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LKQ Corp. (LKQ)

Business Update Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for joining LKQ Corporation's European Segment Update Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer-session. [Operator Instructions]

Thank you. Joseph Boutross, LKQ's Vice President of Investor Relations, you may begin your conference.

Joseph P. Boutross
Vice President, Investor Relations, LKQ Corp.

Thank you, operator. Good morning, everyone, and thank you for joining us for an update on our European segment. On the call with me today are Nick Zarcone, Varun Laroyia, and Arnd Franz. Please refer to the LKQ website at lkqcorp.com for the accompanying slide presentation for this call.

Today, we have a number of prepared remarks by Nick, Varun, and Arnd and then we will open the call to questions. I'll remind you that we are in the middle of our third quarter and I kindly ask that you limit your questions specifically to our European segment and to today's prepared comments and presentation.

Now, let me quickly cover the Safe Harbor. Some of the statements that we make today may be considered forward-looking. These include statements regarding our expectations, beliefs, hopes, intentions or strategies. Actual events or results may differ materially from those expressed or implied in the forward-looking statements as a result of various factors. We assume no obligation to update any forward-looking statements. For more information, please refer to the Risk Factors discussed in our Form 10-K and subsequent reports filed with the SEC.

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And, with that, I am happy to turn the call over to our CEO, Mr. Nick Zarcone.

Dominick P. Zarcone

President, Chief Executive Officer & Director, LKQ Corp.

Thanks, Joe, and good day to everybody on the call. Our European business has evolved materially over the past few years and during our May 2018 Analyst Day, we highlighted a series of key initiatives that we believe will help improve our European margins. We thought it timely to provide an update on those key initiatives and also discuss some new important activities that will fundamentally transform how we operate the business, a project we are calling 1 LKQ Europe. Rather than try and jam that discussion into our quarterly earnings announcement, we thought it better to have a separate, more detailed discussion with you, so we appreciate your time and attention today.

I will provide some historical perspectives to level set the discussion. Arnd Franz will walk us through how we plan to drive our margins over the next few years, and then Varun Laroyia will highlight the key investments required to make this happen and how we will fund those activities.

I always start our presentations with our mission statement, which is set forth on slide 4. In the end, everything we do is aligned with achieving the words on this page, to become the leading global distributor of vehicle parts and accessories and to effectively serve three key constituencies: our customers; the 51,000 employees who bring the mission to life; and the approximately 1,700 communities around the world in which we operate. We started our European expansion in October 2011 when we acquired Euro Car Parts and since then have broadened our geographic reach through the acquisition of several other market-leading companies.

As illustrated on slide 5, today we are, by a wide margin, the largest, most profitable distributor of automotive parts in Europe, with metrics that are unparalleled in the industry with respect to the number of countries and customers served, number of locations operated, SKUs offered and total revenue generated. There simply is no other company like LKQ Europe and we believe our position is and will continue to be a meaningful competitive advantage.

While we have been quite successful in creating a unique platform that cannot be replicated, when building the platform through more than 70 acquisitions over 8 years, no one should be surprised that today we have an overly complex organization. As highlighted on slide 6, today we have multitudes of everything, including IT systems, private label brands, customer portals, product catalogs and infrastructure systems. Perhaps, most importantly, our procurement activities and product assortment strategies are fairly fragmented, and that creates a significant opportunity for us to simplify the business to provide an even better customer experience, create a stronger, more streamlined competitive position, and enable us to more fully realize the potential benefits from our size and scale.

To help us think through the best way to optimize the business and create a road map for migrating from where we are today to the future state, we engaged a third-party consulting firm to work alongside our European business leaders and our corporate strategy team. During the first and second quarter of this year, we created a design for a sleeker, more agile organization, which internally we refer to as 1 LKQ Europe. Simply stated, going forward, we will begin to operate more as a single business as opposed to a collection of independent businesses.

Under 1 LKQ Europe, some things will absolutely remain the same, while other activities will need to transform over time. What stays the same? While we operate in 21 different countries, we are really a local business. The customers in Brussels only care about the service they receive locally and really are unaffected by our operations

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in Birmingham or Berlin or Budapest. Since the customer sits at the center of everything we do, the customer experience will remain in the hands of our local managers and service personnel. But there are many activities and support systems that have nothing to do with the customer interaction and that's where we can simplify the business through a more centralized approach.

