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AutoZone (AZO) Earnings Report: Q2 2016 Conference Call Transcript

The following AutoZone conference call took place on March 1, 2016, 10:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Bill Rhodes; AutoZone; Chairman, President, CEO
- Bill Giles; AutoZone; CFO
- Unidentified Company Representative; AutoZone;

Other Participants

- Simeon Gutman; Morgan Stanley; Analyst
- Matthew Fassler; Goldman Sachs; Analyst
- Dan Wewer; Raymond James; Analyst
- Seth Basham; Wedbush Securities; Analyst
- Seth Sigman; Credit Suisse; Analyst
- Michael Lasser; UBS; Analyst
- Mark Becks; JPMorgan; Analyst
- Bret Jordan; Jefferies; Analyst
- Mike Baker; Deutsche Bank; Analyst
- Chris Bottiglieri; Wolfe Research; Analyst
- Michael Montani; Evercore ISI; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Welcome to the AutoZone conference call.

(Operator Instructions)

Please be advised, today's call is being recorded. If you have any objections, please disconnect at this time.

This conference call will discuss AutoZone's second-quarter financial results. Bill Rhodes, the company's Chairman, President and CEO will be making a short presentation on the highlights of the quarter.

The conference call will end promptly at 10 AM Central time, 11 AM Eastern time.

Before Mr. Rhodes begins, the company has requested that you listen to the following statement regarding forward-looking statements.

Unidentified Company Representative ():

Certain statements contained in this press release are forward-looking statements. Forward-looking statements typically use words such as believe, anticipate, should, intend, plan, will, expect, estimate, project, position, strategy and similar expressions. These are based on assumptions and assessments made by our management in light of experience and perception of historical trends, current conditions,

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expected future developments and other factors that we believe to be appropriate.

These forward-looking statements are subject to a number of risks and uncertainties including without limitation credit market conditions, the impact of recessionary conditions, competition, product demand, the ability to hire and retain qualified employees, consumer debt levels, inflation, weather, raw material costs of our suppliers, energy prices, war and the prospect of war including terrorist activity, construction delays, access to available and feasible financing, the compromising of the confidentiality, availability or integrity of information including cyber security attacks, and changes in laws or regulations.

Certain of these risks are discussed in more detail in the Risk Factors section contained in Item 1A under Part 1 of this Annual Report on Form 10-K for the year ended August 29, 2015. And these risk factors should be read carefully.

Forward-looking statements are not guarantees of future performance. Therefore actual results, developments, and business decisions may differ from those contemplated by such forward-looking statements and events described above, and then the risk factors could materially adversely affect our business. Forward-looking statements speak only as of the date made.

Except as required by applicable law, we undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Actual results may materially differ from anticipated results.

Operator:

It is now my pleasure to introduce your host for today's call, Mr. Bill Rhodes. Thank you. You may begin.

Bill Rhodes (Chairman, President, CEO):

Good morning and thank you for joining us today for AutoZone's 2016 second-quarter conference call. With me today are Bill Giles, Executive Vice President and Chief Financial Officer, IT and ALLDATA; and Brian Campbell, Vice President, Treasurer, Investor Relations and Tax.

Regarding the second quarter, I hope you've had an opportunity to read our press release and learn about the quarter's results. If not, the press release along with slides complementing our comments today, are available on our website, www.autozoneinc.com. Please click on Quarterly Earnings Conference Calls to see them.

To begin this morning, I want to thank all AutoZoners across the globe for another solid quarter. In the second quarter, we continued to execute our strategies to organically grow our business.

We expanded our US retail footprint with the opening of another 30 new stores. Our commercial business continued to grow with sales increasing 8%. We opened 32 net new programs for the quarter.

We now have the commercial program in 81% of our domestic stores. And we continued to expand our presence in Mexico, opening nine stores this quarter. We did not open any new stores in Brazil this quarter and currently have eight stores in operation.

Lastly, we opened two new IMC branches, bringing our total branch count to 24. While we currently have approximately 90% of our total company sales coming from our domestic AutoZone stores, we believe we have great growth prospects in domestic locations, commercial, international, and our other businesses.

If I could sum up the quarter in a short statement, I would call out our major highlights. I'd say we continued on our game plan of executing our inventory availability and delivery frequency initiatives while adding more labor hours in our stores in an effort to constantly improve our customers' experiences.

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While winter temperatures were milder this year than last, we did not see a material change in business trends from one month to the next overall. Yet, certain cold weather categories, those that have larger sales during these months, were below last year's numbers while others balanced out our performance. And yes, as you would expect, our performance in the Midwest and Northeast were below other markets, but they were in line with our expectations considering the weather patterns.

Probably the biggest unknown for us this quarter was when would income tax refunds begin to be remitted to consumers by the IRS? By quarter end, total refunds were generally comparable to remittances last year, but they were issued very, very late in our quarter.

We feel our retail business is benefiting from a continued focus on customer service, improving parts availability, and lower overall fuel prices. Lower gas prices we feel are contributing to Americans driving more.

Regarding commercial, we saw colder weather markets growing sales at a slower pace than other markets. We believe the milder temperatures led to less failure-related repairs being done in those particular markets.

However, we believe the mild temperatures will not have a material lasting effect on our sales performance heading in to the summer. We feel a hot summer is the next thing we will be watching for in regards to sales performance.

Getting back to DIY, our number one business priority, the business did quite well in the second quarter. We generated positive traffic and ticket on a same-store basis, and performance was generally consistent across the country.

While the macro economy is favorable for DIY performance right now, we also continue to gain share and would attribute those share gains to our investments in store labor and our inventory availability initiatives. We are committed to providing Wow Customer Service at every store with every customer. Regarding commercial, we've continued with our inventory placement and distribution strategies to respond to the ever-increasing challenge of part proliferation in our industry.

