O REILLY AUTOMOTIVE INC
Form 10-Q
November 08, 2005
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ___________________ to ____________________

Commission file number 0-21318

O'REILLY AUTOMOTIVE, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Missouri | 44-0618012 |
| (State or other jurisdiction | (I.R.S. Employer Identification No.) |

of incorporation or

organization)

233 South Patterson
Springfield, Missouri 65802
(Address of principal executive offices, Zip code)

(417) 862-6708
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No [ ]

Indicate by a check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes x No [ ]

Common stock, $0.01 par value 112,079,344 shares outstanding as of September 30, 2005. As of that date, the aggregate market value of the voting stock held by non-affiliates of the Company was approximately $3,158,395,914 based on the last sale price of the common stock reported by the Nasdaq Stock Market (National Market).

This report contains a total of 22 pages of which this page is number 1.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

FORM 10-Q

Quarter Ended September 30, 2005

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**PART I FINANCIAL INFORMATION**
**ITEM 1. FINANCIAL STATEMENTS (UNAUDITED)**

**O REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2005 (Unaudited) | December 31, 2004 (Note) |
|---|---|---|
| | (In thousands, except share data) | |
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 51,591 | $ 69,028 |
| Accounts receivable, net | 72,791 | 60,928 |
| Amounts receivable from vendors, net | 38,458 | 52,976 |
| Inventory | 715,257 | 625,320 |
| Deferred income taxes | 4,783 | - |
| Other current assets | 12,533 | 5,225 |
| Total current assets | 895,413 | 813,477 |
| Property and equipment, at cost | 941,043 | 791,794 |
| Accumulated depreciation and amortization | 262,011 | 224,301 |
| Net property and equipment | 679,032 | 567,493 |
| Notes receivable, less current portion | 30,197 | 21,690 |
| Other assets, net | 57,368 | 29,697 |
| Total assets | $ 1,662,010 | $ 1,432,357 |
| **Liabilities and shareholders' equity** | | |
| Current liabilities: | | |
| Income taxes payable | $ 2,790 | $ 9,736 |
| Accounts payable | 287,851 | 240,548 |
| Accrued payroll | 18,762 | 15,130 |
| Accrued benefits and withholdings | 46,025 | 35,794 |
| Deferred income taxes | - | 7,198 |
| Other current liabilities | 54,532 | 24,817 |
| Current portion of long-term debt | 75,444 | 592 |
| Total current liabilities | 485,404 | 333,815 |
| Long-term debt, less current portion | 25,468 | 100,322 |
| Deferred income taxes | 39,517 | 38,440 |
| Other liabilities | 13,943 | 11,963 |
| Shareholders' equity: | | |
| Common stock, $0.01 par value: | | |
| Authorized shares 245,000,000 | | |
| Issued and outstanding shares 112,079,344 at September 30, 2005, and 55,377,130 at December 31, 2004 | 1,121 | 554 |

| | | |
|---|---|---|
| Additional paid-in capital | 351,744 | 326,650 |
| Retained earnings | 744,813 | 620,613 |
| Total shareholders equity | 1,097,678 | 947,817 |
| Total liabilities and shareholders equity | $ 1,662,010 | $ 1,432,357 |

Note: The condensed consolidated balance sheet at December 31, 2004, has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by United States generally accepted accounting principles for complete financial statements.

See Notes to Condensed Consolidated Financial Statements.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(Unaudited)

