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ORLY - Q2 2017 O'Reilly Automotive Inc Earnings Call

EVENT DATE/TIME: JULY 27, 2017 / 3:00PM GMT

OVERVIEW:

Co. reported 2Q17 results. Expects 2017 total revenue to be $8.9-9.1b, EPS to be $11.77-11.87 and 3Q17 EPS to be $3.10-3.20.

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PRESENTATION

Operator

Welcome to the O'Reilly Automotive Second Quarter Earnings Conference Call. My name is Victoria, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded. And I will now turn the call over to Mr. Tom McFall. Mr. McFall, you may begin.

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

Thank you, Victoria. Good morning, everyone, and thank you for joining us. During today's conference call, we will discuss our second quarter 2017 results and our outlook for the third quarter and the remainder 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 Second 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. Our financial results for the first 6 months of 2017 were below our expectations, but we strongly believe the customer service delivered by our team on a daily basis is the best in our industry. And we remain confident their contributions will continue to drive us forward as the market leader. Now I'd like to spend a few minutes discussing our second quarter comparable store sales results before I turn the call over to Greg, Jeff and Tom for a more detailed overview.

As we announced in our press release earlier this month, our comparable store sales results of 1.7% for the second quarter fell below the guidance of 3% to 5% we set going into the quarter. We established our second quarter guidance with the expectation that business would normalize as we move past the volatile weather backdrop of the first quarter based on our confidence in the strength of the fundamental drivers of demand in our industry, and our trends exiting the first quarter and entering April were in line with our expectations. However, as we moved through the quarter, we continued to see pressure to overall demand in the industry.

As we have seen in the past, when our industry encounters sluggish demand like we saw in the first half of 2017, it can at times be difficult to determine the exact causes of the slowdown and the degree to which any single item is creating a headwind, especially when multiple factors have the potential to impact demand over short periods of time. Having said that, we believe there are a few key identifiable factors which have negatively impacted demand in the automotive aftermarket in 2017.

First, we continue to face pressure to our comparable store sales results from a second consecutive mild winter. As we have said multiple times in the past, we don't enjoy talking about the impact weather has on our business as it's a factor that is simply out of our control and ultimately balances out over the long term. However, it is simply a reality that over short periods of time, the single most significant factor that drives variability in our business is weather. The winter of 2017 was similar to 2016 in that we again experienced very mild weather by historical standards and the lack of more typical extreme winter weather led to less parts failure than we would normally expect to see. This weather dynamic, as well as a mild start to summer in many of our markets, contributed to the sluggish demand we saw in the second quarter.

In addition to the headwinds we've seen from weather, we also believe our top line results have been impacted by a cyclical softness of consumer demand in our industry. 2014, 2015 and 2016 were extremely strong years for O'Reilly and for the industry as a whole. And we capitalized by generating comparable store sales of 6%, 7.5% and 4.8%, respectively, during the last 3 years. The key macro industry factors that drive robust demand for auto parts improved significantly during these periods as we saw above-average increases in annual miles driven, supported by significant reductions in gas prices and steady improvements in total employment. While these fundamental factors are very stable drivers of demand for our industry and still remain favorable, we believe we simply aren't seeing the same level of year-over-year benefit, and demand has softened as these gains have moderated.

We have seen a similar dynamic play out with the demographics of the vehicle population. For the last several years, our industry has benefited from low, stable scrappage rates and a continually rising average age of vehicles as a result of the quality of engineering and manufacturing of today's vehicles. We expect to continue to see this trend of high reliability late into the typical vehicle lifecycle. But the depressed new vehicle sales totals during the period from 2008 to 2011 are likely mitigating some of the benefit we would otherwise realize from the increasing age of the U.S. fleet, which has been a significant tailwind for us the past several years.

Against this industry backdrop, we also believe that certain sectors of our customer base aren't as confident as we would like them to be. In particular, we believe our lower-income consumers face significant pressures and are still in a period of significant economic uncertainty. Additionally, we think this uncertainty is especially pronounced among Hispanic consumers. And we think this has resulted in a decline in overall spending from this demographic, which is a very important customer base for our business.

The demand for the majority of our products we sell is nondiscretionary and our customers simply cannot defer repairs that impair the drivability of their vehicle. However, some repair and maintenance can be extended or deferred. At any given point in time, while it's difficult to measure in aggregate terms, we know there is a significant amount of unperformed or underperformed maintenance in the U.S. vehicle fleet. During these periods of strong demand, like we have seen over the past several years, it is very likely we benefited from a reduction in unperformed maintenance in the vehicle fleet just as it is also likely that we are now experiencing an increase in the level of deferred repair and maintenance, driven by the factors I previously described. Ultimately, these swings are cyclical since, with the stable amount of annual miles driven, a consumer can only defer needed repairs for so long.

