

November, 1, 2017

O'Reilly Automotive, Inc. ORLY
Marco Kloster



Sector: Services
Industry: Aftermarket Auto Parts
Current Price: 213.90
Target Price: 243.99

O'Reilly Automotive, Inc., together with its subsidiaries, engages in the retail of automotive aftermarket parts, tools, supplies, equipment, and accessories in the United States. The company provides new and remanufactured automotive hard parts.

BUY

Current Price:	\$213.90
Target Price:	\$243.91
Market Cap:	\$18.9B
EBITDA Margin	22.1%
Gross Margin	52.4%
Operating Margin	19.4%
D/E	4.72

Catalysts: Forward looking projections that call for positive/negative outlook that will strengthen your thesis. Example:

- Short Term: Success in new store revenue will drive up total revenue
- Mid Term: An increased number of stores will bust revenue in the mid and long term
- Long Term: A higher annual miles driven will increase the demand for auto parts service in the United States.

Thesis:

O'Reilly's Q3 upsetting results and Amazon's threat of gaining market share as an auto part distributor have put some pressure on auto part service retailers. However, I am confident in the long-term outlook for the automotive aftermarket. A continued aging of U.S. light vehicle population and ORLY's service segment will guarantee O'Reilly a successful organic growth and an increase profit margins consequently. In my opinion, ORLY is a "buy", with a 1-year price target of \$243.91.



Company Overview

O'Reilly Automotive, Inc., incorporated on December 20, 2010, is a specialty retailer of automotive aftermarket parts, tools, supplies, equipment and accessories in the United States. The Company sells its products to both do-it-yourself (DIY) and professional service provider customers. The Company's product line includes new and remanufactured automotive hard parts. Currently, O'Reilly operates nearly 5,000 stores in 47 states.



In 2016, they derived approximately 58% of their sales from DIY customers and approximately 42% of their sales from their professional service provider customers. Historically, they have increased their sales to professional service provider customers at a faster pace than the increase in their sales to DIY customers due to the more fragmented nature of the professional service provider business, which offers a greater opportunity for consolidation.

Q3 Financial Results

Sales for the third quarter ended September 30, 2017, increased \$119 million, or 5%, to \$2.34 billion from \$2.22 billion for the same period one year ago. Gross profit for the third quarter increased to \$1.23 billion (or 52.6% of sales) from \$1.17 billion (or 52.7% of sales) for the same period one year ago, representing an increase of 5%. However, selling, general and administrative expenses (“SG&A”) for the third quarter increased to \$768 million (or 32.8% of sales) from \$722 million (or 32.5% of sales) for the same period one year ago, representing an increase of 6%. Operating income for the third quarter increased to \$462 million (or 19.7% of sales) from \$448 million (or 20.2% of sales) for the same period one year ago, representing an increase of 3%.

Net income for the third quarter ended September 30, 2017, increased \$5 million, or 2%, to \$284 million (or 12.1% of sales) from \$278 million (or 12.5% of sales) for the same period one year ago. Diluted earnings per common share for the third quarter increased 11% to \$3.22 on 88 million shares versus \$2.90 on 96 million shares for the same period one year ago.

Comparable Store Sales

Comparable store sales increased only by +1.8% compared to the estimated +4.2% LY. The slowdown in same stores decrease in sales negatively affected the profit margins. The third quarter gross margin of 52.6% came in at the bottom end of ORLY’s guidance expectation as result of the pressure to their gross margins from deleverage of fixed cost on low sales volumes weather-driven obstacles.

Hurricane Harvey and Hurricane Irma affected approximately 450 stores. The stores had to be closed in average three to four days. In addition, distribution centers in Houston, Texas, and Lakeland, Florida were also impacted for a short period during the storms. Even though nearly 10% of the stores were affected by the storms, they were closed for four days and ORLY was able to make up for lost volume during the closure period. As reported in the Earnings Call Transcript, the storm-related losses in the third quarter, but they should not expect these costs to be material going forward. Excluding the timing impact of the hurricanes, the results for the quarter were relatively steady with September finishing as the strongest month of the quarter.



Moreover, the impact of two consecutive mild winters coupled with a mild summer in 2017 also did not help O'Reilly with their profitability. Cold winters and hot weather increases the demand for auto parts. Consumers need to replace A/C units and batteries more often at such circumstances. The impact to the addressable vehicle population from depressed new vehicle sales totals during the period from 2008 to 2011 and the significant economic pressure and uncertainty faced by many of their customers.