Over the past two years, we implemented new methodologies to improve our hard parts placement techniques in all stores. We continued the rollout of more frequent deliveries to an additional approximately 300 net new stores in the quarter. We now have a total of 1300 locations out of our 5,000-plus locations on multiple weekly deliveries.

As we've been discussing, this rollout focuses on increasing from once a week deliveries from our distribution centers to either three or five times a week. Our results continue to confirm this new strategy is appropriate.

With the varying weekly sales volumes of our stores, replenishment needs vary as well. Over the remaining two quarters of the fiscal year, we expect to roll this increased frequency model to approximately 700 additional stores, ending the fiscal year with approximately 2,000 stores with this enhanced service model.

The implementation of this initiative will create a gross margin headwind of approximately 20 to 30 basis points until we complete the rollout. While this effort will take a few years to complete, we would ultimately expect about two thirds of our stores to have increased frequency of deliveries. This past quarter's deleverage from deliveries was less than the previous quarter.

I appreciate our team's efforts to manage these rollouts on a cost-effective basis. This is a material change in how we do business. And our teams are executing it well and managing the cost effectively.

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Our sales lift from this effort continues to show the investments make economic sense. Additionally, we continue to be very pleased from our sales results from the mega hub stores. We ended the quarter with five mega hubs with no new openings this quarter, although we expect to add approximately five additional mega hubs over the last two quarters of the fiscal year.

As a reminder, these supersized AutoZone stores carry 80,000 to 100,000 unique SKUs of inventory, approximately twice what a normal hub store carries. They provide coverage to both surrounding stores and other hub stores multiple times a day or on an overnight basis.

Our sales results thus far in our open mega hubs continue to exceed our expectations. We're experiencing sales improvements from both our retail and commercial businesses. While there's incremental cost of these rollouts including payroll and fuel to execute the extra deliveries, we feel their cost deleverage is relatively modest.

Our current assumption on this rollout is that we won't experience meaningful deleverage from this initiative in FY16. Currently five mega hubs support approximately 700 stores on a same-day basis and roughly 2,000 stores in total, and once built out, we would expect to have a network of mega hubs in the neighborhood of 25 to 40 total locations.

Consistent with the increased frequently of delivery from our distribution centers, we expect to complete our mega hub expansion over the next few years. Along with improving our local parts availability and assortment, we continue to manage this organization to provide exceptional service for our customers, provide our AutoZoners with a great place to work with opportunities for advancement, and ensure we do it on a profitable basis to provide strong returns for our shareholders.

As I mentioned a few minutes ago, we continue to invest in store labor in order to say Yes, We Got It more frequently. Yes, We Got It is a new operating mantra for us in 2016. We've made meaningful enhancements in the last few years to our availability of inventory, and now it is time to ensure our customers experience and see that substantial change.

As traffic has increased in our stores, we understand and appreciate the need to be appropriately staffed to handle our customers' needs. When customers have requests for a part, product, or simply advice, our objective is to say to them -- yes, we've got it.

While still in the early implementation stage, our team has enthusiastically embraced this notion. With the current positive macro environment, we want to make sure our AutoZoners have the tools and specifically the staff necessary to provide our customers with the Wow Customer Service experience they deserve.

We also want to touch on the efforts that are ongoing with regard to capturing data about our customers' shopping patterns against all our platforms. We believe it's essential to be able to share information and process seamlessly between our stores, commercial shops, phone, and online experiences in order to meet all of our customers' needs. While still in the early stages of this work, we believe having a holistic and seamless enterprise-wide perspective on our customers will benefit us greatly over the next several years.

This will be a significant endeavor for us over the next couple years. We've spent a lot of time mapping through the capture of this data in order to leverage it to better serve our customers. We think this will be a real differentiator for us over the next several years. More to come later on this initiative.

Lastly, in order to support more frequent deliveries to new stores as well as mega hubs, we continue to expect to open two or three distribution centers over the next two or three years. At present, we're in the early stages of planning their openings and don't expect any distribution center to come online until

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FY17. FY16 will incur some capital and operation expenses related to development, but the larger portion of capital spend will be in FY17 and FY18.

To summarize our plans, we expect to roll out more frequent distribution center deliveries and more mega hub locations over the next few years. We also expect to open two or three new domestic distribution centers over this time. While our total company CapEx will not be materially different this year from past, we do expect to incur approximately 20 to 30 basis points gross margin headwind from these investments alone.

Now turning to the second quarter's results, our sales increased 5.3% on top of 7.7% growth in Q2 of last year. Our domestic same-store sales were up 3.6%.

Our growth in both sales and earnings were very consistent with our results from Q1. This quarter's sales results were also very consistent throughout the quarter, excluding the last couple of weeks.

During the quarter, tax refunds in total were generally comparable to prior year. However, from a timing perspective, they flowed very late in the quarter.

In regard to our three primary merchandise category splits in our US stores, failure-related product sales performed the best. Discretionary had the next highest growth rate, followed by maintenance. While all three showed nice growth, we attribute the variance in sales trends between these businesses to the timing of winter events -- for example, the polar vortex effects this year versus last.

As I said earlier, both traffic and ticket were positive for our DIY and commercial businesses. For the quarter, we opened 32 net new programs and have the commercial program in 81% of our domestic store base. Our total domestic sales grew 6% on the quarter. Our domestic commercial sales growth was up 8%.

The commercial sales growth rate while still impressive has slowed. Some of the reduction in growth is due to opening fewer new programs in recent years and having a lower percentage of the programs on the maturation curve. Despite this expected change, our sales slowed a bit more than we expected, and we are working diligently to gain back that momentum.