With respect to certain matters, decision making and execution will be managed on a more consistent pan-European basis as opposed to a market by market basis. It has become clear that the time to start this journey is now. We were very successful with this strategy in the build-out of our North American segment where we effectively created 1 LKQ North America and were able to maintain the entrepreneurial and local nature of our operations, while benefiting from the simplicity and scale of doing things the same across the platform. Now, we plan on doing it again in Europe.

This will be a multiyear process and will require a reorganization of our non-customer-facing teams and support systems. In order to operate in a more centralized manner, over time, we will also need to build some enablers that don't exist today, including, among other items, a small European headquarters office, a common ERP platform and a rationalized product portfolio. The establishment of a central office will likely be 2020 event. And based on our detailed analysis to date, we will likely locate the office in the Greater Zurich, Switzerland area with about 70 people. We will look to primarily staff them within and utilize the great talent from our local teams, which has the benefit of providing a whole new set of career options wherein our people can assume a broader Pan-European slate of responsibilities.

The ERP migration was started in Q4 of last year and will take more than five years to complete, as we will minimize the project risk by converting a single platform at a time as opposed to flipping the switch on the entire European organization simultaneously. Arnd will mention the work that has been started on rationalizing the product line.

Over the next couple of years, we will be deploying cash to assist in the migration and development of the enabling infrastructure. Importantly, there are three key types of outlays: transformation cost, restructuring cost, and capital expenditures. Varun highlighted some of these outlays in our Q2 earnings call and he will provide more transparency as to both the longer-term estimates and how we intend to finance these expenditures later in this presentation.

As mentioned, we first discussed our European margin improvement plans in May 2018 and I will now bring you current as to how some of those initiatives are playing out before Arnd and Varun will discuss the future. So, let's turn to slide 7. We start with Q1 2018, as that was the most recent set of quarterly results prior to the May 2018 Analyst Day presentation. As noted, our European segment EBITDA margin in Q1 2018 was 7.3%. This level was lower than our historical average and, as you will recall, reflected some of the issues incurred while starting up our new distribution center in Tamworth, England, which we referred to as T2.

So, what's happened over the past 18 months? Many of the profit improvement initiatives identified during the Analyst Day presentation in May 2018 have begun to be realized, including benefits related to lower national distribution cost in the UK including the stabilization of T2, improved performance of Andrew Page, some initial benefits from our procurement and standardized catalogue projects, and a variety of smaller initiatives.

Collectively, these items have improved our margins by 190 basis points. What we did not anticipate in May 2018 was the negative impact the broad European economic downturn was going to have on our industry, which we estimate impacted our EBITDA margins by approximately 50 basis points; also, the impact of one fewer working day in the second quarter of this year, which resulted in a 40 basis point decline in margins.

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Still, on an apples-to-apples basis, before transformation cost, EBITDA margins in Q2 2019 were 8.3%, reflecting a 100 basis point improvement when compared to Q1 2018. The transformation cost during the second quarter, which primarily related to design work on the new ERP platform, totaled approximately 30 basis points.

Stahlgruber, which was not included in the Q1 2018 results, had a 20 basis point negative impact on the consolidated European margins during the second quarter. Including those two items, reported EBITDA margins in the second quarter of 2019 were 7.7%, a 40 basis point improvement compared to Q1 2018. We are clearly making progress, but still have a way to go to reach our full potential.

And, finally, earlier this year we announced that Arnd Franz had joined the European leadership team as Chief Operating Officer. And a few weeks ago, as part of a thoughtful succession planning process, we announced that Arnd will become CEO of our European operations at the end of this month.

As noted on slide 8, Arnd has spent most of his career in the European automotive parts industry, including 18 years at the MAHLE Group, a large German-based supplier of parts to both the automotive OEMs and the independent aftermarket. We are delighted to have someone with Arnd's significant operating experience on our team as he brings a unique perspective to our organization.

As a senior leader of an OEM supplier, Arnd understands both the need to continuously drive cost out of the system and the operating discipline and rigor required to make operational processes repeatable and scalable. I am very confident in his ability to utilize those skill sets at LKQ. Almost six months into his LKQ career, we have asked Arnd to share some of his initial observations and discuss our plans to continue to improve the relative profitability of our European operations.