| | Three Months Ended September 30, 2005 | 2004 | Nine Months Ended September 30, 2005 | 2004 |
|---|---|---|---|---|
| Product sales | $ 542,906 | $ 455,162 | $ 1,530,354 | $ 1,293,623 |
| Cost of goods sold, including warehouse and distribution expenses | 306,990 | 256,993 | 869,299 | 736,426 |
| Gross Profit | 235,916 | 198,169 | 661,055 | 557,197 |
| Operating, selling, general and administrative expenses | 168,331 | 142,039 | 471,762 | 402,798 |
| Operating income | 67,585 | 56,130 | 189,293 | 154,399 |
| Other expense, net | (561) | (791) | (1,034) | (1,675) |
| Income before income taxes and cumulative effect of accounting change | 67,024 | 55,339 | 188,259 | 152,724 |
| Provision for income taxes | 18,401 | 20,652 | 63,500 | 57,057 |
| Income before cumulative effect of accounting change | 48,623 | 34,687 | 124,759 | 95,667 |
| Cumulative effect of accounting change, net of tax | - | - | - | 21,892 |
| Net income | $ 48,623 | $ 34,687 | $ 124,759 | $ 117,559 |
| Net income per common share basic: | | | | |
| Income before cumulative effect of accounting change | $ 0.43 | $ 0.31 | $ 1.12 | $ 0.87 |
| Cumulative effect of accounting change, net of tax | - | - | - | 0.20 |
| Net income per common share | $ 0.43 | $ 0.31 | $ 1.12 | $ 1.07 |
| Net income per common share assuming dilution: | | | | |
| Income before cumulative effect of accounting change | $ 0.42 | $ 0.31 | $ 1.10 | $ 0.86 |
| Cumulative effect of accounting change, net of tax | - | - | - | 0.20 |
| Net income per common share assuming dilution | $ 0.42 | $ 0.31 | $ 1.10 | $ 1.06 |
| Weighted-average common shares outstanding basic | 111,911 | 110,280 | 111,423 | 109,847 |
| Adjusted weighted-average common shares outstanding assuming dilution | 113,830 | 111,556 | 113,164 | 111,254 |

See Notes to Condensed Consolidated Financial Statements.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| | Nine Months Ended September 30, 2005 | 2004 |
|---|---|---|
| Net cash provided by operating activities | $ 183,107 | $ 197,601 |
| Investing activities: | | |
| Purchases of property and equipment | (149,601) | (126,220) |
| Proceeds from sale of property and equipment | 793 | 1,248 |
| Payments received on notes receivable | 3,419 | 2,231 |
| Advance on notes receivable | (7,261) | - |
| Acquisition, net of cash acquired | (62,909) | - |
| Reduction (increase) in other assets | 1,045 | (1,830) |
| Net cash used in investing activities | (214,514) | (124,571) |
| Financing activities: | | |
| Payments on long-term debt | (451) | (20,841) |
| Proceeds from issuance of common stock | 14,421 | 10,336 |
| Net cash provided by (used in) financing activities | 13,970 | (10,505) |
| Net (decrease) increase in cash and cash equivalents | (17,437) | 62,525 |
| Cash and cash equivalents at beginning of period | 69,028 | 21,094 |
| Cash and cash equivalents at end of period | $ 51,591 | $ 83,619 |

See Notes to Condensed Consolidated Financial Statements.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2005

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of O Reilly Automotive, Inc. and Subsidiaries (the Company ) have been prepared in accordance with United States generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2005, are not necessarily indicative of the results that may be expected for the year ended December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004 ( 2004 Form 10-K ).

2. Acquisition

On May 31, 2005, the Company purchased all of the outstanding stock of W.E. Lahr Company and its subsidiary, Midwest Auto Parts Distributors, Inc. and combined affiliates ( Midwest ) for $63 million cash, net of cash acquired, including acquisition costs. Midwest is a specialty retailer, which supplies automotive aftermarket parts in Minnesota, Montana, North Dakota, South Dakota, Wisconsin and Wyoming. The acquisition was accounted for using the purchase method of accounting, and accordingly, the results of operations of Midwest are included in the consolidated statements of income from the date of acquisition. The purchase price was allocated preliminarily to assets acquired and liabilities assumed based on their estimated fair values on the date of acquisition with the excess allocated to goodwill. The acquisition of Midwest was not material for pro forma presentation requirements.

3. Stock Split

On May 20, 2005, the Company s Board of Directors declared a two-for-one stock split that was effected in the form of a 100% stock dividend payable to all shareholders of record as of May 31, 2005. The stock dividend was paid on June 15, 2005. Accordingly, this stock split has been recognized by reclassifying $559,000, the par value of the additional shares resulting from the split, from retained earnings to common stock.