In recent weeks, we've executed incremental trading and have enhanced the focus of our management teams including store managers on reaccelerating our commercial growth. We believe our future in this business remains quite bright.

As part of our strategy of increasing inventory levels in local markets closer to our customers, this past quarter we opened one additional hub location and now operate 179. In addition to opening over time more mega hub locations, we also expect to open additional standard hub locations. Over time, we expect to operate as many as 200 to 225 stores as hub stores.

Regarding IMC, we opened two new branches this quarter and continue to be excited by our opportunities. IMC parts catalog is currently accessible to over 700 AutoZone locations today, and we believe there are great sales growth opportunities in the future for both our retail and commercial customers.

Regarding Mexico, we opened another nine stores this quarter and now have 451 total locations in Mexico. While foreign currency headwinds persist, Mexico's peso sales have done quite well. Assuming the peso stabilizes, we expect the pressure on our US dollar earnings from our Mexico business to begin to abate starting this summer in the June to July time frame as we begin to lap the most significant exchange rate increases.

For the quarter, the foreign currency headwinds lowered our EBIT growth rate by 2 percentage points. At the end of the quarter, the peso was down 29% versus last year and 16% from the end to Q1.

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Sales in our other businesses for the quarter were up 3% over last year. As a reminder, our ALLDATA and eCommerce businesses which include www.AutoZone.com and Auto Anything make up this segment of sales.

Each of these businesses operate in increasingly competitive environments, and our sales have slowed a bit. Again, while we understand weather this winter was warmer, we are optimistic for sales this upcoming quarter.

The biggest tailwind at the moment in our opinion is the increased miles driven across the country. This leads to more failure and maintenance-related demand and benefits both our DIY and DIFM businesses.

While we focus on both the short-term and long-term performance, we remain committed to delivering consistent, strong earnings performance and extending our streak of 38 consecutive quarters of double-digit EPS growth which is an important milestone for us. Our delivery frequency initiative and expansion of our mega hubs will add some headwinds on our operating margin for the remainder of FY16, our focus remains on growing operating profit dollars at acceptable return levels.

Now let me review our highlights regarding execution of our operating theme for 2016, Live the Pledge. The key priorities for the year were, great people providing great service, profitably growing our commercial business, leveraging the internet, improving inventory availability, and Yes, We Got It.

On the retail front this past quarter under the great people providing great service priority, we increased staffing levels in our stores. We've also been aggressive on our technology investments and believe these initiatives will help differentiate us on a long-term basis.

We realize as customers have become much more tech and mobile savvy, we have to have a sales proposition that touches all the ways they desire to interact with us. Our current and future technology investments will lead to sales growth across all of our businesses.

On the Yes, We Got It front, we've added training, metrics, and most importantly, share of voice to educate our store level AutoZoners to help all of our customers with any part, product, or device needs they have. We're excited about this initiative.

We should also highlight another strong performance on return on invested capital as we were able to finish the quarter at 31%. We're proud of this metric as it is one of the best if not the best in all of hard line's retailing.

However, our primary focus has been and continues to be that we ensure every incremental dollar of capital that we deploy in this business provides an acceptable return well in excess of our cost of capital. It is important to reinforce that we will always maintain our diligence regarding capital stewardship as the capital we invest is our investors' capital.

Before I pass the discussion to Bill Giles to talk about our financial results, I'd like to thank the entire organization for executing on our many operating initiatives while providing our customers with great service and managing our expenses appropriately and prudently. Now I will turn the call over to Bill Giles.

Bill Giles (CFO):

Thanks, Bill, and good morning, everyone. To start this morning, let me take a few moments to talk more specifically about our retail, commercial, and international results for the quarter. For the quarter, total auto parts sales which includes our domestic retail and commercial business, our Mexico and Brazil stores and our 24 IMC branches increased 5.4%.

Switching over to macro trends, during the quarter, nationally unleaded gas prices started out at $2.09 a

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gallon and ended the quarter at $1.72 a gallon, a $0.37 decrease. Last year, gas prices decreased $0.55 per gallon during the second quarter starting at $2.82 and ending at $2.27 a gallon. We continue to believe gas prices have a real impact on our customers' ability to maintain their vehicles, and as cost reductions help all Americans, we hope to continue to benefit from this increase in disposable income.

We also recognize the impact of miles driven on cars over 11 years old, the current average, is much different than on newer cars in terms of wear and tear. Miles driven increased in both October, November, and December, and we don't have January data yet.

For all of 2015, miles driven finished up 3.5%, an incredibly strong number on a historical basis. It represents the largest percentage growth in over a decade. The other statistic we highlighted is the number of seven-year and older vehicles on the road, which continues to trend in our industry's favor.

For the trailing four quarters, total sales per average AutoZone store was $1.78 million. For the quarter, total commercial sales increased 8%. In the second quarter, commercial represented 18% of our total sales and grew $30 million over last year's Q2.

While the sales trajectory of the business slowed a bit in Q2, some of this is due to slower growth from our lower mix of new programs. We've intensified the focus of our entire team including store managers on reaccelerating our growth in commercial, and we've recently executed some incremental commercial training programs.

This past quarter, we opened 32 net new programs versus 29 programs opened in our second quarter of last fiscal year. We now have our commercial program in 4,228 stores supported by 179 hub stores. Approximately 1,100 of our programs are three years old or younger, 26% of the base.

With our inventory additions and the support of the IMC acquisition, we are well positioned to grow our base business. Over the last several years, a significant amount of our focus has been on opening new programs, and that will continue to be the case, albeit at a slightly moderated case. This year, we plan on opening around 250 commercial programs, approximately 150 more programs over the next two quarters.

We have a very talented sales force, and we are enhancing training and introducing additional technology to optimize the productivity of the sales force. We have increased our efforts around analyzing customer purchasing trends and in stock trends.

