms and, more importantly, on the tremendous efforts of our team to overcome significant challenges and provide outstanding customer service.

In total, we had approximately 450 stores impacted by the storms, with the closures concentrated over the 3- to 4-day time period when each storm made landfall, though the majority of the impacted stores were closed for less than 2 full days. In addition, our distribution centers in Houston, Texas, and Lakeland, Florida, were also impacted for a short period of time during the storms. While we sustained some damage as a result of the storms, and we'll continue to evaluate the total cost of the storms, we did not see a material headwind from storm-related losses in the third quarter, and we don't expect for these costs to be material going forward.

As both Greg and Greg previously discussed, the headwind from store closures during the worst of the storms we'd estimate was offset in the quarter by the incremental sales volumes we captured upon reopening the stores in the affected markets. Our ability to recover quickly from disasters such as these hurricanes isn't a new phenomenon for our company, and our teams have long prided themselves in being among the first businesses to reopen and be there for our customers after a disaster. Getting an auto part stores up and running after events like the ones we faced in the third quarter requires a tremendous amount of hard work and dedication by our team, including everything from removing water and damaged product from the affected stores to working with limited lighting and no air-conditioning; writing manual tickets in the absence of electricity or communication; unloading trailer loads of generators, gas cans and other post-hurricane supplies; and the list goes on and on. While this certainly provides a benefit as we begin to make up for the lost days of sales, the real benefit we generate is the goodwill we create with our customers by being there to provide the supplies and repair parts necessary to help them recover from the storms. This goodwill is the direct result of the hard work and sacrifice shown by our store and DC teams to overcome these challenges and take care of our customers, despite many of them also facing personal impact from these storms.

We remain committed to contributing our resources in helping those affected by the hurricanes, and we're extremely grateful for the amazing contributions of Team O'Reilly during the storms.

Now I'd like to spend a little time talking about our SG&A expense for the third quarter. Our SG&A was 32.8% of sales, which represents a 32-basis-point increase over the third quarter of 2016. As we saw in the second quarter, the deleverage of our SG&A spend was the direct result of the top line pressure to our comparable store sales results. On a dollar growth basis, we were pleased with the strong expense control management demonstrated by our teams, as average per store SG&A expense in the third quarter increased by 50 basis points as compared to the same period last year. This disciplined focus on expense control by our store and distribution center teams is the result of active daily management in each store, DC and office to ensure that every dollar we spend is directed toward improving the service levels we provide to our customers.

Our SG&A spend is deliberate, and the adjustments we've made to respond to the current sales environment during the course of 2017 have been measured and gradual. We execute our business model with the expectation that our high level of customer service will drive robust sales growth over the long term, and we will not overreact to make dramatic adjustments that would negatively impact our customer service levels. As a result, we will continue to see some deleverage pressure at low single-digit comps, but the strong expense control focus of our team has significantly limited this pressure and enabled us to generate a third quarter operating profit percentage of 19.7%, which continues to be one of the best results in all of retail.

Based on our strong expense control in the third quarter and our expected spend for the remainder of the year, we now expect that our average per store SG&A increase for the full year of 2017 will be in the range of 1% to 1.5% over our previous stated range of 1.5% to 2%.

Before I turn the call over to Tom, I'd like to spend a few minutes discussing our store growth in the first 9 months of the year and our plans moving forward. In the third quarter, we successfully opened 50 net new stores, bringing our year-to-date total to 155 net new stores spread across the country in 34 different states. During the first quarter -- the fourth quarter, we'll achieve our 2017 new store growth target of 190 stores, which includes, as Greg discussed earlier, the opening of our 5,000th store last week. This is an incredible achievement for our company, and we remain as confident as ever in our ability to execute our growth strategy. Our excitement about our future new store growth opportunities is the result of the strong performance of our new stores, which continue to exceed both our historical averages and our internal expectations even against a more challenging backdrop for the industry.

As we look forward to 2018, we expect another strong year of new store expansion and are establishing a store growth target of 200 net new stores. I'd like to conclude my comments today by again thanking our team for their continued dedication to providing the best customer service in our industry. Our teams have responded to the market conditions we faced throughout 2017 by working that much harder to take care of our customers, and that relentless commitment is the key ingredient as we move forward and continue to take market share.