Before I turn the call over to Greg, I want to emphasize our strongly held belief that the headwinds to consumer demand are affecting the entire industry and that the current environment is not dissimilar from periods of softer demand we have experienced multiple times during our history in this business. Our focus during these down cycles is exactly the same as when business in our industry is very strong. We are relentless in serving our customers to build long-term relationships and do not rely solely on overall industry growth to drive our sales growth. We have the best team of professional parts people in the business, and we are very confident we are well positioned to continue to grow our market share by providing our customers the incredible levels of customer service on which we've built 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. To begin, I'd like to echo Greg's comments and thank Team O'Reilly for their relentless dedication to providing outstanding customer service. 2017 has been a challenging year thus far. But our team's commitment to customers haven't -- hasn't wavered a bit, and we continue to be well positioned to profitably gain market share moving forward.

I would now like to provide some additional color on our second quarter comparable store sales results. As Greg has already mentioned, we exited the first quarter and entered April on an improved trend as we began to see some pickups in typical spring business. However, as we moved through the quarter in May and June, we encountered increased softness to our business. And even though the change in comparable store sales was positive in each month of the quarter, the step-down in business in the last 2 months of the quarter drove the shortfall to our comp guidance, resulting in the 1.7% increase we reported on July 5.

On a category basis, we saw broad pressure across product lines throughout the quarter. But the headwinds were most pronounced in weather-related categories. These categories include ride control and driveline, which was susceptible to increased wear and tear during the harsh winter conditions. We also experienced softness in the last 2 months of the quarter in categories such as cooling, HVAC and refrigerants. The headwinds in these hot weather categories were especially prevalent in the Central and sub-Southeastern U.S., which are significant markets for us and did not see typical high temperatures during the second quarter.

On a comparable store sales increase -- our comparable store sales increase was driven by increase in average ticket size, all set by pressure on ticket counts for both DIY and professional customers. Our DIY comps in the second quarter slightly outpaced professional customer comps for the first time in recent history, though both were positive during the quarter. We believe 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 evaluate our top line performance, one of the benefits we have on the professional side of our business is that we know by customer where the demand came from in a prior period. And as you would suspect, we spend a significant amount of time visiting our professional customers to understand their business. It is very clear to us that the softness we have seen in the first half of 2017 is also being felt by the shops we service as we received consistent feedback that their business has been slow this time of year and their customers have been more likely to defer repairs when possible.

I would now like to spend some -- a few minutes discussing the comparable store sales guidance we provided in yesterday's press release. As we develop guidance, we evaluate the key drivers for demand in our industry, and we remain very positive about the long-term outlook for the automotive aftermarket. We would expect the total miles driven in the U.S. and total vehicle population to continue to increase steadily as a result of population growth and a stable, growing economy. Further, as Greg mentioned earlier, the average age of vehicles has increased steadily over the last several years, and we believe the strong reliability of vehicles manufactured over the last decade will continue to support demand for parts late into a vehicle lifecycle.

However, while we remain confident concerning the strength of our industry over the long term, it is clear several factors are combining to create near-term headwinds in our industry. As a result, we felt it prudent to set our guidance within -- in line with the current business environment. And as such, our updated comp guidance range of 1% to 3% for the third quarter reflects a lower level of growth than we expect to generate over a long-term basis.

On a 2 and 3-year stack basis, the revised guidance range for the third quarter is consistent with our actual results in the first and second quarters of 2017. Our business thus far in the quarter is solid. And we are comfortable with our 1% to 3% guidance, keeping in mind that the majority of the quarter is still in front of us. We are also revising our full year guidance to 1% to 2% from our previous guidance of 3% to 5% based on our actual performance during the first 6 months of 2017 and our revised expectations for the remainder of the year.

This full-year guidance also incorporates calendar headwinds in the fourth quarter resulting 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 a Sunday last year. Both of these calendar shifts create headwind for us since most professionals shops are closed on Sunday and it represents our lightest volume day of the week.

I'd now like to discuss our gross margin results for the second quarter and our revised guidance for the full year. Our second quarter gross margin of 52.4% was below our expectations as we saw a deleverage of fixed costs within our gross margin on the lower-than-expected sales volume. With the update to our sales guidance, we would expect to see similar pressure from deleverage on fixed cost in the back half of 2017 and now expect our full-year gross margin to be within the range of 52.5% to 52.9%. We continue to see an absence of broad-based pressure to pricing in our industry, and we assume no significant inflation in both our comparable store sales and gross margin guidance.

I'd like to spend a few minutes discussing our diluted earnings per share results and some discrete items, which benefited EPS for the second quarter. As we disclosed on our press release yesterday, we realized a $9 million benefit in SG&A for a reduction to legal reserve related to a legacy claim. This item represented a $0.06 benefit to EPS for the second quarter. In addition, we also realized a $0.09 benefit in the second quarter from a change in accounting related to the tax benefit from stock option gains. This is the same item that reduced our income tax rate during the first quarter, and Tom will discuss it in more detail later. Excluding both of these benefits, our EPS fell short of our guidance range as a result of soft sales and corresponding leverage pressure on our business but still represented an increase of 11% over the second quarter of 2016.