In summary, we remain committed to our long-term growth strategy. We believe we are well positioned to grow this business and capture increased market share. We believe we can scale this business in a profitable manner, and we continue to be excited about our opportunities in this business for many years to come.

Our Mexico stores continue to perform well. We opened nine new stores during the second quarter. We currently have 451 stores in Mexico.

For the year, we expect to open approximately 40 new stores, and we are on target to open a new distribution center this calendar year. This will mark our second distribution center in the country, and it will support further central Mexico store growth.

As Bill previously mentioned, for the quarter, foreign exchange headwinds lowered our company EBIT growth by over 2 percentage points. While we cannot control movements in functional currency versus planned assumptions, Mexico leadership continues to do an exceptional job managing the peso-denominated business. If the peso stays at these elevated levels, it will continue to pressure our US dollar earnings for the next few quarters.

Regarding Brazil, we opened no stores in the quarter, remaining with eight stores open. While sales

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growth has been very encouraging, we've been challenged by a weak Brazilian real relative to US dollars as well. While the peso devalued 29% year over year, the real devalued 41% this year versus last.

This extraordinary volatility has managed as best as possible. We remain in test phase in Brazil but have been encouraged by our improving operating performance.

Recapping the past quarter's performance for the Company, in total our sales were $2.257 billion, an increase of 5.3% over last year's second quarter. Domestic same-store sales or sales for stores open more than one year were up 3.6% for the quarter.

Gross margin for the quarter was 52.7% of sales, up 50 basis points. The improvement in gross margin was attributable to higher merchandise margins, partially offset by higher supply chain costs associated with current year inventory initiatives.

In regards to inflation, it remains subdued -- in fact in total, slightly down last year. Currently we feel cost will be predictable and manageable. We will remain cognizant of future developments regarding inflation and will make the appropriate adjustments should they arise.

SG&A for the quarter was 35.8% of sales, higher by 40 basis points from last year's second quarter. Increase in operating expenses as a percentage of sales was primarily due to a favorable credit card litigation settlement recognized in last year's quarter and higher domestic store payroll. We continue to believe we are well positioned to manage our cost structure in response to our sales environment.

EBIT for the quarter was $383 million, up 6% over last year's second quarter. Our EBIT margin was 17%.

Interest expense for the quarter was $33 million compared with $35 million in Q2 a year ago. Debt outstanding at the end of the quarter was $4.845 billion or approximately $415 million more than last year's balance of $4.43 billion.

Our adjusted debt level metric finished the quarter at 2.5 times EBITDAR. While in any given quarter we may increase or decrease our leverage metric based on management's opinion regarding debt and equity market conditions, we remain committed to both our investment grade rating and our capital allocation strategy, and share repurchases are an important element of that strategy.

For the quarter, our tax rate was slightly lower than last year's Q2's tax rate. This rate was lowered than planned. Any deviations to our plan are driven primarily by the resolution of discreet tax items as they arrive.

Net income for the quarter was $229 million and up 8% over last year. Our diluted share account of 30.8 million was down 5.4% from last year's second quarter. The combination of these factors drove earnings per share for the quarter to $7.43, up 14.2% over the prior-year second quarter.

Relating to the cash flow statement for the second fiscal quarter, we generated $207 million of operating cash flow. [Netsetstack] were up 5% versus last year.

Capital expenditures for the quarter totaled approximately $100 million and reflected the additional expenditures required to open 43 new locations this quarter. Capital expenditures on existing stores, hub, and mega hub store remodels or openings, work on development of new stores for upcoming quarter and information technology investments.

With the new stores opened, we finished this past quarter with 5,193 stores in 50 states, the District of Columbia and Puerto Rico, 451 stores in Mexico and eight in Brazil for a total AutoZone store count of 5,652. We also had 24 IMC branches open at fiscal quarter end, taking our total locations to 5,676.

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Depreciation totaled $69 million for the quarter versus last year's second-quarter expense of $60 million in line with recent quarter growth rates. With our excess cash flow, we repurchased $150 million of AutoZone stock in the second quarter. At quarter end, we had $548 million remaining under our share buyback authorization, and our leverage metric was 2.5 times at quarter end.

Again, I want to stress we manage to appropriate credit ratings and not any one metric. The metric we report is meant as a guide only as each rating firm has its own criteria.

We continue to view our share repurchase program as an attractive capital deployment strategy. Accounts payable as a percent of gross inventory finished the quarter at 109%.

Next I'd like to update you on our inventory levels in total and on a per location basis. The Company's inventory increased 3.9% over the same period last year driven primarily by new stores over the last 12 months. Inventory for location was $633,000 versus $631,000 last year and $624,000 last quarter.

Finally, as Bill previously mentioned, our continued disciplined capital management approach resulted in return on invested capital for the trailing four quarters of 31%. We have and will continue to make investments we believe will generate returns that significantly exceed our cost of capital. Now I will turn it back to Bill Rhodes.

Bill Rhodes (Chairman, President, CEO):

Thank you, Bill. We are very pleased to report our 38th consecutive quarter of double-digit EPS growth, growing this quarter at a rate of 14.2% over last year.

To execute at a high level, we have to consistently adhere to living the pledge. We cannot and will not take our eye off of execution.

Success will be achieved with a strong attention to detail and exceptional execution. We're confident in our initiatives, and we're pleased with the progress we're making in rolling out our new supply chain model by delivering inventory to our stores on a more frequent basis.

In addition, the performance of our mega hubs has been strong and ahead of our expectations. And we look forward to opening more later this year. We believe these initiatives will benefit both our retail and commercial businesses.