Now, I'll turn the call over to Tom.

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

Thanks, Jeff. Now we'll take a closer look at our quarterly results and updated guidance for the remainder of 2017. For the quarter, sales increased $119 million, comprised of a $57 million increase in comp store sales, a $64 million increase in non-comp store sales, a $1 million decrease in non-comp non-store sales and a $1 million decrease from closed stores. For 2017, we expect our total revenues to be $8.9 billion to $9 billion.

For the quarter, gross margin was 52.6% of sales, which was a 10 basis point deleverage versus the last year. The reduced gross margin percentage was the result of product mix, the loss of leverage on fixed costs and higher shrink, offset in part by a lower LIFO charge. The LIFO impact resulting from continued incremental acquisition cost reductions, was a headwind of $3 million in the third quarter of 2017 versus $10 million in the same period of 2016. We're anticipating the headwind from LIFO in the fourth quarter will be similar to the third quarter.

For the quarter, our tax rate was 35.5% of pretax income, which was better than the 36.4% we anticipated. 1/3 of the positive variance was due to better-than-anticipated results on the totaling of certain tax periods. As a reminder, the third quarter rate is typically lower than the remainder of the year due to the totaling of open tax periods. The remaining 2/3 was due to the required accounting change for the tax benefit relating to share-based compensation. For the fourth quarter, our tax rate will be approximately 37.3% of pretax income before any benefit we may receive relating to the accounting change for share-based compensation.

Now we'll move on to free cash flow and the components that drove our results in the quarter and our guidance expectations for the full year of 2017. Free cash flow for the first 9 months of 2017 was $704 million, which was a $108 million decrease from the prior year, driven by a smaller decrease in our net inventory investment than in the prior year partially offset by higher income. For the full year, we're maintaining our free cash flow guidance of $830 million to $880 million. Inventory per store at the end of the quarter was $600,000, which was a 4% increase from the end of 2016, in line with our expectations for normal seasonal fluctuations. For the full year, we continue to expect inventory per store to grow approximately 1 to -- excuse me, 1.5% to 2%. Our ongoing goal is to ensure we grow per-store inventory at a lower rate than the comparable store sales growth we generate. And while we now project these growth rates will be similar for 2017, we remain confident in our effective deployment of inventory.

Our AP-to-inventory ratio finished the third quarter at 106%, which was where we ended 2016, and we anticipate the end of 2017 will be a similar rate at 106%. Finally, capital expenditures for the first 9 months of the year were $348 million, which was down slightly from the same period of 2016 and in line with our expectations. We continue to forecast CapEx at $470 million to $500 million for the full year of 2017.

Moving on to debt. We finished the third quarter with an adjusted debt-to-EBITDA ratio of 2.08x as compared to our ratio of 1.63x at the end of 2016. The increase in our leverage ratio reflects the $750 million 10-year bonds we issued in August and incremental borrowings on our $1.2 billion unsecured revolving credit facility. Our increased borrowings moved us into our targeted ratio of 2x to 2.25x. We continue to execute our share repurchase program, and year-to-date through this call, we have repurchased 8.3 million shares at an average share price of $234.51 for a total investment of $1.95 billion.

During the third quarter, we repurchased 2.7 million shares at an average price of $200.70. We remain very confident that the average repurchase price is supported by expected discounted future cash flows of our business and we continue to view our buyback program as an effective means of returning available cash to our shareholders.

Finally, before I open up our call for questions, I'd like to thank the entire O'Reilly team for their continued dedication to the company's long-term success.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Michael Lasser from UBS.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Greg, are you seeing any signs or any evidence that the industry is becoming more promotional or pricing pressure is becoming an issue? In light of your gross margin performance in the quarter, I think that's becoming a question mark for the industry at this point.