All earnings per share information included in the accompanying consolidated financial statements has been restated to reflect the effect of the stock split for all periods presented.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2005

4. Stock-based Compensation

The Company has elected to use the intrinsic value method of accounting for stock options issued under our stock option plans and, accordingly, does not record an expense for such stock options. For purposes of pro forma disclosures under the fair value method, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company s pro forma information for the periods ended September 30, is as follows:

| | For the Three Months Ended September 30, 2005 | 2004 | For the Nine Months Ended September 30, 2005 | 2004 |
|---|---|---|---|---|
| | (In thousands, except per share data) | | | |
| Net income as reported | $ 48,623 | $ 34,687 | $ 124,759 | $ 117,559 |
| Stock-based compensation expense, net of tax, as reported | - | - | - | - |
| Stock-based compensation expense, net of tax, under fair value method | 1,620 | 3,559 | 5,040 | 9,646 |
| Pro forma net income | $ 47,003 | $ 31,128 | $ 119,719 | $ 107,913 |
| Pro forma basic net income per share | $ 0.42 | $ 0.28 | $ 1.07 | $ 0.98 |
| Pro forma net income per share- assuming dilution | $ 0.41 | $ 0.28 | $ 1.06 | $ 0.97 |
| Earnings per share, as reported | | | | |
| Basic | $ 0.43 | $ 0.31 | $ 1.12 | $ 1.07 |
| Diluted | $ 0.42 | $ 0.31 | $ 1.10 | $ 1.06 |

5. Synthetic Lease Facility

On June 26, 2003, we completed an amended and restated master agreement relating to our properties leased from SunTrust Equity Funding, LLC (the Facility ). The terms of the amended and restated Facility provide for an initial lease period of five years, a residual value guarantee of approximately $43.2 million at September 30, 2005, and purchase options on the properties. The Facility also contains a provision for an event of default whereby the lessor, among other things, may require us to purchase any or all of the properties. One additional renewal period of five years may be requested from the lessor, although the lessor is not obligated to grant such renewal. The agreement with SunTrust Equity Funding, LLC has been recorded and disclosed as an operating lease in accordance with Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases* and Financial Interpretation No. 46R, *Consolidation of Variable Interest Entities*.

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2005

6. Income Per Common Share

The following table sets forth the computation of basic and diluted income per common share:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (In thousands, except per share data) | | | |
| Numerator (basic & diluted): | | | | |
| Net income | $ 48,623 | $ 34,687 | $ 124,759 | $ 117,559 |
| Denominator: | | | | |
| Denominator for basic income per common share-weighted-average shares | 111,911 | 110,280 | 111,423 | 109,847 |
| Effect of stock options | 1,919 | 1,276 | 1,741 | 1,407 |
| Denominator for diluted income per common share-adjusted weighted-average shares and assumed conversion | 113,830 | 111,556 | 113,164 | 111,254 |
| Basic net income per common share | $ 0.43 | $ 0.31 | $ 1.12 | $ 1.07 |
| Net income per common share-assuming dilution | $ 0.42 | $ 0.31 | $ 1.10 | $ 1.06 |

7. Income Taxes

The Company's provision for income taxes for the third quarter of 2005 included a non-cash tax adjustment of $6.1 million in the quarter resulting from the favorable resolution of prior tax uncertainties. The tax benefit realized in the third quarter is nonrecurring and reflects the reversal of previously recorded income tax reserves related to a prior acquisition. In determining the quarterly provision for income taxes, the Company uses an estimated annual effective tax rate based on expected annual income by jurisdiction and statutory tax rates. The impact of significant discrete items, including the tax benefit realized in the third quarter of 2005, is separately recognized in the quarter in which they occur.