Our long-term model is to grow new store square footage at a low single-digit growth rate, and we expect to continue growing our commercial business at an accelerated rate. Therefore, we look to routinely grow EBIT dollars in the mid single-digit range or better in times of strength. And we leverage our very strong and predictable cash flow to repurchase shares, enhancing our earnings per share growth in to double digits.

We feel the track we're on will allow us to continue winning for the long-term. We believe our steady, consistent strategy is correct. It is the attention to details and consistent execution that will matter.

Our belief is that solid, consistent strategy combined with superior execution drives success. Our charge remains to optimize our performance regardless of market conditions and continue to ensure we are investing in the key initiatives that will drive our long-term performance. In the end, delivering strong EPS growth and ROIC each and every quarter is how we measure ourselves.

We are pleased with our results this past quarter, but we must not be content. We have a lot of work in front of us over the next two quarters, but the future continues to look bright. Now we'd like to open up the call for questions.

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QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Simeon Gutman with Morgan Stanley.

Simeon Gutman (Analyst - Morgan Stanley):

Thanks. Good morning. I have a quick question for Bill Rhodes on the commercial sales growth.

You mentioned it was a little weaker, even absent some noise. And you didn't mention weather in the same breath, but you mentioned some training and labor. Can you share with us what you think the void is on what's not happening on the training or labor side that's causing a little -- I don't know if it's slippage or noise on the commercial sales results?

Bill Rhodes (Chairman, President, CEO):

I would start with one of the things we made specific mention of was that we have fewer stores going through the maturation cycle, and also the stores in that maturation cycle were opened later in our development process, which means they had lower potential than the ones that were open sooner. We're seeing some of our slowdown that is completely attributable to lower new program growth.

But that said, we were still below our expectations for the quarter. Some of that we would attribute to weather patterns, particularly in the Midwest and Northeast, but not all of it.

Frankly we're not exactly sure all the reasons that we had a little bit of a slowdown, but we're very focused on taking our one-team concept and getting our district managers and store managers along with our sales team really re-engaged in a big way in a materially more significant way than in the past. And I think that will pay us dividends for the long-term.

Simeon Gutman (Analyst - Morgan Stanley):

The follow-up, somewhat related to that. If you look at the markets with increased stores that are benefiting from increased frequency, are you making the customers in those stores aware of that? Or are they just seeing it through improved parts availability?

Bill Rhodes (Chairman, President, CEO):

We're not marketing to them. Number one, it's being done on a store by store basis. Clearly local markets will have it or not. But we're not marketing it to them. We're just showing it to them in their yes percentage when they ask for parts.

Simeon Gutman (Analyst - Morgan Stanley):

Thanks. Nice results.

Operator:

Matthew Fassler with Goldman Sachs.

Matthew Fassler (Analyst - Goldman Sachs):

Thanks a lot. Good morning. My question focuses on inventory.

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Your inventory grew I believe at a slower rate than cost of goods for the first time in quite a while. This is as you're obviously ramping up availability. If you could talk about the moderation in year-on-year growth, whether you expect it to continue and impact if any it would have had on sales as you went through the quarter?

Bill Giles (CFO):

I think when you look over time, we've actually increased our inventory quite a bit, and so now it's this $630,000 per store location level. We feel pretty good about that.

As Bill mentioned in the prepared remarks, we spent a lot of time analyzing placements. And so the merchandising organization has done a great job over the last 12 to 15 months of better determining where to place inventory. I think the more frequent delivery will be able to optimize inventory location as well, and obviously we've increased some inventory as we've added some of these mega hubs.

So I would expect our inventory levels to on a per-location basis to be approximately where they are now. They might have some increases as we roll out a few more mega hubs but not significant increases.

Matthew Fassler (Analyst - Goldman Sachs):

So basically growing more or less in line with sales if the trajectory continues as it is?

Bill Giles (CFO):

Right.

Matthew Fassler (Analyst - Goldman Sachs):

My very quick follow-up, you quantified the impact of FX on EBIT, and it's not an insignificant number relative to your algorithm. I'm not sure how much detail you've given on that in the past. How much does that impact in the quarter you just reported, or how does that compare to recent quarters?

Bill Giles (CFO):

What we said on this quarter was we thought it was about 200 basis points or so. And I think last quarter if I remember right, we said somewhere around 100 basis points or so.

So it has had a big impact. We're going to anniversary that somewhere toward the middle to tail end of Q3 relative to the spike we saw on the peso. But I'm sure there's a whole lot of other macro things going on at the same time that are impacting the peso including lower gas prices, et cetera.

So there's a lot of as we call it natural hedges going on, so it isn't singular. But if we were to single that out, it did have almost a 200 basis point impact on EBIT. We expect that to impact us a little bit in Q3 and then we will fully anniversary it in Q4.

Matthew Fassler (Analyst - Goldman Sachs):

Just to get closure on this point, it sounds like there's probably both translational and transactional impact to the extent you're selling product sourced in the US south of the border.

Bill Giles (CFO):

Not necessarily. There's obviously translation and transaction from the balance sheet perspective, but it's mostly transactional from just the Mexico results.

Matthew Fassler (Analyst - Goldman Sachs):

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Got it. Thank you so much.

Operator:

Dan Wewer with Raymond James.

Dan Wewer (Analyst - Raymond James):

Thanks. Bill, your explanation about the slower rate of program growth makes sense, but then presumably that would benefit the sales per program, because they're more mature.

But it looks like they were up less than 1%, sales per program during the second quarter. So trying to reconcile that trend with the rollout and apparent success with the mega hub and distribution frequency initiative?

Bill Rhodes (Chairman, President, CEO):

Yes, first, I'd start with one of the things that happened in the quarter on the more frequent delivery program, we did not roll out any significant amount of stores on that program until very, very late in the quarter. It just doesn't make sense to roll out things during the holiday season. So those over 300 stores that went on that program went on the last couple weeks of the quarter, so you weren't able to see that benefit in there.