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Okay. Well, thanks, Michael. I -- what I would say is that anytime our industry has a year where demand isn't quite as great as it was the prior year, for a prior period or whatever, we have primarily regional independent -- I call them undercover warehouses, that do literally everything they can to hang on to and grow professional business. So we have those kinds of things happening regionally, but there's nothing new. That happens -- you see it more during times of lower industry sales growth than you do in times of higher industry sales growth, but it's nothing new. But I would add to that, that we've seen nothing across the industry that's changed the way that we compete on price and would speculate that there really has been no material change among our competitors, the method by which they go to market relative to price, other than what we've read about one of our competitors who is considering going to a zone-pricing strategy, which all of us, except for them evidently, currently deploy, and we'll just have to see what effect that has. But I guess my comment would be is there's nothing new on the pricing front for us.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

That's helpful. And then my follow-up question is how do you reconcile your comments about weather influencing the industry sales and the fact that your trends improved in September, and it sounds like that's continued into October, despite the fact that it's been abnormally warm in areas of the country like the Northeast? And then if we see another abnormally warm and dry winter, is this 1% to 2% growth rate kind of the new norm for the business?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Yes. Well, what I would say, Michael, is that we've had 2 consecutive winters of mild weather, and we've had a mild summer. I think as winter has approached in some markets, we -- what we've seen is a good reaction in some of the winter preparation-type of items and that, most likely, there are people that know that they didn't do some things to their cars last winter and maybe even the winter before because they had the mild winter, and they're anticipating the need to do it. And so that's -- we feel like that's probably a little bit of a driving factor in the early season prior to weather hopefully turning cold and us having a brutal winter this winter in much of the country. We're not as exposed to the Northeast as some of our competitors, but we do realize it's been softer up there. We're growing up there. So the fact that maybe demand hasn't been as good on a macro level up there as what it typically would be this time of year, we may not see as much because our stores are still in kind of a high growth rate because they're newer stores. Relative to your question on 1% to 2% being the new norm, if weather is to be -- we have another mild winter or something like that, that's yet to be seen. I -- it would be very surprising if we had 3 winters as mild as the 2 we've had in the past. But time will tell, and we'll see. Some of the things that are caused to fail by extreme weather are items that are going to fail no matter what. Extreme weather just causes them to fail earlier than they would have otherwise. So what I would say is that if we have a real cold winter in many markets this year, I would expect demand to be pretty robust. If we don't, some of the things that didn't fail 2 years ago or last year are bound to fail this year just based on time and miles rather than extreme weather. So we would expect there to -- this winter to be a better season for us and I wouldn't expect 1% to 2% to be the new norm.

Operator

And our next question comes from Brian Nagel from Oppenheimer.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

So I, too, just wanted to begin with a question on gross margins. And Tom, I know you addressed this somewhat in your prepared comments, but can you help us understand better what really changed from, say, Q1 -- or I'm sorry, Q2 to Q3, where gross margins went up -- from being up solidly to down slightly? What were the key factors that changed there? And then recognizing you don't give guidance beyond 2017, how should we think about gross -- given what the industry dynamics are right now, how should we think about gross margins as we look out into 2018 and beyond?

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

So your question is, to make sure I have this right, is the year-over-year difference, second quarter to third quarter?

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

That's correct.

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

Okay. So when we look at the second quarter of 2016, we had a significant LIFO charge, and that created a lot of the difference. When we look at our gross margin, we tend to look on a quarter-to-quarter basis, not year-over-year. The best indicator is how we did the quarter before. And there is some seasonality within that based on the product mix that we sell during that quarter. So the comparison of how much we were over in the second quarter versus the third quarter really has to do with that LIFO number. If we look at the sequential margin from the second to the third quarter, we actually improved. And a lot of that is based on seasonality and we'd expect it to continue to improve, per our guidance, in the fourth quarter based on the products. As far as next year, we see a pretty stable pricing environment out there. We see a non-inflationary environment continuing, and we'd anticipate that we'll continue to work hard at improving our gross margins. To the extent that we are better able to leverage our fixed costs, we'll see an improvement. Our merchants are always working on getting better deals. So we wouldn't expect to have the pressure maybe that we've seen this year ex LIFO.

Brian William Nagel - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Got it. That's helpful. And then just my follow-up question, with respect to hurricanes, so it sounds like you got your stores up and running quite quick through the storms. Should we expect any type of recovery demand in your business as we look over the balance of '17 or even beyond?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Well, I think there's always some. The cars that were flooded that weren't totaled, or cars that maybe were in really bad shape that people decided to salvage, there's fluid changes and other things, we've been through this before. And Jeff, I might ask you to kind of speak to some of the things that we see in the stores relative to items that people work on and repair following hurricanes and how long that lasts.

