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ORLY - Q4 2017 O'Reilly Automotive Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 EPS of $3.52. Expects 2018 total revenues to be $9.4-9.6b and EPS guidance of $15.10-15.20, also expects 1Q18 EPS to be $3.55-3.65.

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PRESENTATION

Operator

Welcome to the O'Reilly Automotive Inc. Fourth Quarter and Full Year Earnings Conference Call. My name is Jason, and I will be your operator. (Operator Instructions) Also please note, this conference is being recorded.

I will now turn the call over to Mr. Tom McFall. You may begin, sir.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Thank you, Jason. Good morning, everyone, and thank you for joining us. During today's conference call, we will discuss our fourth quarter 2017 results and our outlook for the first quarter and full year of 2018. 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 & Director*

Thanks, Tom. Good morning, everyone, and welcome to the O'Reilly Auto Parts fourth quarter conference call. Participating on the call with me this morning are our copresidents, Greg Johnson and Jeff Shaw; as well as Thomas McFall, our Chief Financial Officer. David O'Reilly, our Executive Chairman, is also present.

Hopefully, everyone had a chance to read both our fourth quarter earnings release and our leadership succession plan press release. I'll briefly discuss our fourth quarter results and our succession plan before turning the call over to Greg, Jeff and Tom.

I'd like to start the call today by thanking all of our team members for their hard work and dedication to our company. 2017 was a challenging environment for our industry. However, through your commitment to providing outstanding customer service and living the O'Reilly culture, we were able to generate our 25th consecutive year of comparable store sales growth, record revenue and operating income every year since becoming a public company in 1993.

Our comparable store sales for the fourth quarter grew 1.3%, which was in line with our guidance expectations. As we discussed on last quarter's call, we faced very difficult comparisons to last December due to favorable weather across the country in December of 2016 and headwinds from a shift in the calendar.

This calendar headwind resulted from an additional Sunday, our lowest volume day in 2017's fourth quarter when compared to 2016, as well as the timing of the Christmas holiday, which fell on Monday this year versus Sunday last year. These calendar shifts were a combined headwind of approximately 70 basis points to our comparable store sales growth for the quarter.

When we look at our sales progression during the quarter versus our expectations, we got off to a solid start, but hit some weather-related softness mid-November to mid-December and finished up strong with the onset of harsh winter weather in the last half of December. In absolute terms, October and November were solid comparable store sales growth months and December being negative for the reasons I mentioned.

Greg will give some additional color on our fourth quarter comparable store sales growth and our expectations for 2018. Our earnings per share for the quarter of $3.52 benefited significantly from 2 tax-related items. These were $0.15 benefit from the new stock option accounting requirements and $0.62 related to adjusting our deferred tax liabilities in conjunction with the Tax Cuts and Jobs Act of 2017. Tom will discuss these impacts to the quarter and our outlook for next year in more detail in a few moments.

Excluding these tax impacts, our earnings per share for the quarter was $2.75, which was at the top end of our guidance range. Again, Greg and Tom will be covering the details of our fourth quarter performance and our outlook for this year in a moment.

As was disclosed on our 2 press releases last night, after 33 years of serving in many different roles in our company, I plan to take on yet another new role. Succession planning has always been an important and methodical process at our company and over the period from now until our annual shareholder meeting on May 8, we will transition the day-to-day operations of the company to Greg Johnson and Jeff Shaw. As you know, they assume the roles of copresident a year ago. This will allow me a little more free time for my personal life, yet allow me to continue my participation in the direction and management of our company.

Subject to our shareholders' meeting -- subject to our shareholders electing me to the board in May, our board has asked that I assume the role of Executive Vice Chairman and Greg Johnson will be promoted to Chief Executive Officer and Co-President; and Jeff Shaw will be promoted to Chief Operating Officer and Co-President. I will continue to be highly involved in the operations of the business as will David O'Reilly, who will continue as our Executive Chairman.

For those of you who know our company's history, this transition is very similar to 2005 when Ted Wise and I were promoted from copresidents to COO and Co-President and CEO and Co-President, respectively, and took over the day-to-day operations from the David. Greg and Jeff are both extremely talented and experienced individuals who have the full support of our team and our board and I have complete confidence they will continue our company's long-term track record of success.

Before I finish up my prepared comments, I would like to again thank our team for continuing to provide industry-leading service to our customers every day and growing our market share during this difficult past year. I'm extremely proud of all of you and I'm confident 2018 will be an outstanding year for our company.

I'll now turn the call over to Greg Johnson.

Gregory D. Johnson - *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 deep commitment to outstanding customer service and continuing to build our market share through a tough environment.

By always putting the customer first, we're well positioned to sustain profitable growth in our business. Now I'd like to provide some additional color on our fourth quarter comparable store sales results and outline our guidance for 2018.