Moving to the remainder of 2017. We are establishing third quarter EPS guidance range of $3.10 to $3.20 and adjusting our full year guidance to a range of $11.77 to $11.87. Our full-year guidance includes the previously discussed positive benefits realized in the first 6 months of the year from the change in accounting for taxes and legal reserve adjustments as well as the shares repurchased through today's call. But neither the third quarter nor the full year guidance includes any additional benefit related to the accounting change for taxes or additional share repurchases.

Finally, I'd like to take a minute to provide an update on our omni-channel initiatives. Excellent customer service is the driver of our business. And as consumer shopping patterns evolve with advancements in technology, we are committed to providing each of our customers with convenient, seamless buying experience, whether they begin a transition in one of our stores, on the phone or on our website. We are continually evaluating and enhancing our omni-channel experience for our customers and took another great step forward on July 12 with the launch of our newly redesigned oreillyauto.com website. The new site has a dramatically enhanced look, feel and usability. It's easier to navigate and search, has improved responsiveness to multiple devices and is equipped with an enhanced promotional functionality. We are very pleased with the excellent work done by our teams on this key initiative. And I would encourage everyone to check out our new website.

Before I turn the call over to Jeff, I would just like to reiterate our confidence in our business model, our team and the opportunity we have to continue to take market share and generate exceptional returns for our shareholders. Ultimately, we know that long-term success in our industry is the direct result of providing the best value to our customers, the key to which is the exceptional parts availability and customer service we provide. And I would like to thank our team once again for their continued dedication to serving our customers.

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 also like to begin my comments today by thanking our team for their continued dedication to our company's success and the relentless commitment to excellent customer service. So if Greg Henslee and Greg Johnson have discussed our sales results in detail, so I won't repeat what they've said. But I will add a few additional comments to give perspective to what we saw in the marketplace in the first half of 2017.

Those listening today who have followed our company in this industry for a long time know that we operate in a very stable environment in that the highs for our industry are never too high and the lows are never that low. Regardless of the broader market conditions that might exist at any given time, we've always set a very high bar for ourselves, and we're certainly not satisfied with the 1.7% comparable store sales growth results.

In our day-to-day discussions with our field management team, from store managers up the chain to senior vice presidents, we never accept soft market conditions as an excuse for falling short of our goals. One of the most common mottos in our store operations group states that as long as there are customer cars in our competitors' parking lots or there are other company delivery trucks dropping off parts to professionals shops in our markets, we haven't captured all the business that we're entitled to, and we're missing an opportunity to grow sales. This has been our philosophy since the beginning. And it still applies to the current market conditions.

In my 33 years in this business, we've seen many cycles of slower demand in our industry, and we've seen strong demand return after these periods of sluggish growth. Just as importantly, we've seen time and again the opportunity that challenging market conditions can present for our company. Our focus on maintaining an extremely high standard of customer service when business is soft allows us to build long-term relationships ultimately reinforcing our industry-leading position. To that end, while we're not pleased with our performance in the first half of the year, I can attest that our service to our customers has never been better, and we won't let the current market dynamics provide a convenient excuse to fall down on their job of taking care of our customers every day.

Now I'd like to spend a little time talking about our SG&A expense for the second quarter. Our SG&A, excluding the $9 million benefit Greg discussed earlier, was 32.8% of sales, which represents a 55 basis point increase over the second quarter of 2016. The deleverage of our SG&A spend was the direct result of the top line pressure to our comparable store sales results. While we're certainly not pleased with the deleverage of our SG&A spend, we're reasonably pleased with the expense control discipline our team showed by eliminating the dollar growth in average per store SG&A expense in the second quarter to 1.2% as compared to the same period last year. These results reflect some reduction to our expected SG&A in response to the sales environment we encountered in the second quarter but does not reflect any dramatic adjustments, which would negatively impact our customer service levels.

Over the course of our time in this business, we've seen multiple examples where competitors have made significant cuts to SG&A, principally to store and field payroll, which negatively impacted their customer service levels. In each of these instances, we benefited by maintaining our same level of customer service. Ultimately, our customers require a high level of service, and we simply cannot justify to them a shortfall in service just because our sales are soft. To the contrary, our professional customers are encountering the same market conditions that we're experiencing, and they react by working even harder to provide excellent service to their customers and they demand the same from us. Controlling expenses is a key focus of all of our teams. And as we plan for our SG&A spend in the back half of the year, we will make only those adjustments that are prudent and won't negatively affect customer service.