8. Recent Accounting Pronouncements

In November 2004, the FASB issued Statement of Financial Accounting Standards (SFAS) 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4.* The standard requires that abnormal amounts of idle capacity and spoilage costs should be excluded from the cost of inventory and expensed when incurred. The standard is effective for fiscal years beginning after June 15, 2005. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. SFAS No. 123R is a revision of SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes APB No. 25, *Accounting for Stock Issued to Employees*. Among other items, SFAS 123R eliminates the use of APB No. 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R is the first reporting period of the first fiscal year beginning on or after June 15, 2005, which is first quarter 2006 for calendar year companies, such as ourselves, although early adoption is allowed. SFAS 123R permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested

**O'REILLY AUTOMOTIVE, INC. AND SUBSIDIARIES**

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2005

8. Recent Accounting Pronouncements (continued)

awards granted prior to the effective date of SFAS 123R. Under the modified retrospective method, the requirements are the same as under the modified prospective method, but also permits entities to restate financial statements of previous periods based on pro forma disclosures made in accordance with SFAS 123. We currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a lattice model. We have not yet determined which model we will use to measure the fair value of employee stock options upon the adoption of SFAS 123R. See Note 8 of the Company s 2004 Form 10-K for further information. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amount of operating cash flows recognized in prior periods for such tax deductions, as shown in our Consolidated Statement of Cash Flows of the 2004 Form 10-K, were $4.5 million, $5.5 million, and $1.5 million, for the years ended December 31, 2004, 2003, and 2002, respectively. We currently expect to adopt SFAS 123R effective January 1, 2006; however, we have not yet determined which of the aforementioned adoption methods we will use and are still evaluating the standard. See Note 8 of the Company s 2004 Form 10-K for further information on our stock-based compensation plans.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

Unless otherwise indicated, "we," "us," "our" and similar terms, as well as references to the "Company" or "O'Reilly" refer to O'Reilly Automotive, Inc. and its subsidiaries.

***Critical Accounting Policies and Estimates***

The fundamental objective of financial reporting is to provide useful information that allows a reader to comprehend the business activities of our Company. To aid in that understanding, management has identified our critical accounting policies. These policies have the potential to have a more significant impact on our financial statements, either because of the significance of the financial statement item to which they relate, or because they require judgment and estimation due to the uncertainty involved in measuring, at a specific point in time, events which are continuous in nature.

**Cost of goods sold** Cost of goods sold includes warehouse and distribution expenses and estimates of amounts due from vendors for certain merchandise allowances and rebates. These estimates are consistent with historical experience.
**Operating, selling, general and administrative expense (OSG&A)** OSG&A expense includes estimates for medical, workers compensation and other general liability insurance obligations, which are partially based on estimates of certain claim costs and historical experience.
**Accounts receivable** Allowance for doubtful accounts is estimated based on historical loss ratios and consistently has been within management s expectations.
**Revenue** Over-the-counter retail sales are recorded when the customer takes possession of merchandise. Sales to professional installers, also referred to as commercial sales , are recorded upon delivery of merchandise to the customer, generally at the customer s place of business. Wholesale sales to other retailers, also referred to as jobber sales, are recorded upon shipment of merchandise. All sales are recorded net of estimated allowances and discounts.
**Vendor concessions** The Company receives concessions from its vendors through a variety of programs and arrangements, including co-operative advertising, allowances for warranties and volume purchase rebates. Co-operative advertising allowances that are incremental to our advertising program, specific to a product or event and identifiable for accounting purposes are reported as a reduction of advertising expense in the period in which the advertising occurred. All other vendor concessions are recognized as a reduction of cost of sales when recognized in the consolidated statement of income.
**Stock-based compensation** We have elected to use the intrinsic value method of accounting for stock options issued under our stock option plans and accordingly do not record an expense for such stock options. For purposes of pro forma disclosures under the fair value method, the estimated fair value of the options is amortized to expense over the options' vesting period. Our pro forma information for the periods ended September 30, is as follows:

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| | (In thousands, except per share data) | | | |
| Net income as reported | $ 48,623 | $ 34,687 | $ 124,759 | $ 117,559 |
| Stock-based compensation expense, net of tax, as reported | - | - | - | - |
| Stock-based compensation expense, net of | 1,620 | 3,559 | 5,040 | 9,646 |

| | | | | |
|---|---|---|---|---|
| tax, under fair value method | | | | |
| Pro forma net income | $ 47,003 | $ 31,128 | $ 119,719 | $ 107,913 |
| Pro forma basic net income per share | $ 0.42 | $ 0.28 | $ 1.07 | $ 0.98 |
| Pro forma net income per share- | | | | |
| assuming dilution | $ 0.41 | $ 0.28 | $ 1.06 | $ 0.97 |
| Earnings per share, as reported | | | | |
| Basic | $ 0.43 | $ 0.31 | $ 1.12 | $ 1.07 |
| Diluted | $ 0.42 | $ 0.31 | $ 1.10 | $ 1.06 |