Jeff M. Shaw - *O'Reilly Automotive, Inc. - Co-President*

Sure. Well, I mean, obviously, the big ones would be -- the immediate would be the filters and the fluids and the things to kind of get the flooded cars that weren't totaled back in service. Following that, I mean, there's going to be damage to rotating electrical. That's -- we should see a bump in that in the affected markets. It's hard to tell. I mean, we've been through several of these over the years. And in those affected regions, there will be some post-hurricane demand for some period of time. I don't know exactly when that will play out.

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

One additional benefit, Brian, is that many of the cars that were totaled, the people that -- whose car was totaled, they'll go out and buy new cars. Many of them, I would speculate many of our customers that had cars that were totaled and got insurance checks have probably never bought a new car and wouldn't this time, so they're out buying used cars. As a matter of fact, the used car market in Houston is robust. There aren't enough used cars down there, and auctions across the U.S. are filling the need for cars in those flooded areas. So as these customers buy these used cars, many times, someone with a car that's new to them takes it through a maintenance cycle, which is generally good for us. So I think that late in 2017, 2018, we do stand to have some benefit from those used cars that are new to families that go through a maintenance cycle to become the family car.

Operator

And our next question comes from Kate McShane from Citi Research.

Kate McShane - *Citigroup Inc, Research Division - MD, Head of the U.S. Discretionary and U.S. Apparel and Retail Analyst*

I think you'd mentioned in the prepared comments just some of the better results that you were seeing at your new stores. Can you walk through how close some of these newer stores are to existing stores? And what is exactly driving some of these better results and how they can maybe be leveraged into the rest of the fleet?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Okay. Well, our -- we put in just some fantastic new stores, and I think you may be surprised to know that one of our largest growth markets is Texas, where we have a number of stores and operate in virtually every market. So they're backfill stores. And in Houston, Dallas, Austin, San Antonio, markets like that, we're constantly evaluating where we might put additional stores. So some of the new stores we opened are stores that are reasonably close to existing stores, but we know by the work we do demographically that we're not getting as much business as we could potentially get if we had another store, and we justify opening an additional store. On the other hand, many of our new stores are in Florida and the northeast, where we don't have existing stores. And those stores where we don't have overlap, we establish our brand and do very well. I was just -- I just attended our new store up in Norwich, Connecticut, which was our 5,000th store, I attended that opening. And it's just incredible, the number of customers that come in who are thankful we're there, happy we're there, enthused about the new store, impressed with the way the store looks. So we do a lot around promotions and putting a great team in the store to get a store off to good start. And frankly, over the years, we just got better at it than we were in the past. And today, our new store openings outpace what they had a few years ago, and we're pleased with the new stores we opened, both in backfill markets and in new store growth markets.

Operator

And our next question comes from Simeon Gutman from Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

First question is on sales. I wanted to ask how do you know if some of the strength that you saw in September, October wasn't just this hurricane rebound that you mentioned and that you don't see -- that trends won't soften from there? I guess, maybe you can talk to some geographic markets or categories of parts.

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Yes, that's how we would know, Simeon, is simply because we know the effect that those regions that were affected, what they can -- what effect they can have and did have based on the detail we obviously see on the whole company. And we know that, that was -- that is not the primary reason of the improvement, although we did have -- we have had some rebound in those markets. But there just isn't enough scale there to cause us to -- cause an effect on the whole company the way that you might be alluding to.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

Got it. Okay. And then I want to ask about the sweet spot. We've talked a lot a bit -- a lot about it, and there's a lot of ways to slice it. I mean, clearly, 2017 wasn't the year it happened, or at least it was clouded by weather, but it would seem like 2018 should be a year where, mathematically, the number of cars in that sweet spot do increase. Do you agree with that? And is there any rhyme or reason for it to occur earlier or later in next year?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

No. I agree with you that we should begin seeing it in 2018. The 2008 to 2011 cars will be on the tail end of the demand curve, and their presence in the vehicle population and the number of those cars won't be as impacting on the overall demand in the industry.