As I said earlier, some of the slowdown in commercial was clearly the maturation cycle, but some of it is we were frankly disappointed, marginally disappointed with our performance in commercial. Our team has all hands on deck. We had a spring sales meeting last week. That was the predominant topic, and I'm highly confident that our team will take the ball from here and reaccelerate our growth.

Dan Wewer (Analyst - Raymond James):

That's a great opportunity to evaluate what's the benefit from the mega hub coverage, what's the benefit from the increased delivery frequency. You have 500 stores that have both the mega hub access and multiple delivery availability. When you think about those two different initiatives, where do you seem to be getting the biggest sales payback?

Bill Rhodes (Chairman, President, CEO):

They were both performing at or above our expectations. Frankly the mega hubs are out performing our expectations. By the way, the mega hubs, which a couple of them are multiple years old, are continuing to grow, so we're really excited the maturation continues two, two and a half years later.

As we've said before, the combination of those two programs is driving a benefit of between $1,000 and $1500 per program -- per store that they get them. That holds true. If anything, it's a little bit stronger or toward the higher end of that as we roll it out.

Dan Wewer (Analyst - Raymond James):

Bill, real quickly, can you give an example or two of what you're focusing on, the increased education or training in the commercial initiative, just an example of what conversations or teaching would be taking place at the store level?

Bill Rhodes (Chairman, President, CEO):

I would say one big thing is a lot of our AutoZoners, myself included, grew up on the retail side of the business. We didn't grow up on the wholesale side of the business.

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To use a baseball analogy, our fastball is retail. We've got to develop a fastball that's also commercial. We're really focused on getting everybody in the organization taking our whole one team notion to the next level.

That includes getting our district managers and store managers along with the sales team even more focused on growing the commercial business. Those are a talented group of people, and I'm highly confident they will embrace that notion and take us to the next level.

Dan Wewer (Analyst - Raymond James):

Okay. Thank you.

Operator:

Seth Basham with Wedbush Securities.

Seth Basham (Analyst - Wedbush Securities):

Thanks a lot and good morning.

Bill Rhodes (Chairman, President, CEO):

Good morning.

Seth Basham (Analyst - Wedbush Securities):

My first question is just on the success of the delivery initiatives. When you think about the stores that received increased deliveries earliest in the development of this rollout, are they still out-comping control group stores?

Bill Rhodes (Chairman, President, CEO):

I would say as they anniversaried it, on the delivery frequency they're not comping at a higher level. They pretty much get that benefit very early. It's all about the customer calling, and yes, we have the product at higher level than we had it before.

so the benefit is almost immediate. There's not a marketing halo except to the extent that when we say yes on a water pump, we may also get the hose sale as well, but all those benefits are pretty much immediately. I wouldn't expect they'd grow year over year.

Seth Basham (Analyst - Wedbush Securities):

Got it. So the mega hubs that are maturing --

Bill Rhodes (Chairman, President, CEO):

The mega hubs are continuing to grow. I think that is the more we say yes for hard to find parts, the more customer calls us first versus somebody else for a harder to find part.

Seth Basham (Analyst - Wedbush Securities):

That's very helpful. Secondly, looking at your gross margins on a really strong quarter, can you provide a little bit more insight in to how you're reducing your product cost so much?

Bill Giles (CFO):

There's a variety of things that the merchandising organization is doing in order to improve quite frankly

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sourcing. So one of the things we talked about last quarter is that we're increasing our global sourcing efforts and identifying opportunities there.

I'd say that's still early on, so there's more opportunity for that as we look out over the next several quarters, several years frankly. So I think there's opportunities there, mostly acquisition cost.

Seth Basham (Analyst - Wedbush Securities):

Very good. Thanks a lot. Nice results.

Operator:

Seth Sigman with Credit Suisse.

Seth Sigman (Analyst - Credit Suisse):

I just wanted to follow up on that gross margin point. Clearly a lot of momentum in gross margin helping offset some of the investments that you made. How do you think about that playing out in the second half of the year?

Just wondering if you will see greater impact in Q3 and Q4 from the increase in delivery frequency? I think as you pointed out, you're adding 700 stores in the second half, you only added 300 in the first half which was late in the quarter. So just wondering how that plays out and if you will continue to see some of those offsets.

Bill Giles (CFO):

We've added more than that. We will probably add -- the way to think about it is we will probably add about 300 stores a quarter on the more frequent delivery. So we will probably have this ratable pressure of about 20 to 30 basis points on the supply chain perspective.

We've had opportunities to offset that through merchandising tactics, working with our vendors, as well as lower acquisition cost. So it's difficult to predict out exactly what gross margin will do over the next couple of quarters, but I think we feel pretty good about this quarter's results, and we'd expect something similar, maybe not quite this strong going forward.

Seth Sigman (Analyst - Credit Suisse):

Okay. That's helpful. Then as we think about the strength in the retail side of the business, how do we think about the pace versus prior quarters? It's hard to see with FX, but just wondering did it accelerate versus prior quarters?

In general, how should we be thinking about the drivers there between the inventory availability initiatives. Obviously there's a lot of disruption in the market as well. Also I think you pointed out just improvements you're seeing within your customer base.

Bill Giles (CFO):

Yes, I would say it felt pretty steady overall I think from the performance of the retail business for the quarter with the exception of the flow of the tax money, and that created some volatility overall. Clearly as you pocket the United States, there was a little bit of a weather impact in the Northeast, and there's a minor impact in the South Central area from oil. But other than that, it seems like it's been relatively stable and consistent throughout there.

Then if I heard you correctly, I just wanted to make a footnote to one thing you said. The same-store sales

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are domestic-based, so the foreign exchange rate wouldn't have had any impact on that.