While we're reducing our guidance expectations for comparable store sales growth for the remainder of 2017, we still expect to staff our business to provide the customer service levels necessary to gain market share and grow our business. As a result, we're leaving our average per store SG&A increase unchanged at 1.5% to 2% in order to execute this strategy, although we now expect to come in at the bottom of that range. The revision to our full-year operating margin guidance reflects this expected SG&A spend.

Before I turn the call over to Tom, I'd like to spend a few minutes discussing our store growth in the first 6 months of the year and our plans moving forward. In the second quarter, we successfully opened 46 net new stores, bringing our year-to-date total to 105 net new stores. We're well on our way to achieving our new-store growth target of 190 stores for 2017. As we have for several quarters now, our store growth in the second quarter was spread across the country with openings in 23 different states. We remain pleased with the performance of our new stores, which continue to open strongly as compared to both our historical averages and our internal expectations.

We're very confident in the strength of the long-term prospects for our business and in our strategy of investing capital in new-store growth at a high rate of return for our shareholders. Our success in opening profitable stores in new, diverse market areas as well as continuing to fill out existing markets we've operated in a long time is a confirmation of the success of our business model. Our ability to leverage our extensive distribution network to provide industry-leading inventory availability allows us to replicate our success and capture market share as we expand into new markets.

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. The key driver of our past success is the hard work and professionalism of our team, which will be the fuel that drives our growth moving forward.

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 to $114 million, comprised of a $54 million increase in comp store sales; a $60 million increase in non-comp store sales; a $1 million increase in non-comp, non-store sales; and $1 million decrease from closed stores. Consistent with our historical practice, we have included the results of the acquired Bond stores as a component of our comparable store sales percentage calculation starting in the first quarter.

For 2017, we now expect our total revenues to be $8.9 billion to $9.1 billion, which is a reduction from our previous range of $9.1 billion to $9.3 billion as a result of our performance in the first 6 months of 2017 and our revised comparable store sales growth guidance range for the full year. For the quarter, gross margin was 52.4% of sales, an improvement of 60 basis points over the prior year, driven by substantially lower LIFO headwind in the second quarter of 2017.

The LIFO impact resulting from continued incremental acquisition cost reductions was a headwind of $10 million in the second quarter of 2017 versus $23 million in the same period of 2016 when we realized significant cost reductions from a specific supplier negotiation. We are anticipating the headwind for each of the third and fourth quarters of 2017 to be approximately half of the second quarter amount but could see additional headwinds if cost reductions exceed our current expectations.

I would now like to provide some additional details on the impact to our earnings per share from the new share-based compensation accounting standard. As Greg indicated, we realized a benefit in the second quarter of $0.09 related to the application of the new standard, which requires excess tax benefits related to share-based compensation payments to be recorded through the income statement. For us, this primarily relates to gains our team members realize upon the exercise of stock options, where the company receives a corresponding tax benefit in excess of the previously estimated benefit recognized upon issuance of the equity award. Previously, these benefits were reflected directly in shareholders' equity and were not recorded through the income statement.

As a result of the change in the accounting standard, our effective tax rate for the second quarter was 35.2% of pretax income, a reduction from 36.9% for the second quarter of 2016. Excluding the impact of this accounting change, our core underlying effective tax rate for the quarter was 37.3% of pretax income, in line with our expectations. For the full year, we continue to expect this core tax rate, excluding the benefit from the accounting change, to be 37.0% with a lower expected core tax rate for the third quarter of approximately 36.4% in anticipation of the adjustments to our tax reserves for the totaling of certain open tax periods.

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 6 months of 2017 was $451 million, which was a $128 million decrease from the prior year, driven by an increase in our net inventory in the first half of 2017 compared to a decrease in the prior year. We are reducing our full-year guidance to a range of $830 million to $880 million from our previous range of $930 million to $980 million. This reduction reflects a lower net income expectation corresponding to our revised total revenue guidance as well as lower projected AP as a percent of inventory.

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 1.5% 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 second quarter at 104%, which is down from 106% at the end of 2016 and was below our expectation as a result of the lower level of inventory purchases related to the soft sales environment in the first 6 months of the year. We would now expect this pressure to our AP percentage to persist throughout -- through the end of the year, in line with our revised total revenue guidance. As a result, our adjusted free cash flow guidance assumes a revised expectations that our AP-to-inventory ratio will finish the year at approximately 105% versus our previous guidance of 107%.

Finally, capital expenditures for the first half of the year ended at $228 million, which was up slightly from the same period of 2016 and in line with our expectations. We continue to forecast FX at $470 million to $500 million for the full year of 2017.

Moving on to debt. We finished the second quarter with an adjusted debt-to-EBITDA ratio of 1.95x as compared to a ratio of 1.63x at the end of 2016. The increase in our leverage ratio reflects incremental borrowings on our newly expanded $1.2 billion unsecured revolving credit facility and an increase in the volume of share repurchases in the first 6 months of 2017. Our increased borrowings moved us toward our targeted range of 2 to 2.25x. And we would continue to expect to move into this range as timing is appropriate.