For the fourth quarter, our comparable store sales results were driven by an increase in average ticket offset in part by pressure on ticket counts on the DIY side of the business. The Professional business outperformed the DIY business during the quarter. The increase in average ticket continues the long-term trend of increasing parts complexity, although we did see some inflation on same SKU pricing, primarily seasonal items during the fourth quarter, which if it continues, will lend additional support to our top line growth moving forward.

On a category basis, we saw strength in winter-related categories across most of the country, which was partially offset by extremely tough comparisons to 2016 for winter-related categories on the West Coast, which did not see the same benefits last year. For the first quarter of 2018 and the full year, we're establishing comparable store sales guidance at 2% to 4%. The key assumptions in developing our guidance are total employment will remain strong and support a modest improvement in miles driven.

However, increasing gas prices could limit the growth of miles driven and put added pressure on lower income consumers. We further assume weather will be normal, pricing in the industry will be rational and inflation will continue to be muted. Our final major assumption is that the pressure in our industry from the depressed new vehicle sales totals during the period from 2008 to 2011 will begin to abate.

Thus far in the quarter, harsh winter weather across the country has helped support the benefit in our northern markets, although unusual snow and ice in the southern markets have been a headwind to business, since these markets are much less equipped to handle inclement weather and consumers frequently stay home until conditions improve.

In total, we are pleased with our business thus far in the quarter. However, built into our guidance is consideration that our sales volume in Q1 is seasonally weighted to the end of the quarter, where we have our toughest comparisons. In general, the much more inclement weather this winter season has compared to the past 2 mild winters should help drive our business throughout the year.

For the quarter, our gross margin of 52.9% was within our expectations and our full year gross margin of 52.6% was in the middle of our updated full year guidance of 52.5% to 52.7%. For 2018, we're establishing our full year guidance at 52.5% to 53% of sales. The increased expectations are attributable to better leverage on fixed cost for more robust sales, modest improvement in merchandise margin and a slightly lower LIFO charge of $18 million versus $22 million in 2017, partially offset by pressure to increase transportation cost.

We expect our 2018 LIFO charge will be front-loaded in the first 2 quarters of the year based on current vendor negotiations with cost increases most likely offsetting the negotiated price decreases in the back half of the year.

The Tax Cuts and Jobs Act of 2017 will dramatically reduce our future tax expense. We expect the savings to be approximately $215 million in 2018, and we feel it's appropriate to take a portion of these savings and allocate it back to the business with a focus on continuing to improve the levels of service we offer our customers.

Our focus is to further enhance the levels of customer service we offer by accelerating enhancements to our omnichannel efforts and to continue to build on our industry-leading customer service.

The costs of this investment to represents a 70 basis point headwind to our SG&A and an incremental $30 million of capital expenditures.

Jeff will give further details in the improvements of our in-store service levels, but I'd like to take a minute to discuss our omnichannel efforts.

Regardless of how our customers begin their interaction with us, whether it's in-store, online or over the phone and complete their transactions whether in-store, at-home delivery or with us delivering the order at their shop, we want to provide a seamless shopping experience that engages the customer and delivers a superior customer experience.

During 2018, we will accelerate our investment in our electronic portals, OReillyauto.com, for our DIY customers and First Call Online for our professional customers. Our projects focus on improving the usability, content, search functionality and general touch and feel of these portals to ensure we're exceeding our customer expectations.

We will also be focused on better using the data we collect to increase the speed of customer interactions and transactions, improve the smoothness of transactions between the different channels and use past buying patterns to better anticipate our customers' needs. Without going into the details of these specific projects, I do want to say that we're excited about our enhancements and we'll be able to achieve this year -- that we'll be able to achieve this year and the foundation we'll put in place for improvements in the dynamic -- in this dynamic part of our business.

With the additional spend on operating expenses for these investments and the omnichannel and service levels we provide to our customers, we're setting our 2018 full year operating profit guidance at 18.5% to 19%.

For the first quarter, we are setting our earnings per share guidance at $3.55 to $3.65. For the full year, our guidance is $15.10 to $15.20. Our full year guidance includes an estimate for the tax benefit for the new option accounting adopted in 2017, and the impact of shares repurchased through this call, but does not include any additional share repurchases.

Before I turn the call over to Jeff, I'd like to thank our team for their hard work in 2017. I look forward to serving as the company's Chief Executive Officer, and I'm excited about the potential for our performance in 2018 and beyond.

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. To begin today, I'd also like to thank our team for their tireless commitment to providing outstanding customer service. Your dedication to our valued customers has allowed us to strengthen existing relationships and to build new ones. We run our business to develop long-term relationships with our customers who expect high service levels regardless of the sales environment. And as a result, we have a relatively high fixed cost model, which has supported our market share growth year-after-year.

With our business model and new store growth rate, our leverage point for SG&A is in the comparable store sales range of 2.5% to 3%. Comparable store sales of 1.3% for the quarter and 1.4% for the year is well below our historic and expected future growth rates.