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION (CONT.)**

***Recent Developments***

On May 31, 2005, the Company purchased all of the outstanding stock of W.E. Lahr Company and its subsidiary, Midwest Auto Parts Distributors, Inc. and combined affiliates ( Midwest ) for $63 million cash, net of cash acquired, including acquisition costs. Midwest is a specialty retailer, which supplies automotive aftermarket parts in Minnesota, Montana, North Dakota, South Dakota, Wisconsin and Wyoming. The acquisition was accounted for using the purchase method of accounting, and accordingly, the results of operations of Midwest are included in the consolidated statements of income from the date of acquisition. The purchase price was allocated preliminarily to assets acquired and liabilities assumed based on their estimated fair values on the date of acquisition with the excess allocated to goodwill. The acquisition of Midwest was not material for pro forma presentation requirements.

On May 20, 2005, the Company s Board of Directors declared a two-for-one stock split that was effected in the form of a 100% stock dividend payable to all shareholders of record as of May 31, 2005. The stock dividend was paid on June 15, 2005. Accordingly, this stock split has been recognized by reclassifying $559,000, the par value of the additional shares resulting from the split, from retained earnings to common stock.

All earnings per share information included in the accompanying consolidated financial statements has been restated to reflect the effect of the stock split for all periods presented.

***Results of Operations***

Product sales for the third quarter of 2005 were $542.9 million, an increase of $87.7 million or 19.3% over product sales for the third quarter of 2004. Product sales for the first nine months of 2005 were $1.5 billion, an increase of $236.7 million or 18.3% over product sales for the first nine months of 2004. These increases are due to the opening of 33 net, new stores during the third quarter of 2005 and 183 net, new stores during the first nine months of 2005, including 72 stores added due to the acquisition of Midwest. Increases in comparable store product sales(1) of 6.1% and 7.6% for the third quarter and first nine months of 2005, respectively, also contributed to the increase in product sales compared to the same periods in the prior year. At September 30, 2005, we operated 1,432 stores compared to 1,205 stores at September 30, 2004.

Gross profit increased 19.0% from $198.2 million (or 43.5% of product sales) in the third quarter of 2004 to $235.9 million (or 43.5% of product sales) in the third quarter of 2005. Gross profit for the first nine months increased 18.6% from $557.2 million (or 43.1% of product sales) in 2004 to $661.1 million (or 43.2% of product sales) in 2005. The increase in gross profit dollars is primarily a result of the increase in the number of stores open during the third quarter and first nine months of 2005 compared to the same periods in 2004, and increased sales levels at existing stores. The increase in gross profit as a percentage of product sales for the first nine months of 2005 compared to 2004, is primarily due to a reduction in the cost of merchandise from vendors and a reduction in warehouse and delivery expenses as a percentage of product sales.

Operating, selling, general and administrative expenses ( OSG&A expenses ) increased $26.3 million from $142.0 million (or 31.2% of product sales) in the third quarter of 2004 to $168.3 million (or 31.0% of product sales) in the third quarter of 2005. OSG&A expenses increased $69.0 million from $402.8 million (or 31.1% of product sales) in the first nine months of 2004 to $471.8 million (or 30.8% of product sales) in the first nine months of 2005. The dollar increase in OSG&A expenses resulted from the addition of team members and resources in order to support the increased level of our operations.

Other expense decreased by $0.2 million in the third quarter of 2005 compared to the third quarter of 2004 and decreased by $0.6 million for the first nine months of 2005 compared to the first nine months of 2004. The decreases in both periods being compared were primarily due to decreases in interest expense as a result of lower borrowings under our credit facility.