Seth Sigman (Analyst - Credit Suisse):

Understood.

Operator:

Michael Lasser with UBS.

Michael Lasser (Analyst - UBS):

Good morning. Thank you for taking my question. Bill Rhodes, you're making progress with the inventory availability initiative.

Your sales per commercial programs still several hundred thousand dollars below some of the other players in the industry. Do you think the current initiatives you have in place are going to be able to enable the Company to meaningfully close that gap over time, or do you have to do something else to get there?

Bill Rhodes (Chairman, President, CEO):

I think we believe strongly in our current strategy. We believe this inventory availability initiatives are going to make a material difference in both our retail and commercial businesses. And I think this discussion we're having today about taking our one team approach to the next level is really going to get our organization, which is an incredibly strong execution oriented organization, that will help take us to the next level.

Where do we end up? When I sit back and think about it, a lot of people want to talk about moving from $9,000 a week to $13,000, $14,000 a week. If you think about it, the DIFM business is bigger than the DIY business.

Over time I'd love for our DIFM business to be bigger than our DIY business. That's going to take years if not decades, but I don't want to set our sights to any short-term target that would limit our thinking.

Michael Lasser (Analyst - UBS):

Has the most immediate impact from the increased inventory availability been to the DIY business?

Bill Rhodes (Chairman, President, CEO):

No, I would say the most immediate impact is on both sides of the business. In fact if anything, it's slightly disproportionate to the commercial business, which is what you would expect particularly on the mega hub because these are later model products that are harder to find.

Michael Lasser (Analyst - UBS):

My follow-up question is so with that being said and the slowdown in growth on the sales per commercial program basis within the quarter, was there any consistency or pattern that you saw? Because it doesn't sound like it was the stores that are getting the increased inventory availability. If anything, those are doing better than average. So I guess there's some other bucket of stores that is flowing?

Bill Rhodes (Chairman, President, CEO):

I wouldn't say it's some other bucket of stores. I would say it was generally across the board. Certain markets where there were weather impacts were hit slightly more than others, but it was generally across

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the board.

Michael Lasser (Analyst - UBS):

Okay. Thank you so much.

Operator:

Chris Horvers with JPMorgan.

Mark Becks (Analyst - JPMorgan):

Hi, it's Mark Becks on for Chris. I want to come back to the commentary around the tax refund. I think you said it's comparable at quarter end.

Just wanted to fully understand, does that mean you wouldn't anticipate any impact as you move in to Q3? Or do you think there's still some lift from the delayed tax refunds to the next quarter?

Bill Rhodes (Chairman, President, CEO):

What we said was at the end of the quarter, total refunds were generally consistent with where they were last year, but they really flowed very late in the quarter. There was a massive amount of refunds that were processed the Wednesday before our quarter ended. We obviously had a very nice weekend.

Did we get all the benefit we normally get in the quarter? Probably not, but it's really hard to say. In the past, we've called out two different times that we thought the tax refund timing either benefit us or hurt us by 100 basis points in sales for the quarter.

We didn't quantify it this time, so are thoughts are it was clearly less than that. But there's probably a bit of it that's going to flow in to the third quarter.

Mark Becks (Analyst - JPMorgan):

Okay. That's helpful. One other quick follow-up, I will let Bill Giles jump in here. Maybe I'm reading a little too much into it, but the repo activity was a little bit of a modest deceleration in the quarter.

I think historically that's followed your cash flow, and you've taken out that in the middle of the year to support a ramped repo in the back half. Maybe any insight you'd be able to give there.

Bill Giles (CFO):

You said it spot on. That's exactly right. The second quarter is typically a slightly lower cash flow quarter.

We obviously bought more stock this year than we did last year at this time because of the IMC acquisition that we incurred last year, but share repurchases is a little bit lighter in Q2. But we will ramp that up as we head toward the back half of the year.

Mark Becks (Analyst - JPMorgan):

Great. Thanks.

Operator:

Bret Jordan with Jefferies.

Bret Jordan (Analyst - Jefferies):

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Good morning, guys. On the IMC you just mentioned, you said it's got catalog availability to 700 of your stores. Can you talk about how it's impacting those stores' commercial business?

Bill Rhodes (Chairman, President, CEO):

As we've said for a long time, the number one reason we're in the IMC business is for the IMC standalone business. It's a business we're very excited about on a long-term basis, but it does provide for those customers, those AutoZone commercial customers that do some high-end import business, it does increase us to increase our ability to say yes on those special needs.

So when you think about that business today, it's maybe a couple hundred dollars per store per week in incremental sales. It's not a huge difference in the commercial business, but it is a nice help. At any time, you can say yes to something they really need, that helps you move up the call list over the long-term.

Bret Jordan (Analyst - Jefferies):

Thank you. Then in other, you mentioned between ALLDATA and e-commerce slowed a bit. Was it e-commerce?

Is there anything changing in that space, or is it just general slowing around the seasonal category? Is Rock Auto or Amazon having any impact?

Bill Giles (CFO):

I wouldn't say we're not seeing much impact from an e-commerce perspective overall. I think ALLDATA has had a little bit more competitive pressure in the marketplace, and that's probably slowed their growth a little bit. So that's probably more what you're seeing there.

Bret Jordan (Analyst - Jefferies):

Okay. Great. Thank you.

Operator:

Mike Baker with Deutsche Bank.

Mike Baker (Analyst - Deutsche Bank):

Hi. Thanks. Two questions. One, bigger question.

You said at one point earlier in the call that the economy is favorable for DIY right now. Does that imply that you think it's more favorable for DIY than the commercial business? And if so, why is that, and has that changed at all?

Bill Rhodes (Chairman, President, CEO):

I would say we are number one much more educated on how the economic cycles impact our DIY business than we are the DIFM business just because we've been in that business for so much longer and we have a much more mature business.