Industry Outlook

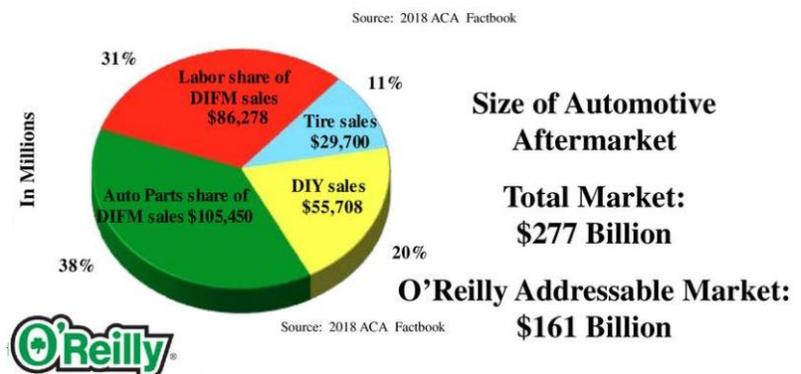
The automotive aftermarket industry includes products and services purchased all types of vehicles after the original sale. The total size of the automotive aftermarket is estimated to be approximately \$277 billion. This market is made up of four segments: labor share of professional service provider sales, auto parts share of professional service provider sales, DIY (Do-it-Yourself) sales and tire sales. O'Reilly's addressable market within this industry is approximately \$161 billion, which includes the auto parts share of professional service provider sales and DIY sales. They do not sell tires or perform for-fee automotive repairs or installations.

The industry is currently facing normal cyclical short-term pressures, but it is still very stable and healthy condition will return to the long-term growth rates in the industry as the industry has historically experienced. As a result, all the companies in the sector have suffered

macroeconomic pressure, and ORLY being one of the better performers according to their peers.

Looking at the broader automotive aftermarket, ORLY have benefited from solid macroeconomic trends and the core underlying drivers of business in their industry. Total miles

driven is the main industry driver. Since 2008 miles driven have been flat due to economic pressures, but starting in 2014, there has been an increase in miles driven once again. Total miles driven in the U.S. is up 1.7% year-to-date through August and gas prices continue to remain stable at low historical levels.



Competition

Top Ten Auto Parts Chains

1. AutoZone Inc. (5,381) ¹
2. Advance Auto Parts (5,189) ²
3. O'Reilly Auto Parts (4,934)
4. Genuine Parts/NAPA (1,368) ²
5. Pep Boys/Auto Plus (1,069) ²
6. Fisher Auto Parts (500) ²
7. Auto-Wares (172) ²
8. Replacement Parts (170)
9. Automotive Parts Headquarters (121)
10. Hahn Automotive (89)

¹ U.S. Domestic stores

² Company owned stores

Source: 2018 ACA Factbook or latest SEC filing

The sale of automotive aftermarket items is highly competitive in many areas, including customer service, product availability, store location, brand recognition and price. O'Reilly competes in both the DIY and professional service provider portions of the automotive aftermarket and are one of the largest specialty retailers within that market. ORLY competes primarily with national retail and wholesale automotive parts chains (such as AutoZone, Inc. (AZO), Advance Auto Parts (AAP), CARQUEST, NAPA, etc.). Regional retail and wholesale automotive parts chains and wholesalers also represent a competition towards ORLY. Now, more than ever, online retailers that carry automotive replacement parts, maintenance items and accessories (such as Wal-Mart Stores, Inc. and Amazon, Inc.) are also taking part of the auto parts market share battle, in which have put some pressure on ORLY, AZO and AAP specifically.

O'Reilly competes on the basis of customer service, which includes merchandise selection and availability, technical proficiency and helpfulness of store personnel, price, store layout and convenient and accessible store locations. Their dual market strategy requires significant capital, such as the capital expenditures required for their distribution and store networks and working capital needed to maintain inventory levels necessary for providing products to both the DIY and professional service provider portions of the automotive aftermarket.