(1) Comparable store product sales are calculated based on the change in product sales of stores open at least one year. Percentage increase in comparable store product sales is calculated based on store sales results, which exclude sales of specialty machinery, sales by outside salesmen and sales to employees.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION (CONT.)**

***Results of Operations (continued)***

Our estimated provision for income taxes decreased $2.3 million for the third quarter of 2005 compared to the same period in 2004, as a result of the favorable resolution of prior tax uncertainties partially offset by the effect of increased taxable income in the third quarter of 2005. Our estimated provision for income taxes increased $6.4 million for the first nine months of 2005 compared to the same period in 2004, as a result of increased taxable income for the first nine months, partially offset by the resolution of prior tax uncertainties in the third quarter of 2005. The tax benefit realized in the third quarter of 2005 is nonrecurring and reflects the reversal of previously recorded income tax reserves of $6.1 million related to a prior acquisition. Our effective tax rate was 27.5% and 33.7% of income before income taxes for the third quarter and first nine months of 2005, respectively, compared with 37.3% and 37.4% for the third quarter and first nine months of 2004, respectively.

Principally, as a result of the foregoing, net income increased from $34.7 million (or 7.6% of product sales) in the third quarter of 2004 to $48.6 million (or 9.0% of product sales) in the third quarter of 2005. Net income increased from $117.6 million (or 9.1% of product sales) in the first nine months of 2004 to $124.8 million (or 8.2% of product sales) in the first nine months of 2005. The decrease in net income as a percentage of product sales in the first nine months of 2005 compared to the same period in 2004 is the result of the cumulative effect of accounting change of $21.9 million in the first quarter of 2004.

***Liquidity and Capital Resources***

Net cash provided by operating activities decreased from $197.6 million for the first nine months of 2004 to $183.1 million for the first nine months of 2005. During 2004, we negotiated extended payment terms with many suppliers, which resulted in a large increase in accounts payable. The decrease in cash provided by operating activities for 2005 from 2004 was primarily due to a smaller increase in accounts payable.

Net cash used in investing activities increased from $124.6 million during the first nine months in 2004 to $214.5 million for the comparable period in 2005, primarily due to the acquisition of Midwest and increased purchases of property and equipment resulting from new store growth in 2005.

Net cash provided by financing activities was $14.0 million in the first nine months of 2005, compared to using $10.5 million in the first nine months of 2004. The increase in net cash provided by financing activities is primarily due to lower repayments of long-term debt in 2005.

We have available an unsecured, five-year syndicated revolving credit facility in the amount of $100 million (the Credit Facility ). The Credit Facility was guaranteed by all of our subsidiaries and may be increased to a total of $200 million, subject to availability of such additional credit from either existing banks within the syndicate or other banks. At September 30, 2005, none of the Credit Facility was outstanding. Letters of credit totaling $26.1 million were outstanding at September 30, 2005. Accordingly, we had aggregate availability for additional borrowings of $73.9 million under the Credit Facility. The Credit Facility, which bears interest at LIBOR plus a spread ranging from 0.50% to 1.00% (3.86% at

September 30, 2005) is to expire in July 2010.

In May 2006, $75 million of our private placement notes become due. We anticipate repaying these notes with cash expected to be provided by operating activities or a combination of such cash and available borrowing capacity under our revolving credit facility.

Our continuing store expansion program requires significant capital expenditures and working capital principally for inventory requirements. The costs associated with the opening of a new store (including the cost of land acquisition, improvements, fixtures, inventory and computer equipment) are estimated to average approximately $900,000 to $1.1 million; however, such costs may be significantly reduced where we lease, rather than purchase, the store site. Although the cost to acquire the business of an independently owned parts store varies, depending primarily upon the amount of inventory and the amount, if any, of real estate being acquired, we estimate that the average cost to acquire such a business and convert it to one of our stores is approximately $400,000, exclusive of the cost of inventory. We plan to finance our expansion program through cash expected to be provided from operating activities and available borrowings under our existing credit facilities.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION (CONT.)**

***Liquidity and Capital Resources (continued)***

During the first nine months of 2005, 183 net, new stores were opened. The Company plans to open 39 additional stores during the remainder of 2005. The funds required for such planned expansions are expected to be provided by operating activities and the existing and available bank credit facilities.