Clearly the economic cycle that we're in with lower gas prices, which are leading to really, really high miles driven, is very favorable for us. Those same impacts, those same indicators should impact the commercial business, but we believe at this stage in our commercial business development, it's much more on us and our development of that business than it is on economic macro factors.

Mike Baker (Analyst - Deutsche Bank):

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Understood. That makes sense. I guess as a follow-up to that DIY and commercial growth, who do you think you're taking market share, and are you taking more or less share in DIY or DIFM? Clearly DIFM business is growing faster, but is that indicative of the market growing faster or are you taking more share?

Bill Rhodes (Chairman, President, CEO):

I think clearly we're taking share in both businesses. We're probably taking a disproportionate share in the commercial business, but because we're later to the party than many of our competitors, so we're earlier in the maturation cycle. As far as getting in to specifics, I will let you all look at individual companies' performance and make those determinations for yourself.

Mike Baker (Analyst - Deutsche Bank):

Understood. Thanks for the color.

Operator:

Chris Bottiglieri with Wolfe Research.

Chris Bottiglieri (Analyst - Wolfe Research):

My first question is your gross margin has been robust. Obviously a lot of this is acquisition cost, but I'd think there are some other drivers.

Just want to get your thoughts. How much of this directionally would be oil-based products, keeping pricing versus cost coming down, integration, benefits of IMC and general oil benefits on your transportation network?

Bill Giles (CFO):

There are some of those in there. To go backwards, there's a little bit of benefit certainly from lower gas prices, fuel cost that's going to impact supply chain and frankly SG&A a little bit as well.

In addition to that, actually the inflation/deflation is relatively moderated. There's more deflation a little bit in categories like oil. Frankly, deflation typically is not helpful for us from a margin perspective. Inflation would be a little bit better for us on a long-term basis.

I would give the credit back to the merchandising organization from an acquisition perspective, working with the vendors, optimizing where we're buying the inventory. Going direct with certain opportunities as well, increasing private label product where we have opportunities to do so. We're pretty well penetrated in private label today, but there continues to be opportunities for us to expand our penetration on private label, and that's helped a little bit.

Many of the improvements I'd say we've seen, not all but the majority are sustainable, so I think we've got a good play-book to continue to do that. Having said that, as you mentioned, we continue to have headwinds from lower margin businesses growing at a faster rate and some of the initiatives we have from an inventory perspective.

Chris Bottiglieri (Analyst - Wolfe Research):

Got you. One follow-up unrelated question. You guys were obviously well ahead of the rest of the party in terms of putting together a DIY program.

On a monetary value, it seems you'd exceed your competitors. Are you seeing any impact from these

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traditional competitors using DIY programs in terms of rewards? Can you talk about retention rates or number of members, anything to give context to how your own rewards loyalty program has performed?

Bill Rhodes (Chairman, President, CEO):

Our loyalty program, which we've had in some form for basically a decade continues to perform well and is an important part of our value proposition to our customers. As other people have gotten in to the loyalty problem, we've obviously paid very close attention to it, but at the macro level our DIY business is performing very well right now.

So I think we're confident with what we're doing. We're confident with the benefits we're getting out of the loyalty program and look forward to continuing to perform well.

Chris Bottiglieri (Analyst - Wolfe Research):

Great. Thanks a lot, guys.

Operator:

Michael Montani with Evercore ISI.

Michael Montani (Analyst - Evercore ISI):

It's Mike Montani on for Greg Melich. On CapEx, can you guys give a little more color on what you think this year will be and the outlook for the next couple years given the expectations for the DCs and mega hubs? And then I had a follow-up.

Bill Giles (CFO):

I think we said we'd pay $600 million or so for FY16. At this pace, it will probably be a little bit lower than $600 million. For next year, probably back closer to the $600 million, maybe a little bit over that depending on how we finish up this year.

And then the following year, I think we will probably migrate down in to the mid $500 millions or so once we get the distribution centers open. That would be the only aberration if you will call it from a CapEx perspective. Other than that, we're opening square footage at around 3% and continuing to invest in our existing base stores to make sure they look fresh and current every day, then also to invest in technology in order to make sure our platforms can support our business as we grow.

Michael Montani (Analyst - Evercore ISI):

Great. Thanks. If I could on the margin side, you mentioned higher wage cost. Could you help understand how much of that is head count per store, increased hours versus wage rate and any healthcare expense you might be seeing or not seeing?

Bill Giles (CFO):

I think mostly our payroll is really intentional investment in our payroll dollars in the stores in order to improve customer service as well as the training that Bill talked about earlier. From a wage rate perspective, I'd say we're continuing to see an increase in wage rates, but not anything different than what we had expected to see and frankly not much different than what we've seen in prior years.

Obviously around the country there's pocketed areas, but for the most part it's been steady as she goes. From a health medical perspective, we're not seeing any significant changes necessarily to our current cost rates, so that seems to be pretty much in check as well.

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Michael Montani (Analyst - Evercore ISI):

Great. Thank you guys.

Bill Giles (CFO):

Thank you.

Operator:

Thank you. At this time, I would like to hand the call back to Mr. Bill Rhodes for closing comments.

Bill Rhodes (Chairman, President, CEO):

Before we conclude the call, I'd like to take a moment to reiterate that our business model continues to be solid. We're excited about our growth prospects for the year. We will not take anything for granted as we understand our customers have alternatives.

We have a solid plan to succeed this fiscal year, but I want to stress that this is a marathon and not a sprint. As we continue to focus on the basics and focus on optimizing long-term shareholder value, we're confident AutoZone will continue to be very successful. Thank you for participating on today's call.

Operator:

Thank you. That concludes today's conference.

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