The professional service provider segment have shown a more significant sales growth compared to the DIY segment. I believe an investment on the service segment is a game changer for O'Reilly and a reason for my bullish view on this stock. While Amazon auto parts will soon gain more and more market share in the DIY segment, current Auto Parts Retailers would have a hard time competing with the tech giant. ORLY's revenue deviation from DIY to service would ensure that they do not compete head on with Amazon, like the AZO and AAP will.

Amazon Auto Parts Pressure

Amazon.com (AMZN) is quietly penetrating the \$50 billion Do-It-Yourself auto parts market where the top auto parts stores have long been dominant. ORLY's CEO, Greg Henslee, commented that the company has faced a more challenging sales environment than it expected for the quarter due to continued headwinds. Henslee's comment could refer to its brick-and-mortar competition in Advance Auto and AutoZone, but it seems more appropriate to consider Amazon's entrance into this industry as a big headwind for those involved.



Within the past year, Amazon has made deals with the largest auto parts makers in the United States. Moreover, at this point, most large auto parts suppliers are selling to Amazon. Just this past September,

Jefferies issued a report saying that Amazon was offering same-day delivery for auto parts in 40 major U.S. cities. Not only this, but the firm also noted that the prices were on average 23% less than these major chains.

O'Reilly Automotive, Inc. currently derived approximately 58% of their sales from their DIY customers and approximately 42% of their sales from their professional service provider customers. An increased of sales in the professional service segment would ensure that ORLY would feel less pressure from largest retailer compared to AutoZone Parts and Advance Auto Parts. In my opinion, auto parts have an advantage over Amazon by offering customers the option of talking to a knowledgeable staff member in-store. As millennials are less and less knowledgeable about cars, customers will continue to frequent Auto Part stores (especially the ones that are specializing in professional service, such as ORLY).

Growth Strategy

O'Reilly's rapid expansion is due to their ability to strategically open new stores to consolidate the fragmented automotive aftermarket. During 2016, they opened 210 net, new stores and acquired 48

Bond Auto Parts stores and they plan to open approximately 190 net, new stores in 2017, which will increase their penetration in existing markets and allow for expansion into new, contiguous markets. Growth through the number of stores is directly related to constructing a new facility or renovating existing ones and by acquiring independently owned auto parts stores, typically by the purchase of substantially the entire inventory of such stores.

Continually enhance the growth and functionality of their e-commerce website is crucial to compete



with online retailers that are jumping in the DIY segment. Although O'Reilly have been investing more in their professional service, their user-friendly website they have the ability to retain and acquire new customers in the DIY segment. The website allows the customers to search product and repair content, check the in-store availability of their products, and place orders for either home delivery or in-store pickup. Improving the functionality of their website will ensure that O'Reilly remains very competitive when Amazon starts gaining market share in the DIY segment.

Ownership

Ownership Type	10/30/16	Curr ↓	Change
11) Investment Advisor	80.92	81.94	+1.02
12) Hedge Fund Manager	5.72	8.14	+2.42
13) Pension Fund	2.75	2.44	-0.31
14) Individual	2.38	2.03	-0.35
15) Bank	3.62	1.87	-1.75
16) Government	2.13	1.34	-0.79
17) Sovereign Wealth Fund		0.94	
18) Insurance Company	0.81	0.86	+0.05
19) Brokerage	1.30	0.13	-1.17
20) Holding Company	0.12	0.13	+0.01
21) Corporation	0.08	0.05	-0.03

Currently, 86.64% of O'Reilly is owned institutionally, with 80.92% coming from advisors and 5.72% from hedge funds. Investment Advisors have increased their position by 1% over the past year. Hedge Funds have been increasing their position by 2.42% in the last twelve months. Even though the cyclical auto parts industry had a sluggish growth in the past year, investors are betting on the increase of number of aged cars in the United States is going to drive the value of the company higher in the future.

Conclusion:

I am very confident in the long-term outlook for the automotive aftermarket. A steady increase in total miles driven along with growth in the total vehicle population in the U.S. and will continue to benefit as the high quality vehicle engineering and manufacturing supports demand for parts laid into vehicles lifecycle. An increase in total miles driven will ensure that the U.S. demand for aftermarket auto parts continues to increase at around 1.5% annually, offering a chance to ORLY to continue growing at a constant rate. As ORLY specializes more in the services segment, they would be able to continue growing and acquiring other companies, even if Amazon establish themselves in the DIY market. My price target for ORLY is \$243.91 PT. In addition, I made a chart that shows a pessimistic and an optimistic outcome relative to my prediction. For the pessimistic outcome, I assumed a decrease of 1% in my total revenue, and an increase of 1% in operating costs and capital expenditure deviation from my original and realistic assumption. The new evaluation resulted in a possible 12.68% decrease in the share value. On the contrary, for my optimistic version, a 1% increase in total revenue, and a 1% decrease in operating costs and capital expenditure would result in an increase of 29.93% in the share price compared to the current price.