We believe that our existing cash and cash equivalents, cash expected to be provided by operating activities, available bank credit facilities and trade credit will be sufficient to fund both our short-term and long-term capital and liquidity needs for the foreseeable future.

***Off Balance Sheet Arrangements***

We have utilized various financial instruments from time to time as sources of cash when such instruments provided a cost effective alternative to our existing sources of cash. We do not believe, however, that we are dependent on the availability of these instruments to fund our working capital requirements or our growth plans.

On December 29, 2000, we completed a sale-leaseback transaction. Under the terms of the transaction, we sold 90 properties, including land, buildings and improvements, which generated $52.3 million of additional cash. The lease, which is being accounted for as an operating lease, provides for an initial lease term of 21 years and may be extended for one initial ten-year period and two additional successive periods of five years each. The resulting gain of $4.5 million has been deferred and is being amortized over the initial lease term. Net rent expense during the initial term will be approximately $5.5 million annually.

In August 2001, we completed a sale-leaseback with O Reilly-Wooten 2000 LLC (an entity owned by certain shareholders of the Company). The transaction involved the sale and leaseback of nine O Reilly Auto Parts stores and resulted in approximately $5.6 million of additional cash to the Company. The transaction did not result in a material gain or loss. The lease, which has been accounted for as an operating lease, calls for an initial term of 15 years with three five-year renewal options.

On June 26, 2003, we completed an amended and restated master agreement to our $50 million Synthetic Operating Lease Facility, relating to our properties leased from SunTrust Equity Funding, LLC (the Synthetic Lease ), with a group of financial institutions. The terms of the Synthetic Lease provide for an initial lease period of five years, a residual value guarantee of approximately $43.2 million at September 30, 2005, and purchase options on the properties. The Synthetic Lease also contains a provision for an event of default whereby the lessor, among other things, may require us to purchase any or all of the properties. One additional renewal period of five years may be requested from the lessor, although the lessor is not obligated to grant such renewal. The Synthetic Lease has been accounted for as an operating lease under the provisions of FASB SFAS No. 13 and related interpretations, including FASB Interpretation No. 46.

We issue stand-by letters of credit provided by a $50 million sublimit under the Credit Facility that reduce our available borrowings. These letters of credit are issued primarily to satisfy the requirements of workers compensation, general liability and other insurance policies. Substantially all of the outstanding letters of credit have a one-year term from the date of issuance and have been issued to replace surety bonds that were previously issued. Letters of credit totaling $26.1 million and $18.6 million were outstanding at September 30, 2005 and 2004, respectively.

***New Accounting Standards***

In November 2004, the FASB issued SFAS 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4.* The standard requires that abnormal amounts of idle capacity and spoilage costs should be excluded from the cost of inventory and expensed when incurred. The standard is effective for fiscal years beginning after June 15, 2005. We do not expect the adoption of this standard to have a material effect on our financial position, results of operations or cash flows.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION (CONT.)**

***New Accounting Standards (continued)***

In December 2004, the FASB issued SFAS No. 123R, *Share-Based Payment*. SFAS No. 123R is a revision of SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes APB No. 25, *Accounting for Stock Issued to Employees*. Among other items, SFAS 123R eliminates the use of APB No. 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. The effective date of SFAS 123R is the first reporting period of the first fiscal year beginning on or after June 15, 2005, which is first quarter 2006 for calendar year companies, such as ourselves, although early adoption is allowed. SFAS 123R permits companies to adopt its requirements using either a modified prospective method, or a modified retrospective method. Under the modified prospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. Under the modified retrospective method, the requirements are the same as under the modified prospective method, but also permits entities to restate financial statements of previous periods based on pro forma disclosures made in accordance with SFAS 123. We currently utilize a standard option pricing model (i.e., Black-Scholes) to measure the fair value of stock options granted to employees. While SFAS 123R permits entities to continue to use such a model, the standard also permits the use of a lattice model. We have not yet determined which model we will use to measure the fair value of employee stock options upon the adoption of SFAS 123R. See Note 8 of the Company s Annual Report on Form 10-K for the year ended December 31, 2004 ( 2004 Form 10-K ) for further information. SFAS 123R also requires that the benefits associated with the tax deductions in excess of recognized compensation cost be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after the effective date. These future amounts cannot be estimated, because they depend on, among other things, when employees exercise stock options. However, the amount of operating cash flows recognized in prior periods for such excess tax deductions, as shown in our Consolidated Statement of Cash Flows of the 2004 Form 10-K, were $4.5 million, $5.5 million, and $1.5 million, for the years ended December 31, 2004, 2003, and 2002, respectively. We currently expect to adopt SFAS 123R effective January 1, 2006; however, we have not yet determined which of the aforementioned adoption methods we will use and are still evaluating the standard. See Note 8 of the Company s 2004 Form 10-K for further information on our stock-based compensation plans.