Operator

And our next question comes from Dan Wewer from Raymond James.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - U.S. Hard Line Goods Analyst*

Greg, I want to follow up on that same topic. Back in 2008, the company had an unexpected weakening of same-store sales along with the economy. It had a nice rebound of 4.6% in 2009, a little bit of a similar pullback in 2012 results, followed by a recovery to 4.3% comps in 2013. When you think about next year, do you think that we're set up for a snapback in comp sales maybe to at least the midpoint of 3%? It sounds like you're a little bit more bullish on vehicle demographics as well for next year.

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Dan, what I'd say is that having been a little bit surprised this year with the softness that we experienced, we -- you don't know how a year is going to play out when do your plan. And Tom and his team do an outstanding job budgeting and forecasting and so forth. But what I would say is we have much easier compares next year, and we've had tough compares for several years in a row now. So I would say that on the tail end of what we would view as this air bubble in the vehicle population and the easier compares, yes, we would expect to have a better comp store sales year next year than what we had this year. And while we haven't done the work for our -- to forecast and set our plan and give guidance yet, I'm hopeful that we will arrive at a point at the end of this year based on our performance in the fourth quarter that we have confidence in setting a more aggressive comp store sales plan for next year.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - U.S. Hard Line Goods Analyst*

Also, you commented on the feedback from your commercial customers and they indicated they think the weakness is impacting them as well. What are they saying about the dealers' service business? The public companies have been showing that their service business has been strengthening. Is there a risk that they're having some impact on that down-the-street mechanic and that could be having some influence on their softer results?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Well, I think that there is something to that, Dan. I think that the shops that do diagnostic work and drivability work that's relatively technical, I think that the dealers are doing -- have done a better job in the last several years of trying to hang onto some of that business. Not necessarily because of the revenue and profit generated from the repairs, although that's beneficial, but more so because they're trying to get the next new car buy. The people that buy new cars and go through a warranty process where they have warranty work done at the dealer, they try to hang on to them thinking that if they're a new car buyer, someone that is going to buy a new car versus a used car, that they have a better chance of getting that next new car sale if they do a good job from a service standpoint. So I think that some of our competitors, depending -- I mean, some of our customers, depending on how technical of a shop it is, does view the dealers as being a significant competitor. And when it comes to the shops that do primarily undercar, brake work, alignments, tires, chassis and suspension work relative to alignments and tire wear, I don't think they're nearly as exposed to that, and they don't have an issue with the dealers because the dealers, I don't think just do -- they don't do that much of that kind of work.

Operator

And our next question comes from Bret Jordan from Jefferies.

Bret David Jordan - *Jefferies LLC, Research Division - Equity Analyst*

Could you talk about the comp, the magnitude of the comp improvement? Some of the suppliers are talking about some, I guess, almost good POS data from their perspective on September, and maybe talk about how much we saw improvement as the quarter progressed. And then, maybe regional spread. You talked about the central states being the weakest, but if you could give us some idea of sort of the spread between worst and best?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Yes. Well, yes, we don't want to get into a lot of detail about our comps, specifically by month. But we said that September was the best month of the third quarter and that better trend has continued into the -- into the fourth quarter. Although we don't want to sound overly aggressive, because we know we have this tough compare coming in December and we have the headwinds from the holiday and the extra Sunday and so forth. But yes, I think that what you're hearing from suppliers would be reasonably accurate about the improvement that's been seen in September and October. And I'm sorry, I forgot the second half of your question.

Bret David Jordan - *Jefferies LLC, Research Division - Equity Analyst*

The regional spread, how much did the central states underperform your strong markets?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Right. Yes, the Central and East would be softer than our West. The West Coast and the western half of the country has been our best performing this past quarter.

Bret David Jordan - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then as a follow-up question, on M&A, obviously the GPC guys bought Monroe and Rochester, or are buying, and you'd done the Bond deal a year ago. Are you seeing more of the smaller independents, the undercar warehouses you talk about, that maybe are challenged in a soft environment looking to sell now?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

There's always a few out there that are ready to sell. Some overlap with us, which causes valuation to be a problem. But yes, I think the softness in the business causes more of them to be interested in selling than they are in times of robust business.

Operator

Our next question comes from Alan Rifkin from BTIG.