At this time, I would like to publicly thank John Quinn for his 10 years of dedicated service to LKQ, including spending the last five years leading the European operation through a time of unprecedented growth and expansion, as we have tripled the size of the business during his tenure. John, we wish you all the best for a fun and healthy retirement.

And I will now turn the floor over to Arnd.

Arnd Franz

Chief Operating Officer-LKQ Europe, LKQ Corp.

Thank you, Nick, for your kind introduction. First of all, I would like to say that it is a great pleasure for me to join you and Varun today here on this call. We have an exciting story to tell, and I would like to start by sharing my initial observations having joined LKQ about 150 days ago after spending 20 years in the automotive industry.

Please turn to slide 9 and let's start with a look at what LKQ has accomplished so far in Europe, which in my opinion is one of the most competitive automotive markets with high complexity and high entry hurdles. The LKQ team has created a unique growth story by acquiring the market leaders in many of the large markets. Although most of these markets have been surprisingly slow this year, which has also affected LKQ, the company has been able to withstand this trend better than our competition and, therefore, gain share.

LKQ's procurement activities have already generated some initial synergies and are promising more to come. Our product management efforts have defined hundreds of activities to streamline our product portfolio and we have started their implementation. With these and more things happening, we have been able to maintain the strong

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entrepreneurial culture that made our European distributor brands leaders in their market with day in, day out focus on the needs of our customers.

Importantly, LKQ knows we need the right tools to take this business to the next level. So, when the key enablers for the future are already in flight, even if we still utilize a variety of IT systems, our big data initiative has successfully completed pilot projects with algorithms that are telling us how we can better meet our customers' expectations in price positioning and availability.

We also have very experienced and success-proven teams with clear rollout plans to bring our operations on common ERP and cataloging systems. We are convinced that LKQ will be a leader in the future digital marketplace, not only for repair and service parts, but for many services around our customers' automobiles, taking our local solutions of today on a European level and adding more exciting technology as we go.

But what's next? After making many successful acquisitions, it's time to integrate. Our teams are convinced they are part of a fascinating story as we become 1 LKQ Europe. We will set free energies and synergies that are only possible with the volumes and the capabilities of an organization of our size. We believe we will not only be a leader in size and geographical reach, but especially in the way we can shape key value drivers for the aftermarket of the future. Over the next two years, we will dramatically leverage our scale in the way we do procurement and how we run our operations with a consistent execution of our plan and initiatives. But let's take a closer look at some of those.

When you look at some of our main initiatives in a simplified way, as set forth on page 10, one of the key themes is the reduction of the complexity how we run this business today, pretty much coming from the variety of acquisitions. We will stop having hundreds of supplier negotiations and start having highly effective state-of-the-art sourcing processes. We will reduce the number of our private label brands and will push a carefully selected number of great brands with exceptional quality and market reputation and great value. We will run intelligent customer behavior logics to be close to the minds of our customers when they make buying decisions. And we will take out more than 20 ERP systems today and replace them with one platform to make data directly accessible and processable throughout our organization.

You will notice that our private label initiative for our LKQ product brands will be one of our most important initiatives. We expect that the majority of LKQ's organic growth will come from our LKQ product brands, which will be promoted through our strong distribution footprint, from chassis to oils to power train to electrical components. The LKQ brands stand for high quality and an excellent value proposition. They are the leaders in their home markets and we expect them to become leaders across Europe.

These initiatives will develop unparalleled dynamics using the unique scale of LKQ in Europe. Although our market share is still in the single digits in a highly fragmented European market, we are nearly three times bigger than the second largest competitor. Our procurement volumes in the relevant categories are absolutely comparable to the aftermarket volumes of the large European OEMs, in many cases higher. We will utilize this opportunity to create value for our customers and our shareholders. But we believe that also our employees and our suppliers and the communities we work in will see great benefits from our initiatives as we will become a more attractive and known partner for all of them.

I'd now like to turn to the key topic of today's session, how are we going to drive our margins over the next few years and for that, please turn your attention to slide 11. As you know from our review of LKQ's second quarter results, 2019 has been a challenging year with soft markets across Europe. Nevertheless, we currently anticipate a full year EBITDA margin of 7.8% to 8.3% on a reported basis, which equates to a range of 8% to 8.5%,

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excluding transformation costs. We believe our key initiatives efforts will add 190 to 220 basis points of margin by 2021. I will provide more detail on that in a minute.