We tightly manage our expenses in all sales environments, but at these sales levels, we expect to experience de-leverage on our SG&A as we will not make short-term dramatic cuts in our SG&A, since that would significantly impact our service levels and damage our long-term customer relationships.

As a result, we experienced SG&A deleverage of 87 and 66 basis points for the quarter and year, respectively. When we look at total increase in average SG&A spend per store, we were up 1.2% for the year, which was below our beginning of the year guidance and reflects our efforts to prudently manage expenses lower during slower sales periods.

Looking closer at our full year SG&A spend, we were below expectations on payroll, incentive compensation and professional services and fees, offset in part by rising benefit cost, utilities and vehicle cost.

As Greg mentioned earlier, we're going to take a portion of our tax savings and allocate it to increased operating expenses to further enhance our best-in-class customer service. This investment, combined with normalization of incentive compensation, will result in 2018 SG&A per store increasing in the range of 3% to 3.5%. This additional spend is focused in 3 main areas: Omnichannel, which Greg already discussed; enhanced benefits and wages at the store level; and the in-store technology to improve the efficiency of our store teams.

The key driver of our in-store customer service levels is the knowledge of our professional parts people. As we continue to experience wage pressure, driven by the waterfall effect and increasing minimum wages and the extremely labor tight market, we absolutely must be able to attract and retain team members who have automotive knowledge and a willingness to live the O'Reilly culture.

We must also ensure our parts professionals continue to enhance their knowledge base and are as efficient as possible. We have several significant projects directly aimed at accomplishing this. We don't want to discuss these upcoming enhancements in detail, but we're very confident they will generate a solid return on the capital we invest.

On the expansion front, we had a busy year. We opened 190 new stores, converted the 48 Bond stores and expanded our Greensboro DC from 5 -- 300,000 to 500,000 square feet to support our continued growth.

For the year, capital expenditures came in at $466 million, which was below our guidance due to a higher mix of lease stores, delays in some projects and generally just tightening our belt during a soft year. For 2018, we're setting our CapEx guidance at $490 million to $520 million. We plan to open 200 new stores during the year and the primary increase in our CapEx is accelerating our IT project spend.

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 to continue to take market share.

Now I'll turn the call over to Tom.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Thanks, Jeff. Now I'll take a closer look at our quarterly results and our guidance for 2018. For the quarter, sales increased $92 million, comprised of $38 million increase in comp store sales, a $53 million increase in noncomp store sales, a $2 million increase of noncomp nonstore sales and a $1 million decrease from closed stores.

For 2018, we expect our total revenue to be $9.4 billion to $9.6 billion. The Tax Cut and Jobs Act of 2017 had a dramatic impact on our fourth quarter earnings and it will continue to have a significant positive impact on our tax rate on a go-forward basis. For the fourth quarter, we recorded a tax benefit of $53 million or $0.62 per share related to the remeasurement of our federal deferred tax liability from a tax rate of 35% down to the new 21% tax rate. This deferred liability relates to timing differences for our historic tax deductions exceeded our deductions recorded for GAAP. These differences reverse over time, but will now reverse at the new lower tax rate.

During the quarter, we also recorded a tax benefit of $13 million, $0.15 per share relating to the new accounting for share-based compensation. For the full year, our tax benefit for the new required accounting for share-based compensation was $49 million or $0.50 per share.

For 2018, we expect our tax rate to be approximately 23% to 24% of pretax income. The new lower rate is a result of lower -- the lower federal tax rate. In comparison to 2017, we expect our EPS to be affected by a $0.59 headwind from the one-time reduction of our deferred tax liabilities in the fourth quarter of 2017; a $2.50 increase from the new lower federal tax rate; and a $0.30 headwind from a tax deduction for share-based compensation with the lower benefit driven by lower expected gains on exercises of options. We expect the quarterly tax rate will be relatively consistent, however, the quarter-to-quarter differences in the tax benefit from share-based compensation will create fluctuations on our quarterly tax rate as a percent of pretax income.

Now we'll move on to free cash flow and the components that drove our results for the year and our expectations for 2018. Free cash flow for 2017 was $889 million, which was a decrease of $89 million from the prior year. This decrease was due to a lower decrease in net inventory, offset in part by lower capital expenditures. In 2018, we expect free cash flow to be in the range of $1.1 billion to $1.2 billion, with the increase driven by higher pretax income and lower cash taxes, offset in part by higher CapEx. Inventory per store at the end of the quarter was $600,000, which was a 4.2% increase from the end of 2016. Our ongoing goal is to ensure we grow per store inventory at the lower rate than the comparable store sales we generate. And unfortunately, we didn't achieve that goal this year as soft sales, especially in seasonal categories, resulted in a higher a year-end inventory value than anticipated.