***Inflation and Seasonality***

We have been successful, in many cases, in reducing the effects of merchandise cost increases principally by taking advantage of vendor incentive programs, economies of scale resulting from increased volume of purchases and selective forward buying. As a result, we do not believe our operations have been materially affected by inflation.

Our business is seasonal to some extent primarily as a result of the impact of weather conditions on store sales. Store sales and profits have historically been higher in the second and third quarters (April through September) of each year than in the first and fourth quarters.

***Internet Address and Access to SEC Filings***

Our Internet address is www.oreillyauto.com. Interested readers can access the Company s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, through the Securities and Exchange Commission website, www.sec.gov. Such reports are generally available on the day they are filed. Additionally, the Company will furnish interested readers upon request and free of charge, a paper copy of such reports. Written requests for paper copies may be sent to our Corporate Secretary at O Reilly Automotive, Inc., 233 South Patterson, Springfield, Missouri 65802.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF**

**RESULTS OF OPERATIONS AND FINANCIAL CONDITION (CONT.)**

***Forward-Looking Statements***

We claim the protection of the safe-harbor for forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. You can identify these statements by forward-looking words such as expect, believe, anticipate, good, plan, intend, estimate, p or similar words. In addition, statements contained within this filing that are not historical facts are forward-looking statements, such as statements discussing among other things, expected growth, store development and expansion strategy, business strategies, future revenues and future performance. These forward-looking statements are based on estimates, projections, beliefs and assumptions and are not guarantees of future events and results. Such statements are subject to risks, uncertainties and assumptions, including, but not limited to, competition, product demand, the market for auto parts, the economy in general, inflation, consumer debt levels, governmental approvals, our ability to hire and retain qualified employees, risks associated with the integration of acquired businesses, weather, terrorist activities, war and the threat of war. Actual results may materially differ from anticipated results described or implied in these forward-looking statements. Please refer to Exhibit 99.1 of this Form 10-Q, for additional factors that could materially affect our financial performance.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are subject to interest rate risk to the extent we borrow against our revolving credit facility with variable interest rates. Since no amounts were outstanding under the revolving credit facility at September 30, 2005, changes in interest rates would not have any effect. In the event of an adverse change in interest rates and assuming the Company had amounts outstanding under the credit facility, management would likely take actions that would mitigate our exposure to interest rate risk particularly if our borrowing levels increase to any significant extent; however, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effects of the change in the level of overall economic activity that could exist in such an environment.

**ITEM 4. CONTROLS AND PROCEDURES**

Management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has reviewed and evaluated the effectiveness of our disclosure controls and procedures as required by Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of September 30, 2005. Based on such review and evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of September 30, 2005, to ensure that the information required to be disclosed by the Company in the reports that we file or submit under the Exchange Act (a) is recorded, processed, summarized and reported within the time period specified in the Securities and Exchange Commission s rules and forms and (b) is accumulated and communicated to the Company's management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. There were no material changes in our internal control over financial reporting during the quarter ended September 30, 2005, that have materially affected, or are reasonably likely to materially affect, internal controls over financial reporting.

**PART II - OTHER INFORMATION**

**ITEM 6. EXHIBITS**

Exhibits:

| Number | Description | Page |
|---|---|---|
| 10.35 | Credit Agreement, filed herewith. | 17 |
| 31.1 | Certificate of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith. | 68 |