We continue to execute our share repurchase program. And year-to-date, we've repurchased 5.3 million shares at an average share price of $253.13 for a total investment of $1.3 billion. During the second quarter, we repurchased 3.5 million shares at an average price of $245.26. Our average purchase price was driven by the completion earlier in the quarter of our targeted total dollar amount of repurchases prior to the significant decrease in the price of our stock. While we did not anticipate the stock price decline in setting our buying grid program for the quarter, 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 to return available cash to our shareholders.

Finally, before I open up our call to your 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 Victoria, 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 Matt Fassler from Goldman Sachs.

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

My first question, Tom, is a follow-up on your last topic, which related to the buyback. So you bought back a lot earlier in the quarter. I think this is the first time in a while that there had been no buyback subsequent to the end of the quarter. And I know the stock was already -- had already come under pressure at that point in time. So can you discuss the mechanics of the grid and of the program and where you are today? We know where your leverage is, but what your comfort level is with it and how you all feel about moving into that range now, given where the stock price is versus recent history.

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

Okay. When we look at our buyback program, we have a certain period of time that we have an open window. As we entered the last 3 to 4 weeks of the quarter, we closed trading. But we filed a 10b5-1 and we buy off a predetermined grid. So if we look at this last quarter, when we filed our grid, we had a certain amount of dollars of shares we were going to buy. And we bought those dollars of shares prior to the reduction of the stock price. So in that closed period, we can adjust our purchases.

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

So you're able now to reset the grid, if you will, and start again? And would that be what you'd expect to have happened in the ordinary course?

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

So our open-to-buy period opens 2 days after our conference call and will close again about 3 weeks before the end of the third quarter. And we will make daily market decisions on buying shares back during that period.

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

That's super helpful. And then the follow-up I'd like to ask, it's related to your comments on Hispanic customers. It's obviously an atypical topic, but it's been coming up from time to time. For you all to mention it, presumably you have an empirical sense that this has been a factor. So if you can talk about what you've observed, if it's on a regional basis and how one actually assesses that this is transpiring and maybe how big of a magnitude of that is in terms of the impact on the business.

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

Okay. Well, to start, Matt, I don't have a measure of the magnitude. But what I can tell you is that in the area -- in our market areas that we know to be heavier Hispanic areas, South Texas, Arizona, Southern California, just those areas, not there aren't significant Hispanic populations in other parts of the country, but those are the most prominent, we've seen some kind of unexplainable softness. And then also the words we hear from The Street are that some of the Hispanic shops are not open, they've closed. There's just not as much traffic in those Hispanic areas as what there has been, and then -- so we've kind of asked ourselves these questions internally. And there's an organization called NPD that gathers data for all retailers. And this observation applies not just to the automotive aftermarket but to other industries as proven by the data that NPD has gathered from a multitude of retailers, which shows that these areas that are heavy Hispanic, that there's been a decline in retail transactions, not just in the Hispanic demographic but in general. It's attributed to those being heavy Hispanic areas that is being attributed to this kind of decline in spending among the Hispanic population.

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

And has this trend been evident, Greg, through the fiscal year? Or did this particular piece of it accelerate in the second quarter?

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

It's been kind of talked about. It was talked about early in the year as kind of a foreseen problem and something that many observed. And then I'd say late in the first quarter, NPD started talking about it. And I think that now it's a pretty well-known observation among most retailers that it's a bit of an issue in these heavy Hispanic areas.

Operator

Our next question comes from Seth Sigman from Crédit Suisse.

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

My first question is around the trend in July. So I think you said that the business is solid thus far in the third quarter. Does that imply an improvement from the end of the second quarter? And then if so, Greg, you highlighted a number of issues that are weighing on the industry. Most are not necessarily short-term issues. So I guess the question is what could be driving that sequential improvement? And is there anything specific that you're doing differently?

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

The trend is -- well, what we would say is business has been solid. Yes, we've had a slight improvement over the first or the second quarter. We have confidence in our 1% to 3% guidance. We have tough compares on a 3-year stack basis. But we feel confident that we will be on our guidance. As far as the drivers of the softness in our business, multiple factors. The weather thing cures. The vehicle population, the bubble I talked about and vehicles that were made from -- or sold in 2008 to 2011, that kind of cures over time. When there's economic uncertainty and consumers defer repairs, that kind of that cures. We benefited the last 2 to 3 years from some decrease in the amount of unperformed maintenance. And we may be building more unperformed maintenance right now as a result of those deferrals. But we feel like that cures over time. The primary thing that we're doing right now that I think positions us better long term is we're aggressively pursuing a more robust omni-channel strategy. We want customers -- as any retailer would, we want customers to see O'Reilly Auto Parts for what we are, the same as if they walk in a store, if they're on their phone or their computer at home or their iPad or whatever it is. And I think the launch of our new website puts us in a much better position to show customers the quality of the company that we are and the levels of the service that we provide. But then secondly, as we position ourselves to execute our strategy from an online promotions and things like that, and that's where the process is doing. I don't want to go into a lot of detail about exactly what our strategy is because I don't want to tell our competitors what we're doing ahead of us doing it. But I will tell you that it's a primary focus of our company. And I think it's one of the things that will help us drive improved comparable store sales in the future.