Alan Michael Rifkin - *BTIG, LLC, Research Division - MD and Retail Hardlines and Broadlines Research Analyst*

My first question relates to inflation, both with respect to commodity prices as well as wages. Greg, one of your chief competitors talked about that they were seeing some inflation in commodity pricing. I was wondering why at this point you're not really seeing that. And then as the second half to that first question, what are you seeing, if any, with respect to wage pressure inside your stores?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Okay. Well on commodity pricing, and we've -- I'm sure that we are shopped electronically as we shop our competitors just ongoing, and we have seen a little bit of inflation in commodities over time. So we do see some benefit from that, although it's not material across of the scope of our whole inventory since the majority of our business is hard parts and batteries and things like that. Although we continue to be very aware of how our competitors price and look for every opportunity to adjust our prices where we see an opportunity to do so. On wages, I think we see the same pressures that our competitors see. It's well known throughout the country that several municipalities have their minimum wage set well above the U.S. minimum wage, and it's just we work to make sure that our stores are as productive as they can be, and Jeff Shaw and his team just do a great job of managing this. Jeff, you might talk a little bit about the productivity things and some of the things we're doing with our drivers from a routing standpoint, things like that, to help drive productivity in our stores, if you'd like.

Jeff M. Shaw - *O'Reilly Automotive, Inc. - Co-President*

Yes. I mean, anytime there's low unemployment, I mean, there's going to be wage pressure, and these municipalities don't really help things. But when payroll goes up, you've got to manage productivity team member by team member, and we do that with various things, and we're using more and more technology all the time to try to leverage our team member productivity to keep our SG&A in line. So it's just the same thing we've always fought. I mean, we'll work through it and manage it quarter-to-quarter and year-to-year.

Gregory D. Johnson - *O'Reilly Automotive, Inc. - Co-President*

Alan, this is Greg Johnson. I'd like to just add to the commodity pricing question. I don't think we've seen anything out of the norm this year from a commodity pricing. The commodity -- a lot of the commodity pricing is based on pricing of various metals, fuel-based pricing, things like that. We see fluctuations every year, and we've been able to pass along most of those price increases.

Alan Michael Rifkin - *BTIG, LLC, Research Division - MD and Retail Hardlines and Broadlines Research Analyst*

Okay. And just a follow-up, if I may. Greg Henslee, you said one of the factors, although further down on the list, that you thought was responsible for the weakness not only in your business, but for the industry, was the addressable vehicles over to 2008 to 2011 time period. That's a pretty long period of time, right, both during the recession as well as the year before and the year after. Does that length of time and the fact that you believe that it is influencing your business, does that maybe give you some pause in terms of changing just the near-term strategy since it looks like it's somewhat of a prolonged period of time, possibly taking down the new store growth just a little bit till we get to the other end of that?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

No, it doesn't, Alan. And just to be -- I'm sure everyone understands this, but I'm going to say it anyway. What we're talking about is just simply the depressed new car sales during those years and there being fewer of those cars in the ideal sweet spot for selling auto parts, which is if you looked across the bell curve of the demand for parts, when that population decreases, it can have an effect. The reason I wouldn't look at it from the perspective you mentioned relative to maybe knowing that's coming and changing our growth is I feel like it's offset pretty significantly by the fact that cars just stay on the road longer. Some of the cars that are older that used to be cars that customers just wouldn't invest in because they were nearing their time to go to the scrapyard, that's just not the case as much. So I think that the effect of this, while it is a factor, is somewhat muted by the fact that there are just more cars on the road that are older that are still worthy of significant investment because they're still pretty good cars.

Operator

And our next question comes from Christopher Horvers from JPMorgan.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

So can you remind us how steep was the decline in the business in December? I know you benefited -- everyone benefited from the cold weather, but at the same time, you also had some headwinds that were starting to emerge with a Hispanic customer. I'm curious if you could also talk about what you're seeing there. Is that customer more stable now? And do you think that was a drag on your business as early as around the election time frame?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

We don't give monthly comp numbers, but I'll tell you, December -- the comp in December was approximately double what it was the other 2 months of the quarter. So it was a significant step up. And a lot of the business during December was directly related to real cold weather. It was batteries and other cold winter items that we sold during that period of time that -- we might replicate this again in December. We'll have to see. If we have real cold weather, then there should be a lot of batteries out there that are ready to fail, and a real cold snap across the country would cause them to fail. So we'll just have to see. But December was a material step up last year for us from a comp store sales basis compared to October and November. On the Hispanic customer, we think it's getting better. Jeff, you made some comments earlier that the -- what some of the RMs and DMs have been saying to you. So we think it's improving. And Jeff, you might have a comment relative to that.