Assumption	1-yr Price Target	% change from current price
Pessimistic	186.77	-12.68%
Realistic	243.99	14.07%
Optimistic	277.7	29.83%

O'Reilly Automotive, Inc.
(ORLY)

CENTER FOR GLOBAL FINANCIAL STUDIES

BUY

Analysis by RICK
11/6/2017

Current Price: **\$214.52**
Dividend Yield: **0.1%**

Intrinsic Value: **\$219.30**
Target Price: **\$243.40**

Target 1 year Return: **13.51%**
Probability of Price Increase: **94.32%**



Description
O'Reilly Automotive, Inc., together with its subsidiaries, engages in the retail of automotive aftermarket parts, tools, supplies, equipment, and accessories in the United States.

General Information

Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	November 3, 2015
Next earnings date	February 7, 2018
Estimated Country Risk Premium	6.19%
Effective Tax rate	24%
Effective Operating Tax rate	24%

Market Data

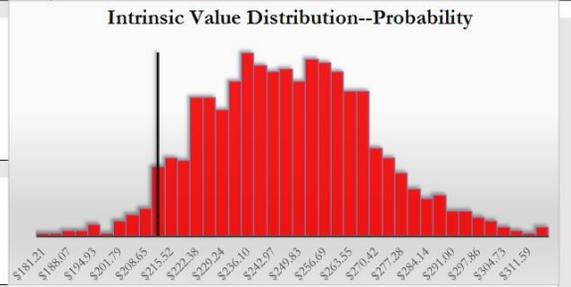
Market Capitalization	\$18,881.34
Daily volume (mil)	1.08
Shares outstanding (mil)	88.02
Diluted shares outstanding (mil)	91.89
% shares held by institutions	116%
% shares held by investments Managers	81%
% shares held by hedge funds	9%
% shares held by insiders	2.18%
Short interest	6.16%
Days to cover short interest	4.41
52-week high	\$286.57
52-week low	\$169.43
Volatility	22.99%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2016	-0.16%	-1.15%
12/31/2016	0.54%	2.38%
3/31/2017	-2.70%	-8.52%
6/30/2017	0.19%	3.03%
9/30/2017	-0.05%	-0.71%
Mean	-0.44%	-1.00%
Standard error	0.6%	

Peers

Advance Auto Parts, Inc.
AutoZone, Inc.
Lithia Motors, Inc.
Asbury Automotive Group, Inc.
Sonic Automotive, Inc.
Group 1 Automotive, Inc.
CarMax Inc.
AutoNabon, Inc.



Management

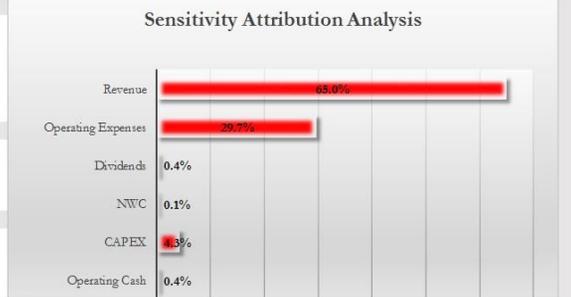
Management	Position
Hemlee, Gregory	Chief Executive Officer
Shaw, Jeff	Co-President
Johnston, Gregory	Co-President
McFall, Thomas	Chief Financial Officer and Senior Vice President of Leg
Groves, Jeffrey	Senior Vice President of Inv
Johnston, Randy	Senior Vice President of Inv

Total compensations growth

1.66% per annum over 5y
33.85% per annum over 5y
N/M
3.99% per annum over 5y
N/M
N/M

Total return to shareholders

7.61% per annum over 5y
7.61% per annum over 5y
0% per annum over 0y
7.61% per annum over 5y
N/M
N/M