We will also benefit from our asset rationalization program, which includes the divestiture of low-margin and non-core businesses. We believe these businesses will perform better as part of a strong local player or a strategic player in fields where we do not do business otherwise. We anticipate that our organic revenue growth will return to a positive range of 1.5% to 2.5% during the planning period. Achieving the lower end should allow us to more than offset a normal inflationary pressure on margins due to rising wages, freight costs, fuel prices and other expenses. At the upper end, we believe we can get operating leverage of 60 basis points, essentially recouping the operating leverage lost in 2019. I will address this in more detail in a few minutes.

So, in total, by 2021, our European EBITDA margins should reach a range of 10.3% to 11.7%, excluding the impact of cost directly related to the transformation. Our reported margins, which will include these expenses, are expected to range from 9.5% to 11.1%. Keep in mind these types of transformation costs will accompany us for the duration of forming 1 LKQ Europe, but will eventually go away. The years until 2021 will not only carry the majority of the transformation and integration burden, but also show only part of the benefits. Initiatives with longer lead times like further centralization, digitalization, and shared services only become materially effective after 2021. That is why we believe we can add another 50 or even 100 basis point of margin after the 2021 timeframe.

Let's move to slide 12 and take a closer look at the impact of our initiatives. When isolating the longer-term sustainable impact of our initiatives, it becomes transparent that procurement, product strategy, and revenue optimization are the biggest value drivers for LKQ Europe, as they collectively are expected to deliver over $130 million of additional EBITDA compared to 2019. We have added a contingency to all of these initiatives that reflects the maturity of the measures, including what already is in the bag, in other words, contractually agreed. It is important to understand that under each of these broad banners are dozens and dozens of individual work streams that will bring our operations together on a standard operating model.

There is also a series of local activities such as the ongoing optimization of T2 and integration of Andrew Page, as well as a variety of specific and important initiatives to adjust our distribution to changing customer requirements and integrate previous acquisitions that should have a positive impact on the margin structure of the business. Underpinning the benefits of the key margin enhancement initiatives is a basic assumption that we will return to low-single-digit revenue growth. While 2019 has been soft, we believe the market dynamics will support a return to positive revenue growth in 2020 and beyond.

LKQ has taken the leading position in the largest automotive aftermarket in the world, Europe. Even if we only consider the European Union, there are more than 280 million vehicles and the car park continues to grow. Not only is Eastern Europe increasing its vehicle density, but also Western European consumers continue to buy more cars. In addition, vehicles become older and older, on average, which has supported growth in the independent aftermarket.

As noted on slide 13, the growth rate in the five years from 2013 to 2017 for the overall size of the car park and for the average vehicle age was 2.0% and 1.4%, respectively. Taken into account opposing factors like the decline in miles driven and especially in recent periods the migration of diesel vehicles out of the Western European market, we still expect an organic growth rate of 1.5%, not taken into account gain of market shares. With some potential recovery from the sluggish market in 2019 and slowdown of some of the mentioned opposing trends and LKQ share gains, we may also see stronger growth rates of 2.5%, resulting in the already described potential upsides on EBITDA.

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Slide 14 sets forth the cadence of how we anticipate European segment EBITDA margins will improve over time. Our expectation is a 70 to 90 basis point improvement into 2020 and another 100 to 190 basis points into 2021, mainly driven by our revenue optimization and product strategy, delivering additional results on top of already strong performing local initiatives.

And those increases are after taking into account higher levels of transformation costs. It is apparent that the disciplined execution of these initiatives will be key to delivering this plan. Our team has high confidence in its success and we have taken precautions in cases where there are more uncertainties. The remaining factor out of our control remains the market development and consumer behavior. So, let's discuss this.

Again, one of the biggest risk to the margin progression is revenue growth. While we believe the 1.5% to 2.5% expectation is reasonable, a continued longer-term economic downturn across Europe will weigh on our results. And we have assumed there are no material changes to demand arising out of the Brexit situation, recognizing that it is a fluid situation which changes day by day.

With that, I will turn to Varun for a discussion regarding the cash required to effect these changes and how we will finance the outlays.

Varun Laroyia

Chief Financial Officer & Executive Vice President, LKQ Corp.

Thank you, Arnd, for your thoughts on the business and the exciting initiatives underway at LKQ Europe. It's great to have another operating lead in the management team, as we execute on the European plan with operational rigor and discipline.