We expect this cycle through this excess inventory in 2018, and we anticipate we'll grow our per store inventory in the range of 1% to 2% this year. Our AP-to-inventory ratio at the end of the quarter was 106%, which was where we ended 2016. We anticipate a slight improvement to 107% at the end of 2018, which will be driven by the higher level of sales.

Moving on to debt. We finished the fourth quarter with an adjusted debt-to-EBITDA ratio of 2.12x, 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 range of 2x to 2.25x.

We continue to execute our share repurchase program and for 2017, we repurchased 9.3 million shares at an average price of $233.57 for a total investment of $2.2 billion.

Subsequent to the end of the year through the date of our press release, we repurchased 0.5 million shares at an average price of $261.72. 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 excess capital to our shareholders.

Finally, before I open up our call for questions, I'd like to thank the O'Reilly team for their dedication to the company and our customers.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Scot Ciccarelli from RBC Capital Markets.

Scot Ciccarelli - *RBC Capital Markets, LLC, Research Division - Analyst*

First question is, can you help quantify what kind of impact you're expecting from the improved car part that you mentioned during the call? Car part meaning, the dropping of car sales we had, obviously, during the downturn.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

When we look at the numbers, we see that, that pressure is going to abate, quantifying that particular factor amongst all the factors is not something we do, but we feel like that was a pressure last year that will be less of a pressure this year, and obviously, we continue to have the aging of the vehicle fleet more vehicles in the end of -- or in the older section that continue to drive demand and growth in our industry.

Scot Ciccarelli - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. And then a question -- the follow-up has to do with the reinvestment amount. So if you kind of go through the numbers, and I'm assuming we're talking about 70 basis points of margin, that's how I think people are interpreting that comment. It's about $65 million, $66 million. Is that all going to wages? Or is there's something else that might be in there? It just seems like a little bit of a high number on the wage front, but maybe there's something else in there.

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

Yes, this is Jeff. I'll take a stab at that one. We feel it's about $65 million and, as I mentioned in the prepared comments, the spend is basically focused in 3 main areas. Wage increases in excess of the historical norms; additional spend on Information Technology; and the enhancements to our team member benefit offering.

Scot Ciccarelli - *RBC Capital Markets, LLC, Research Division - Analyst*

And kind of in that order, Jeff?

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

That's not something that we're going to quantify the individual pieces of, Scot.

Operator

Next, we have Matt Fassler from Goldman Sachs.

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

The first question is actually a follow-up of Scot and I guess asking it simply, do you think you would have made this investment to $65 million without tax reform? And presumably you'd started the 2017 -- 2018 planning process prior to the final bill being passed. Were some of these likely to be in the plan or is this really kind of a switch that you flipped when you realized you'd have this windfall and the opportunity to invest some of those dollars?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Scott, this is Tom. I'll take a shot at this one. When we look at our technology investments, we continue to invest strongly in those over the last 3, 4, 5 years. I think that the tax change has allowed us to accelerate those further. When we look at wage increases, this is the incremental amount in addition to known wage pressures we have. We feel like as the market has tightened and as others have taken action, that we need to be proactive in addressing, especially our low-end store wages, to ensure that we can stay competitive in the market and attract the talent we need in our technical business.

Matthew Jeremy Fassler - *Goldman Sachs Group Inc., Research Division - MD*

Got you. And then my follow-up relates to weather. I guess there's good-bad weather and then bad-bad weather, depending on, I guess, the offshoot between causing parts failure and then keeping cars off the road. If you think about the weather that we've experienced over the past couple of months, a more normal winter for sure, how do you feel about the potential impact of the current weather backdrop on your business later in the year during the summer months when some of those -- when some of that parts failure comes back to drive the business? Is this the kind of backdrop that should be more helpful to you come midyear or is there less relevance?

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

Yes, Matt, this is Greg Johnson. As you said, there's good-bad weather and bad-bad weather. As I said in my prepared comments, bad weather is better for us typically in northern markets and in the southern markets where they're not quite as prepared typically for the weather. From a -- and then there's a short-term and long-term benefits to bad weather as well. In the fourth quarter, we saw that -- very late in the fourth quarter, we saw some benefits to bad weather because of the cold snaps up north. And we do expect to see benefit, as we get into the spring and summer months, resulting from that as well. That could be the evidence of battery failures when the weather goes hot, turns hot rather, and ride control under car categories from damaged roads, things like that, that we typically experience a few months down the road from the actual winter harsh weather.

Operator

Next, we have Mike Baker from Deutsche Bank.

Michael Allen Baker - *Deutsche Bank AG, Research Division - Research Analyst*

I want to follow up on the first quarter comments where you said that the comparisons get more difficult later in the quarter in presumably March. But correct me if I'm wrong, they sort of get a lot easier over the next couple of weeks as just starting right about now we're up against when the tax refunds really fall off the table last year. So could you tell us how you expect that to play out over the next few weeks and how that plays into your guidance?