Profitability

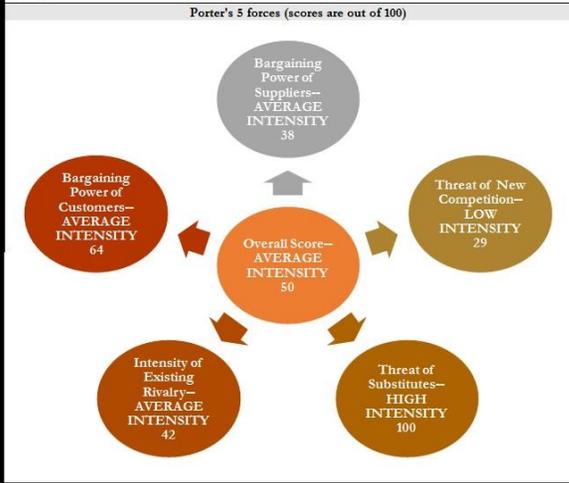
	ORLY (LTM)	ORLY (5 years historical average)	Peers' Median (LTM)
Return on Capital (GAAP)	19.6%	12.90%	4.74%
Operating Margin	10%	8.24%	2.24%
Revenue/Capital (GAAP)	2.00	1.57	2.12
ROE (GAAP)	64.9%	34.0%	4.8%
Net margin	13.7%	11.7%	2.6%
Revenue/Book Value (GAAP)	4.75	2.90	1.82

Invested Funds

	ORLY (LTM)	ORLY (5 years historical average)	Peers' Median (LTM)
Cash/Capital	-12.1%	4.5%	3.4%
NWC/Capital	-7.0%	8.9%	28.4%
Operating Assets/Capital	100.4%	70.2%	63.6%
Goodwill/Capital	18.8%	16.4%	4.6%

Capital Structure

	ORLY (LTM)	ORLY (5 years historical average)	Peers' Median (LTM)
Total Debt/Market Capitalization	0.97	0.47	0.73
Cost of Existing Debt	3.5%	6.0%	3.4%
CGFS Rating (F-score, Z-score, and default Probability)	A	AA	BBB
WACC	9.0%	11.2%	6.6%



Valuation

Period	Revenue Growth Forecast	NOPAT Margin Forecast	Revenue to Capital Forecast
Base Year	5%	16.3%	1.94
9/30/2018	6%	16.0%	2.02
9/30/2019	5%	15.8%	1.48
9/30/2020	5%	15.9%	1.17
9/30/2021	4%	15.9%	0.98
9/30/2022	4%	15.7%	0.85
9/30/2023	4%	16.2%	0.76
9/30/2024	3%	17.4%	0.68
9/30/2025	3%	17.8%	0.62
9/30/2026	3%	18.2%	0.57
9/30/2027	3%	18.5%	0.53
Continuing Period	2%	18.9%	0.49

Return on Capital Forecast

Period	Return on Capital Forecast	WACC Forecast	Price per share Forecast
Base Year	31.7%	9.0%	\$241.76
9/30/2018	32.3%	8.7%	\$274.72
9/30/2019	23.2%	8.6%	\$307.21
9/30/2020	18.7%	8.7%	\$340.47
9/30/2021	15.6%	8.7%	\$374.49
9/30/2022	13.4%	8.8%	\$409.25
9/30/2023	12.3%	9.0%	\$445.11
9/30/2024	11.9%	9.1%	\$481.76
9/30/2025	11.0%	9.1%	\$519.17
9/30/2026	10.4%	9.2%	\$557.29
9/30/2027	9.9%	9.4%	\$596.63
Continuing Period	9.3%	9.5%	

Valuation

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Base Year	5%	16.3%	1.94
9/30/2018	6%	16.0%	2.02
9/30/2019	5%	15.8%	1.48
9/30/2020	5%	15.9%	1.17
9/30/2021	4%	15.9%	0.98
9/30/2022	4%	15.7%	0.85
9/30/2023	4%	16.2%	0.76
9/30/2024	3%	17.4%	0.68
9/30/2025	3%	17.8%	0.62
9/30/2026	3%	18.2%	0.57
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9/30/2026	10.4%	9.2%	\$557.29
9/30/2027	9.9%	9.4%	\$596.63
Continuing Period	9.3%	9.5%	