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

Okay. And then my follow-up question is around the growth algorithm for the company going forward. If we assume 1% to 3% is the new norm for comps over the medium term, how does that play out from an earnings perspective?

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

Do you want to take that, Tom?

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

Yes. Seth, I'm not sure we're saying that our -- or I'm sure we're not saying that our long-term growth rate is 1% to 3%. We're not going to set guidance beyond the end of the year. What I would tell you is that we are a company that opens a lot of stores and have a lot of immature stores, have a lot of growth potential in markets that we're not in. And we're going to need to be in the 2% to 2.5% average store SG&A -- 2% to 2.5% comps to leverage our SG&A. So our expectation on the medium to long term is that we're going to be above that percentage.

Operator

Our next question comes from Scot Ciccarelli from RBC Capital Markets.

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

I guess I'll address the elephant in the room here. There's obviously been a lot of hand-wringing regarding Amazon trying to get more aggressive in this segment. Given some of the product price differentials that we can see, do you guys envision a scenario where you have to enact some type of price matching program over time to protect market share, particularly in the DIY segment?

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

Well, here's what I would tell you. I think if a customer decides to buy an auto part online, which is not a new phenomenon, this has been going on for some time, I think that we're going to take the position that we need to have promotions and other venues on which a customer can buy a product online at a discount compared to what they would buy it for in one of our stores. I can tell you this, if a customer walks into our store and they are buying a product and they bring to our attention that Amazon or RockAuto or whoever it may be has it priced for less, obviously they need the part that day and they want to buy it that day or they wouldn't be in our store. We work with them to come up with a price that makes sense for them to walk out of the store with the part. We don't walk customers over pricing relative to Amazon and online pricing pressure.

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

So Greg, with the growth of RockAuto and Amazon's, let's call it, increased penetration, have you had to work with more customers in terms of trying to find -- make sure that customer doesn't walk back out the door? Has it been a change in that kind of activity?

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

We monitor -- every single price override we do is heavily monitored. I get reporting on it. Jeff gets reporting on it. All of our SVPs, DVPs, we have detailed reporting. And no, it hasn't increased in the last 6 months over what it was in the 6 months prior. It's something that's been going on for some time, but it has not changed markedly in the last 6 months.

Operator

Our next question comes from Michael Lasser from UBS.

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

It was mentioned earlier that for the first time in a while, the professional business undercomped the DIY...

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

Michael, we can't hear you.

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

Is that better?

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

Yes, I can hear you now.

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

It was mentioned earlier for the first time in a while, the professional business undercomped the DIY business. Do you think that there's evidence that you might be losing market share or at least not gaining market share at the same rate that you've been? And why or why not?

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

Michael, we lost you again.

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

Is that better?

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

Yes, I can hear you.

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

So the professional undercomped DIY. Do you think you're losing share in the professional business? And -- or at least not gaining the share that you had been?

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

No, we don't think that. Here's what I would tell you is that we -- in every store, we know the shops around it very well. And what I can tell you is the shops aren't busy as they were this time last year. There's just absolutely no question about it. I think that we've been able to defend and grow the wholesale business that we have or the professional business that we have. And that business has been a little slower this year than what it was last year. And I think the fact that our retail business grew slightly better from a comp store sales perspective than our professional business did just kind of lends to the fact that I don't think this decrease in comp store sales that we've seen this year is appropriately attributed to online for retail as the primary driver of the softness. And I think that the softness runs across both DIY and do-it-for-me.

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

Are you seeing any changes in the competitive...

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

Michael, we can barely hear you.

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

I'm sorry. This is -- the quick follow-up is are you seeing any changes in the competitive landscape on the professional side of the business?

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

We couldn't hear, Mike, I'm sorry.

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

Okay, I'll follow up later.

Operator

Our next question comes from Steve Forbes from Guggenheim.

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

Maybe just a follow-up on that question there that Michael was asking. I mean, from your standpoint, you kind of look at what's going on in both professional and DIY. I mean, can you just remind us or I guess provide us with a little color on what you think the respective growth rates are for the industry by segment? Where are they running? Where -- how should we think about them as we look out really maybe just for the remainder of this year?

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

I would say somewhere in the -- I think the industry put out some reporting here recently that they said that somewhere in like the 1% to 2% range, something like that. And I think the DIY would probably be the low end of that, the do-it-for-me would be the high end of that.