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

Yes, Mike. I can tell you, as I said in the prepared comments, we're pleased with where we stand thus far in the quarter. And looking forward, as you move later in the quarter, we typically see an uptick based on seasonality, we'll see an uptick in parts because our -- due to seasonality. And you're right, there -- the tax benefit did hit us over the next couple of weeks and we were hopeful that we will see improved sales during that period of time and we remain confident in our guidance of 2% to 4% for the quarter.

Michael Allen Baker - *Deutsche Bank AG, Research Division - Research Analyst*

So I guess, when you say hopeful, I mean, does that imply that the 2% to 4% assumes a pick up in the next few weeks? And then maybe a little bit of a drop off in March? Is that the right way to think about it?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

This is Tom. What I would tell you is that we build our sales plan on a daily basis throughout the quarter and build our guidance based on overall market assumptions. And when we had our call last year, we obviously were having a slower-than-anticipated beginning of the year and some of that was the impact of the timing of tax refunds. So we've taken all that into account in developing our guidance for the quarter and we're comfortable with our 2% to 4% guidance based on our progression thus far in the quarter.

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

This is Greg Henslee. Let me just add one thing. When we talk about the quarter, and the reason we talked about the importance of the end of the quarter and the comparisons is simply because of the seasonality that Greg mentioned, and the fact that our sales typically ramp into the quarter. So while we're pleased with where we are in the quarter, the majority of the quarter is in front of us, and we really didn't take a lot of the potential for the timing of tax refunds and stuff into our guidance, but what we did consider just kind of how we did last year, how we would typically ramp and where we're at in the quarter and, as Greg said, we're comfortable with the guidance we gave recognizing that we're pleased with where we're at to this point in the quarter.

Operator

And next, we have Steven Forbes from Guggenheim Securities.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

Maybe just a quick follow-up on the reinvestment. I kind of think about it, if you can touch on why 70 basis points? Why not more, given your margin structure and the likelihood of improving industry backdrop and the share opportunities that exist in certain regions around the country? How do you come up with the 70 basis points?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

This is Tom. I'll answer the question and then turn it over to Jeff. When we look at the likelihood -- when we look at what projects we thought we could accelerate and what the ROI was, that's a more cut and dry item. When we look at what we need to do to be competitive on benefits to retain people and reduce turnover, little more of a cut and dry item. When we look at what we thought the wage pressures were going to be in total based on changes in the market, we did some work and made an estimate. What I'll tell you is that we don't do anything blanket with wages and that's something that Jeff can describe better. Because we're talking about store wages.

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

Really, it would be a store-by-store market-by-market analysis and, obviously, with what's going on in the industry and minimum wages coming up, and things that we're hearing from other retailers about moving wages, we just wanted to be prepared for that and we'll react accordingly by market based on what's going on in the market. As I said in my prepared comments, to make sure that we can and not only attract but retain good solid parts professionals.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

And then -- and maybe just a follow-up on that topic, when you say wages, right, is it strictly just rate or is there also potential investment in incremental labor hours? And then just last one, just given the timing of this impact, should we think about the 70 basis points as an annualized impact? Or is the annualized impact greater because of the potential timing of the wage increases?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

This is Tom. I'll address the annualization. When we look at the benefit portions, when we roll out benefit changes, it's got an ongoing portion of expense, but it's also got an immediate expense impact to catch up our accruals to these new levels. So we would expect the quarter-to-quarter impact to be pretty similar throughout the year, and the annualization to be similar as we have more start-up costs on these items at the beginning of this year and then wages ramp, it will level out. Yes, on the labor hours, I mean, my comment there would be our philosophy is the same as it's always been. We staff for the appropriate volume of the business and we would continue to do that kind of buy market based on what we'll see our sales volume doing.

Operator

Next, we have Greg Melich from MoffettNathanson.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

First, Greg, I want to thank you for all your work over the years with us. And Greg and Jeff, congrats.

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

Thank you.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

So, I wanted to -- I just had 2 questions. One is on inflation. I think you mentioned that in inflation started in the fourth quarter. Could you quantify how much that was and your guidance for this year and the 2% to 4% comp, how much inflation do you expect? And then I had a follow-up.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

This is Tom. Most of the inflation that we saw in the fourth quarter was on seasonal-type items. Our comments in the prepared remarks were that our expectation is that we're going to have yet another year where same SKU pricing doesn't come up. To the extent that we did see some, that would additional tailwind for us.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

So basically same, SKU is the same and it's just commodity sort of flowing through?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Well we saw some same SKU inflation on seasonal items.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

Okay, great. And then the second question was, when you thought about margin investment and ROI from that, it was pretty clear that you went methodically through everything, and I'm curious as to where product investment or gross margin investment flushed out in that equation. Any reason why you didn't look to put some into the product margin or gross margin generally, even as part of a service offering when you look to invest margin?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Since this is a plan question -- this is Tom again, I'll answer the question. We feel comfortable with where our pricing is. Obviously, we are very competitive on the street and our business is very technical business. It's not just the price of the goods that determine what the value is to the customer, and we continue to feel like we're priced appropriately for the services we provide. And then, additionally, there's really nothing to gain for us to -- by lowering price. I mean, if we lower our price today on any given category, you can bet our competitors, with the transparency of the Internet on pricing, are going to lower their price tomorrow. So there's just nothing to gain there. Now if we're priced at line, we always have to fix that, but as Tom said, that's just not the case. We -- I think our company and all of our competitors spend the time, spend a lot of time on ensuring that we're price competitive, and we just don't feel like there's anything to gain by lowering our prices as long as we're in a competitive position.