Jeff M. Shaw - *O'Reilly Automotive, Inc. - Co-President*

Yes. I mean, what we're hearing from some of the heaviest Hispanic markets is the operators feel that it's ticking back up. Foot traffic is picking up and some of the professional business is picking back up. So at this point, it's isolated, but we are hearing some positive comments, more than we've heard all year.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Would -- could you venture, I mean, as you think about that customer, how much perhaps that, that's been a headwind, or whether the headwind, whether in the fourth quarter last year or in the first quarter, is it -- is it like 20 or 30 basis points? Or is it something more material?

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

It would just be an absolute guess, and I'd rather not put a number on it. It's been a factor. There's been enough discussion about it and the information we get from a company called NPD, who you're probably familiar with, that outlines just general retail demand among the Hispanic customer base and where the Hispanic population is most prevalent in driving retail demand across the country has indicated that it's a factor. But it would be very difficult, if not impossible, for us to put a number on the impact.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Understood. And then just as a quick follow-up. Tom, does the shrink headwind continue as you look into the next few quarters? Is this at sort of a new rate of an accrual? Or was this just more of a one-time adjustment here in the third quarter?

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

We would -- we spend a lot of time managing shrink. Our field team, DCs teams do an amazing job; our LP team does an amazing job. And I would tell you that this is just an oddity for us that kind of popped and probably had a lot to do with the timing at the -- of the end of the quarter, and how much inventory we had to move around in different ways based on the events that occurred during the quarter.

Operator

And our next question comes from Chris Bottiglieri from Wolfe Research.

Christopher James Bottiglieri - *Wolfe Research, LLC - Research Analyst*

The first one is clerical. Does your SG&A guidance, is that GAAP? Like, do you adjust that for the legal reserve and for the M&A? Like, how are you looking at that?

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

I'm sorry. Our SG&A guidance would be GAAP.

Christopher Michael Horvers - *JP Morgan Chase & Co, Research Division - Senior Analyst*

GAAP. Okay. And then, so obviously, pretty impressive performance year-to-date. You're basically running flattish versus 3%. This is ex dollars. You strip out depreciation and rent out of your SG&A, versus running 3% for the prior years. I was maybe hoping you can kind of bridge that gap. Like how much is it incentive comp coming out of the SG&A base? How much -- is there any way -- any reason to think that some of these expenses could be pushed into 2018? I just kind of wanted to get your thoughts there.

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

I would tell you, it's just tight expense management and as we talked about before, we have variable compensation for every team member here at O'Reilly from a driver up through our executives. And the percent changes. Obviously, that number is under pressure this year. So there's some savings there that won't occur. But it's good expense management, good expense management of payroll, which is our biggest expense at both the DCs and in the stores. And we have a very -- the expenses that are volume based that go up when we have higher sales and more activity, we've done a good job managing.

Christopher James Bottiglieri - *Wolfe Research, LLC - Research Analyst*

Okay. Then just one brief one on LIFO. Those tailwinds have kind of slowed down a little bit, or I guess, initial headwinds, I call them lag tailwinds. How do you think about kind of your ability to extract better procurement from your vendors? Are you seeing anything change on those discussion points? Is there a certain percentage of your portfolio you've turned over in the last couple of years that makes those slower? Or how do you think about those?

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

Well, as Greg mentioned earlier, we have seen some commodity price inflation, and it's car parts where we continue to get better deals offset in part by inflation on some commodities. So we continue to work on getting great deals. But to the extent that we see commodity pricing increase, that could -- so if we see inflation provide tailwind to the top line and our industry has been pretty effective at pushing price increases for cost increases we receive.

Operator

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

Gregory L. Henslee - *O'Reilly Automotive, Inc. - CEO*

Okay. Thank you, Allie. We'd just like to conclude our call today by thanking the entire O'Reilly team for our continued dedication to customer service in the third quarter and for the year. We look forward to finishing 2017 on a solid note and getting off to a strong start in 2018. I'd like to thank everyone on the call today for attending our call, and we look forward to reporting our fourth quarter of 2017 results in February. Thank you very much.

Operator

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