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

And then just a quick follow-up, right, you talk about investments and what you're doing proactively maybe with the website. So you think about the elasticity of demand and potentially driving enhanced customer value proposition, I mean, are there other incremental investments that you think could have an impact on share? And then maybe just the second component of that is given the trends, right, you're seeing across the industry, are you seeing signs that less well-positioned players or competitors are pulling back investments, pulling back on strategic and proactive investments to maintain profitability as you think about the evolution of the landscape here?

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

Well, I think there are always things that you can do to drive incremental market share. You can give up margin with national accounts. You can put more inventory in the stores. There's a point of diminishing returns on inventory deployment. But the more inventory you have on an auto parts store, the more you'll sell. It's just a proven fact, and we've always known this. But we feel like we're well positioned from a supply chain standpoint and that those kinds of investments in an aggressive sense just don't make sense, considering the level of availability that we have today. I think what we're doing, omni-channel is a great investment and will be good for us. I think some of the things that we can do from a service-level standpoint on the do-it-for-me side of the business relative to having better control and tracking of where our vehicles are, I think that's a positive thing. There are several things, minor things that we are investing in that will drive better customer service levels. And that's ultimately the driver of sales growth in our business. And several things we work on, we don't just put them out there publicly because we don't want to tell our competitors ahead of time what we're doing. But there are several things that we are working on now that we feel like will drive incremental sales growth. As far as competitors pulling back on things, yes, I think there's -- I wouldn't call them investments, I would call them expense savings. So yes, we have a major competitor who's cut their operating expense through field management in a pretty major way. And yes, I would see that as having some impact on their ability to grow sales and provide the levels of the service that maybe they provided before as they have taken advantage of the opportunity to control expenses a little better.

Operator

Our next question comes from Mike Baker from Deutsche Bank.

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

I guess a couple of follow-ups. One, you were asked about the pricing environment and how you would potentially match pricing. But I guess following up on that, have you seen any changes in the pricing environment or anybody getting more competitive, including either your core main competitors, someone like Walmart, some of the online competitors? Are you seeing anyone try to be aggressive on price?

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

Really nothing unusual. There's always promotions that go on, especially when sales are soft. You'll see competitors that go out with, for instance, R-134a, the refrigerant that runs the air-conditioners in vehicles, it's typically sold in 30-pound cylinders. We've seen it being sold below cost on promotions here in the last month or so by some of our competitors. So you see those kinds of things. And then also kind of a phenomenon that's happened in our business is we've -- most of us have started kitting certain repair jobs like brakes, for instance. We now and most of our competitors also sell 2 rotors and a set of brake pads at different levels of pricing that are discounted over what they would be if you bought just the components. And same thing for an air-conditioning compressor job, we would include an accumulator and an orifice tube and a compressor and some flush in a kit and sell that at a price that would be discounted if you just bought the components by themselves. And our competitors do this also. So that kind of promotional activity has lowered prices a little bit, but that's not unusual. These kinds of things have gone on forever. Relative to Walmart and online, I would say nothing has really changed. Most of the online players -- I mean, the only reason anyone buys something online for the most part is when it comes to auto parts, because in other sectors, I think it's a matter of convenience because you don't need it right now and it's easy to order from Amazon or whoever and get it delivered to your house. In auto parts, a lot of times -- most times, it's needed right away, so the only reason you would consider online is price. And they've always been cheaper than the brick-and-mortar stores.

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

Makes sense, sounds like a good deal. I'll have to pick up some of that R-134a, I think you called it. A follow-up, if one can assume that if it's promotional, that might hurt gross margins. I understand you're investing in your stores and you're going to continue to do that. But if we look longer term, do you have areas of cost where you think you could potentially cut if needed if there's any sort of pricing concern that occurs longer term?

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

We do. I mean, there's a lot of cost that are variable in our company that we could cut if we felt like that long term, we needed to do something to drive our profitability. Most of the things we do, because I feel like that we've managed the company pretty tight for a long, long time, most of the things that we would cut would be payroll-oriented. And the biggest part of our payroll, of course, is in our stores providing customer service. And so any of those cuts come at a cost relative to the level of service we're able to provide our customers. And we would think long and hard before we would decide to make a material change there that would result in us not being able to be dominant from a service standpoint as we feel like we are today.

Operator

Our next question comes from Carolina Jolly from Gabelli.

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

Just really quickly, Tom mentioned opportunities under markets that O'Reilly is not currently in. Given the industry weakness, have you seen any improvement in M&A opportunities or targets, especially in the Northeast? And then also just do you have any details around Bond Auto's performance for the quarter?