Gregory Scott Melich - *MoffettNathanson LLC - Partner*

And on the IT investment, I mean, Home Depot made a big thing about ramping spend on more direct distribution. Is that part of the CapEx increase you guys are talking about or no?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

This is Tom. I'll start, and Jeff can add on. But -- investment and distribution is something we've always done and availability is such a crucial piece of what we do. That's always in our CapEx plan.

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

Well -- and frankly, our -- the number of times that we touch a store now is so significant. Frankly, we've gone overboard in the past. There was a time where we had a pretty important market to us where we were touching our stores 12 times a day out of the distribution center. And we finally realized, this is just -- it's crazy, that we're -- that our service levels are that high when they really didn't need to be because we were far out pacing our competitors. We realized we could outpace our competitors still just touching those stores 8 times a day. So if we felt like that we were even slightly in a noncompetitive position from a availability perspective, we've always got the ability to leverage up our service levels for our DC's and frankly, we feel like we had the best availability in the industry as it stands today.

Operator

Next, we have Seth Sigman from Crédit Suisse.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Just on the DIY versus commercial commentary, I think you said DIY was weaker. What do you attribute that to in the quarter? And I guess, was the DIY side of the business facing a more difficult comparison? I'm just wondering, had that improved here in the first quarter?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Yes, the DIY was definitely up against a tougher compares and we're seeing a little bit of an uptick in our professional business there in the fourth quarter. Yes. A key driver of that is that during the cold weather in '16, battery sales were pretty incredible, because batteries that didn't fail during the prior winter failed during that winter. Batteries are aligned and it is heavily skewed to the DIY side of the business. But over time, we would expect that as the complexity of cars continues to be more prevalent, that our do-it-for-me business will simply be a stronger business than our DIY business.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Okay. And then I just want to follow up on the higher expenses for 2018. I know it was asked in a lot of different ways, but is there a way to help us understand what is sort of catch-up spending from 2017? I know you talked about payroll, incentive comp, professional fees all being lower than you had planned in '17. So of that 70 basis points, how much is just simply catch up?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Well, what we've tried to communicate is that the 70 isn't incremental to what our SG&A plan would look like absent the pressures created by the new tax code.

Seth Ian Sigman - *Crédit Suisse AG, Research Division - United States Hardline Retail Equity Research Analyst*

Okay. Well, I guess just given the incremental investments then for this year, for 2018, I mean, bigger picture as you're thinking about past this year, I mean, do you see opportunities to continue to invest or do you think some of these investments are more isolated to 2018?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

We would expect the investment to continue in 2019, but we would hope the investments that we're making that the incremental spending, we'd provide even higher levels of service and leverage that with better sales and really increase team member productivity through technology enhancements as well as reducing our team member turnover.

Operator

Next, we have Alan Rifkin from BTIG.

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

So, thank you, Greg Henslee, for everything you've done in the past and certainly congratulations to both Greg Johnson and Jeff on your new appointments. My first question is a follow-up on the reinvestment from the tax reform. So certainly, one would assume that you're making these investments because you believe that you can yield a higher return at some point in the future. Would it be reasonable to assume that these higher returns would start in 2019 or they'll be further out than that?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Well we try to drive higher sales every day. Our plan encompasses the traction we think we'll get this year. Some of these investments are longer-term investments. We would tell you, a big opportunity for us is to reduce our store level turnover as it impacts our service levels.

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

And if I can add to that, Alan. The 2 things, and Tom mentioned one, turnover and omnichannel. It takes a lot to learn how to sell parts. And by decreasing turnover, we feel like long term we put ourselves in a significantly better position to provide service levels to our customers. And just be the professional parts people that our company has been built on. So that really starts generating immediate returns as we start decreasing the percentage of turnover that we have annually. And then omnichannel, we feel like that if we have an opportunity to do better than we do today. And I feel like we do pretty well today. We can do a lot better. And as we make those improvements to our platforms, I think, we see pretty immediate effects of those improvements, but they're incremental. It builds over time, as our professional customers using our portal, learn to use our software, like our software, become committed to us, partly because of service -- mainly because of service, but partly because they like the way our interface works. And same thing applies to our DIY customers. So while all this is incremental over time, some of it has an immediate positive effect.

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

Okay. And a follow-up, if I may. So throughout 2017, which was certainly a more difficult year than what many of us expected, you cited a number of factors that you thought were transient, whether it was the SAAR number as a result of the recession, the weather, obviously, Hispanic population headwinds, tax return delays, e-com competition. As you sit here in the early stages of 2018 and you look back on what's happened in 2017, do you still believe that all of those factors that I just cited were in fact, transient? Would do you think any of them would be longer term in nature?

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

I'll take it. Well, I think the -- as Tom said earlier, the SAAR issue will resolve this year. So it's hard to measure the extent to which that impacted our business. But we know it had some effect. But that's in the process of curing right now. To me, out of the things that we talked about, SAAR, weather, the Hispanic issue and tax, I feel like weather, having 2 consecutive mild winters and a mild summer, I think, that was probably the factor that impacted us largest. The Hispanic thing, I think, is pretty well resolved and the tax thing is a matter of timing, although the timing is important because if people get their tax refunds at a time when there's cold weather's in place, they're having car trouble, that is going to increase the spend that they put in their car versus maybe a springtime when they've gotten through the winter by patching their car together, and they've got improvements they want to make to their house or something and puts them in a better position to maybe spend money on their house. So the timing is important. But I think that's just a matter of something we look at year to year. But I think the other factors, I think, the Hispanic thing is cured a lot. I think this winter is going to help a lot with the weather issue, and we'll see benefits of that this summer and the SAAR issue is in the process of curing.

Operator

Next, we have Carolina Jolly from Gabelli & Company.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Greg, thanks so much for your service so far. Just quickly, I guess, my one question would just be, do your cash and earnings estimates include any benefit from the new guidelines around the 100% expensing of certain assets?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

That sounds like an accounting question. I'll take that one. Over the years, there have been many programs that have accelerated the depreciation of certain fixed assets and we've taken advantage of those, but I would tell you is that the change in the law changed those this year for us from a headwind as we turned the corner on having a bigger GAAP deduction and tax deduction to equal. So the answer is yes, it does include that. That benefit is not as big for us because of past opportunities to accelerate depreciation.

Anna Carolina Jolly - *G. Research, LLC - Research Analyst*

Okay, perfect. And then I guess, another kind of accounting question. Can you give -- can you quantify any effects on the LIFO charges that might have affected this quarter's margin?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

We were in the $3 million or $4 million range.

Operator

And next, we have Michael Lasser from UBS.

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

My question is a little bit geared towards the first quarter. So you got a 2% to 4%, you said you're pleased with the business, you talked about some of the ebbs and flows. Are you surprised that business hasn't come back stronger?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

What I would say is that we always do as much as we can to drive as much business as we can within reason. I think one of the factors that has probably caused business not to be maybe stronger than it is, but again, we're not displeased with our business. We're pleased with how we've done in January. As Greg mentioned, some of the cold weather that we had pushed down into markets that don't benefit from cold weather immediately. When Dallas-Fort Worth shuts down, and you look out your window and there's no cars on the road, that's just not a good day for us. And those factors existed in many southern markets, which helped dampen maybe the positive effect that we're having from a cold winter. Longer term, the fact that we're having this cold weather and we've had this cold weather through some of the markets, it's going to be a positive thing for our industry this year, I would think.

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

And without getting to granular on what you're seeing by market, when the business does come back in those markets that are normally not used to seeing the weather, is it better than it's been? So the store may be closed when there's a lot of snow, but then the next day it's quite good? Or is that not how it's happening?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Usually those markets don't get as extreme a cold weather that would drive part failure as the northern markets, where it just get brutal cold weather which causes rubber to not be as flexible, causes belts to break, causes starter motors not to work as well, causes batteries to fail, cooling systems freeze up. I mean, there's just all kinds of things that you can have in the extreme weather. You don't get quite as much benefit in the warmer markets that aren't used to cold weather, because in Dallas-Fort Worth, when it gets to 20 degrees, that's really cold weather, but that's really not cold enough to cause the kind of damage that we're talking about in the northern markets.

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

And Michael, this is Greg. Another benefit there, it's fortunate in many of those southern markets, that when they get bad weather and it does impact road conditions, and as I said, they're not as equipped to clear that. But typically, the weather turns around really quickly. You don't have snow and ice on the roads very long. So the recovery is really quick to get back to business as normal.