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

Well, on the M&A environment, there's always companies that we're interested in, in areas in which we don't do business. And I can tell you we're working on some things right now that we've not yet disclosed. But when we have certainty, we will disclose those at the appropriate time. But yes, there's opportunities there that we work on ongoing. And on Bond, we are now well through the inventory conversions. We still have some to do, we are not completely done. But we have reset all the stores to look more like an O'Reilly store and a lot of the merchandise changes that needed to be made to fit our model in our distribution and supply chain have been made. But there's still some ongoing, so we're in a position now to start growing the business from where we're at. So I would say the heavy lifting is -- most of it is behind us, although we still have a little bit in front of us. But we're in a good position there to start executing our business model and start growing the business. And what I would tell you is that Bond performed very well on the do-it-for-me side of the business and they underperformed on the DIY side of the business. So we're going to maintain and grow the business on the do-it-for-me side using all the tools that we provide. But on the DIY side, we'll put those stores in a position to grow DIY business. And we expect the results from them in the next year or 2 now that we have them in a position to execute our business model.

Operator

Our next question comes from Seth Basham from Wedbush Securities.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

My first question is just around some of the color I would love for you to provide around omni-channel functionality. You talked about potentially having a new website with enhanced promotional functionality. Can you give us some more color on that and also how you might reorient your stores to be more omni-channel in nature?

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

Sure. Well, our new website launched earlier this month. It's just a lot cleaner website. It has what's called a responsive design so that if you -- no matter what device you go to the website on, our servers detect the type of device and size of the screen and the fit and the functionality to fit the device you're on, which is a big deal. So those are just kind of primary platform type of things. The bigger changes are in the shopping cart and the ability for us to do some things that we couldn't do in our previous shopping cart. And we feel like that moving forward, that allowing promotions that allow us to be more price-competitive online will be important in light of the fact that there appears to be so much concern over the online players, the way they price products. And we see that and we hear it in our stores, we hear it from others. And we want to make sure that we're in a position to serve customers regardless of how they want to buy a part, whether it's online or from us. One of the biggest factors when it comes to omni-channel for us is the ability for a customer using a mobile device, for instance, to gather information, look up parts. And if they want to order the part and pick it up in the store, they can do so. And a lot of the business that we do online with DIY customers is actually buy online, pick up in store, so they can go online and buy it, print a ticket at the store. We have the parts that are waiting with their receipt when they come in to the store to get it. And it just makes it a really easy transaction. So those kinds of things are important to us. And I feel like they're sticky when it comes to customers using us as a service for parts. And then also just having access to repair information and the things that they need to work on cars, including specifications, torque, the tools they need, stuff like that. So we're just going to become much more engaged in using these devices to help customers do the things that they're doing when they buy products from us. And we're in the process now of executing a strategy that we have worked on for some time now. And the first step in the execution of that strategy was the deployment of the new website, which again has been active now for a couple of weeks.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Got it, that's helpful. And could you remind us or give us some color as to what percentage of your online orders are picked up in the store and whether you're changing any processes in the store to make it even more frictionless for consumers to pick those up?

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

75%.

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

About 75% of it is picked up in store, the remainder is bought online. And so I think we have a pretty seamless process now. And when a customer orders a part, buy online, pick up in store, it works pretty slick. There's not a lot we could do to make it work better unless we knew their license plate number and ran out and gave it to them when they pulled up or something. And we may do that someday. But right now, we're not doing that; they come in to the store. I might mention a majority of our online business is actually B2B. We do -- we have a huge business in B2B, where we're integrated into the shop management systems and we have a great browser product that allows shops to order parts using a browser that we've deployed that allows them to see pricing and availability and get information that they might need to work on cars and so forth. So omni-channel both on the do-it-for-me side and the DIY side is a significant focus for us right now.

Seth Mckain Basham - *Wedbush Securities Inc., Research Division - SVP of Equity Research*

Helpful. And my last question is just around your labor management strategy. You talked about wanting to maintain high service levels even in a slower industry environment. But the number of employees that you have per store has declined about 3.5% for the last 2 quarters. So is there a change in how you're thinking about the mix of full-time versus part-time labor or any other changes to your labor strategy?

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

I think that over the last couple of years, we probably -- well, here's what I would say. Going back to when the Affordable Care Act was originally implemented, we were -- we had way less part-timers than what our competitors had. And we decided maybe it would be -- we should test having more part-timers and kind of pursue that strategy. We did that for some period of time and realized that while there's certainly a place for part-timers in our stores when it comes to drivers and merchandisers and just a variety of jobs that has to take place, for professional parts people to become -- for someone to come to work for us and become a professional parts person, they really need to be full-time. So I would say right now, we're kind of headed back to a little more full-time than we were just a couple of years ago. And that maybe what you're seeing to some degree when it comes to the raw headcount with the decrease you're referring to because we are simply working individuals more hours than what they previously were.

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*

Thanks, Victoria. And we'd like to conclude our call today by thanking the entire O'Reilly team for their diligent work in providing the customer service levels that drive our business. We remain extremely confident in our ability to continue to aggressively and profitably gain market share in the remainder of 2017. I'd like to thank everyone for joining our call today, and we look forward to reporting our 2017 third quarter results in October. Thanks.

Operator

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

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