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

And my follow-up question is, we've all become accustomed to seeing massive share gains from O'Reilly, and you guys widely outperforming your competition. Over the last 4, 5 quarters, your comps have been a little bit more consistent with some of what the peers have been reporting. Do you think it's just harder to gain share perhaps, because share's going to other channels at this point?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Michael, this is Tom. What I would tell you is that some of our competitors have a different scale. They have different measuring period than we have. We're basically looking at our comparable store sales on exactly their calendar. And we continue to be comfortable with our performance. The other thing I would say is that -- a couple things is, one, the SAAR pressure is primarily a DIFM item as those new tires enter their repair cycle, that tends to be a DIFM customer, and we have that at higher percentage than some of our competitors on the do-it-for-me side of the business. The other part is you look at our 2- and 3-year stacks, there's quite a spread. Yes. And then additionally, back a few years ago, when we had some ground to gain just from a per store average standpoint as compared to our best competitors. And again, we have many great competitors. Our per store average is now caught up and ahead of rest of our competitors, and we simply just don't have as much to gain in that general basis, but we still feel like we're best positioned to lead the industry from a comp store sales perspective, and we would expect to continue to do so.

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

And Greg -- one more thing to add to that is it's not just about the publicly-traded peers. I mean, there's over 36,000 parts stores all across the country and there's a lot of market out there, it happens 1 store at a time.

Operator

Next, we have Simeon Gutman from Morgan Stanley.

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

First -- my first question is on sales. I guess following on Michael's question, can you just tell us if you're comfortable for the start of the first quarter, how big is the spread and performance between markets? I don't know if you want to call it good or bad. And then, within the sales part, are you seeing any evidence that you're seeing the vintages of the 6 to 11-year-old cars creep back? And any larger type weather repairs happening, not just batteries and starters and alternators?

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

Simeon, I would say that the spread across markets was fairly similar to what we've seen over the past few quarters with our more mature markets being a bit softer than our less mature markets. Our northern markets and western markets have performed a little better this winter than -- earlier this winter than our central U.S. markets. I'm sorry, what was the second part of your question?

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

The vintages, if you're seeing any signs that -- you're seeing the sweet spot come back already, I mean, in this part of the year. And then as part of that also, just after the weather, are you seeing any bigger type breakage or repairs begin to happen? There's usually a lag after some of the simple things that start to snap.

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

Yes, I wouldn't say we're seeing anything yet. I think most of the upside from the weather is still yet to come. Again, with the exception of the winter weather related categories, wipers, batteries, things like that.

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

To meet -- they meet the demand.

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

Okay. And then my follow-up is on gross margin. I'm trying to think through the components, maybe how price is behaving relative to the cost of goods sold. And so I'm curious if you're seeing any pressure on sort of their price -- the selling price, and the expansion that's embedded in the guidance is coming from just lowering acquisition cost, vis-à-vis your suppliers.

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

Yes, I mean, it's coming from a few different places. As we say, the lowering cost is a small part of that. We expect that to be more so in the front half of the year than on the back half of the year. But a lot of it is coming just from leveraging stronger sales, leveraging our fixed cost across the stronger sales share that we expect.

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

And the selling price is generally stable?

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

Selling price is generally stable. We monitor our pricing with our competitors as do they us constantly, and we feel like we don't expect to see a lot of inflation on the cost side or the selling price side this year.

Operator

And next, we have Christopher Horvers from JPMorgan.

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

A couple of quick follow-ups on sort of weather and the quarter trend. As you look at December, was that real tough compare? Did you accelerate on the 2-year stack? And did you see on that basis much difference in the DIY versus the do-it-for-me side?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Chris, this is Tom. We don't comment on our monthly comps. I guess we commented on 2 months this year because they were negative and the only negative comp months we've had in a long, long time. But individually, we're not going to comment on monthly comps.

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

Okay, understood. And then does -- on the southern markets, I understand that shutting down of DFW and how that would be a negative to overall, but does getting down to the 20s lead to better trends during the summer months in that region?

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Not as much as it would in the northern months, but I think it is helpful. The cold weather is hard on a lot of components. The part of it is just do the damage to roads and things like that from a extended freeze and thaw, and freeze and thaw, and you just don't have as much of that in the southern markets. So you have some benefit, but it's not nearly as positive of a benefit as it would be in the northern markets where you had the deep breeze and then the thaws that are so damaging to the roads.

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

And then, the last question. As you think about your whether assumption is neutral for the year, obviously, January and early February starting out better than a year ago, what's your underlying assumption in terms of the outlook for the summer? Are you expecting a normal summer? A cooler summer? Is that going to offset the early strength on the winter front?

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

Yes. We would expect a warmer summer, and we would expect that based on -- as we said, the more harsh winter we've had this year, more product failures and a better summer selling season.

Operator

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

Thomas G. McFall - *O'Reilly Automotive, Inc. - Executive VP of Finance, CFO and Principal Financial & Accounting Officer*

Actually it's Greg Johnson.

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

Yes. Jason, this a Greg Johnson. Thank you very much. We'd like to conclude our call today by thanking the entire O'Reilly team for your continued dedication to customer service in the third quarter. We look forward to a solid year in 2018. And we like to thank everyone for joining our call today, and we look forward to reporting our 2018 first quarter results in April. Thank you.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. Thank you for participating, and you may now disconnect.

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