Over the next few minutes, I'd like to share two key aspects related to cash flows. One, investments associated with the 1 LKQ program; and two, initiatives underway to fund these investments. Please turn to page 15 of the presentation. On the left-hand side panel, we've laid out the expected cash outlays associated with the 1 LKQ program, including the split between OpEx, CapEx, and the restructuring required to complete the program.

In addition to the 2019 cash outlay that we have covered with our existing cash flow guidance for the year, we anticipate a further $110 million to $130 million split between 2020 and 2021. Year to date in 2019, the European segment EBITDA has been impacted by approximately 20 basis points and the transformation cost impact will tick up in the next two years. We expect the benefits of certain initiatives to provide a small offset in the early years of the program.

In addition, there is a further $80 million to $100 million in cash outlay for the period 2022 through 2024, specifically associated with long cycle, multiyear programs such as the European ERP initiative. Please note that we have not and do not intend to change the definition of our segment EBITDA, and so each quarter we will call out the headwinds associated with the program-related OpEx to give transparency into the core underlying margins, as these costs will eventually transition out.

Please turn to slide 16 of the presentation for details associated with funding of the 1 LKQ Europe program. As you may recall, while we have pushed hard on improving the enterprise free cash flow in 2018 and delivered a very healthy uptick in the second half, it was in 2019 when the formal program was pushed across all three operating segments and is a key metric included in the annual management incentive program.

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For the European segment, specifically, understanding the areas where opportunities lay, the program has focused on the following parameters associated with delivering solid and increasing operating cash flow. One, supplier payment terms normalization, including a vendor financing program; two, stock level rationalization, and we've seen some of that benefit in the current fiscal year; three, an improved supply chain approach, for example, through category management; and fourth, the focus on past due receivables. Our current expectation is that the 1 LKQ Europe program will be entirely funded by the improved trade working capital performance within Europe.

And finally, an update on the European vendor financing program. The segment's annual direct spend is approximately $3.6 billion spread across roughly 1,800 suppliers with an annualized spend greater than $23,000. The top 40 suppliers, essentially our key strategic partners, represent 60% of the spend I just referenced, or about $2.2 billion.

Earlier this year, we formally launched the program in Europe and ran two parallel work streams: one, initiated discussions with key strategic partners, the top 40 specifically, in order to extend payment terms in line with market convention that they have for their customers of similar spend globally; and in parallel, two, secured financing partners in key markets such as Germany, Italy and the United Kingdom. By the end of July, we have completed meetings with suppliers representing 80-plus percent of the spend in scope.

Preliminary feedback, including suppliers that have already signed up to the program, is largely positive. Some have decided to take up the vendor financing option, while others have provided us with the extended payment terms. Our intention is to secure longer payment terms that will generate over $200 million in incremental operating cash flow from the European segment by the end of 2021.

Now, before I turn the call back to Nick, I wanted to note that this is more segment detail than we typically provide on our quarterly earnings call. We will provide the next major update at this level of detail on the European program at our Investor Day in the summer of 2020.

With that, I will turn the call back to Nick to share feedback that we received from our key stakeholders, our strategic vendor partners, and the customers that we serve each day. Nick, over to you.

Dominick P. Zarcone

President, Chief Executive Officer & Director, LKQ Corp.

Thanks, Varun. Hopefully, you can now appreciate why we are so excited about the future of our European business. The opportunity to create shareholder value is significant, and we believe we have the strategy and operating programs to make it come to fruition over the next few years. Perhaps, most importantly, behind Arnd we have a deep and experienced team of management talent across the European segment who will be working hard over the next few years to execute on the various work streams outlined herein. I am confident in their ability to achieve the results we've discussed with you today.

I mentioned that LKQ Europe reflects a unique entity that cannot be replicated. In closing, I would direct your attention to slides 17 through 19 of the presentation, which includes some commentary from a few suppliers and customers alike that reinforce the promise that we have built something special and have a European platform that is truly differentiated from our competitors.

And, with that, operator, we are ready to turn the call over to questions.

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QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Michael Hoffman with Stifel, your line is open.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Hi. Thank you for taking the questions. So, Arnd, welcome to your new role. So, you introduced an interesting concept about a risk related to rev on something you couldn't control, which is the macro. So, how do you feel about the EU's plan to go from 119 grams of CO2 to 95 for the auto sector and the reliance on EV to accomplish that? And those cars don't make money, so the EU is basically putting the auto cycle into a secular downturn, while it struggles to comply with this. What's the implications of that to the strategy?

Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Well, thank you, Michael, for this question that has obviously kept the automotive industry busy for a while. Since CO2 was identified as a major threat to the global climate, of course, it has affected the product portfolios of the OEMs who are supposed to comply with those standards by 2021 and then onwards into 2025 and 2030.

Of course, it's a huge challenge and there are different answers to that question, battery electric vehicles, hybrid vehicles. But the real question for LKQ is how will this affect the aftermarket. Short term, we believe that with some of the decline in volumes of new produced vehicles, so we will see an increase in the average age of the European vehicle park in a stronger way than we've seen in the past year. So, we will have more older cars on the aftermarket because there's less newer cars in the market.

Long term, we will have to understand how we can serve the hybrid and the electrical vehicles going into the second half of the next decade and maybe even a little bit earlier. I am strongly convinced that our teams in the field are well prepared to train the workshops in Europe on how to service hybrid vehicles and how to service electric vehicles.

But there will also be different impacts on our revenue because obviously a battery electric vehicle will have less wear and tear than a combustion engine-driven vehicle, whereas the hybrid vehicle that has both trends – both types of motors onboard will result in a higher wear and tear and higher service needs. But that's early days, so we will have to find out and we will have to make sure that we don't invest money too late, but especially that we don't invest a lot of money too early, which is obviously a big challenge for the automotive OEMs at the moment trying to cope with those regulatory requirements.

Operator: Craig Kennison with Baird, your line is open.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.

Q

Good morning. Thank you for taking my question, and thanks for hosting this call. Question on private label, what is your mix of private label in Europe today and where could that metric go over time?

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Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Yeah. This is Arnd speaking. Thank you for that question. I mentioned that private label or, as we called it, LKQ product brands will be a key driver for our growth in the future. So, we believe and we will work towards a change in the mix of what we sell today versus what we will sell in the future. This will be especially a key margin driver for LKQ in Europe. And so, today our private label sales are between 10% and 20% of our overall sales. And we are looking forward to doubling that number in the next five to seven years.

Operator: Daniel Imbro with Stephens, Inc., your line is open.

Daniel Imbro
Analyst, Stephens, Inc.

Q

Yes. Thanks for taking the questions. Arnd, I guess sort of high level, you were in the industry kind of during the last Great Recession in Europe. Can you just shed some color around what you saw through that cycle, maybe how this downturn has been different? And then, as we look at the margin bridge on page 11, you guys called out the 10 to 60 bps from organic growth of expansion. If we saw the macro remain challenged and growth remains at these lower levels, should we think about that as the "market risk" in this new margin bridge you've given? Thanks.

Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Yeah. Thank you, Daniel. The experience, of course, goes back into a little bit different scenario compared what we can expect for today and tomorrow, because the last big downturn was 2008 and 2009 when we pretty much saw a global impact with very few exceptions in some parts of Asia and South America. But what happened then when you compare the OEM versus the aftermarket was while the OEM was substantially down, we saw a much more dampened impact on the aftermarket. And that's pretty much the same on the heavy-duty business as well as on the more relevant light vehicle business, which characterizes most of our LKQ European business. And I would say that the impact from a downturn on the aftermarket may be between 50% and 80% lower than on the OEM business.

But please keep in mind, situations are different. The current situation is more like a cyclical and partially a technological downturn that's characterized by the uncertainty with the consumers. And in 2008 and 2009, we had a more financially driven situation. But still I would still say that for the aftermarket, the impact from a downturn is a lot lower than on the production of new vehicles, because mainly it's consumer behavior and postponing repair and maintenance to the extent possible when people are trying to protect their cash.

Operator: Stephanie Benjamin with SunTrust, your line is open.

Stephanie Benjamin
Analyst, SunTrust Robinson Humphrey, Inc.

Q

Hi. Thank you for the question. I was just looking kind of – I wanted to get a little bit more color on the margin improvement bridge. It's mainly slide – or looking at slide 12, if you can give a little bit of color on the revenue optimization opportunity, nice margin expansion, just big data, yield management and what that entails. Thanks.

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Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.
A

Thank you, Stephanie. Of course, we have looked at our various initiatives and tried to group them a little bit together and how they fit together as a family to keep the picture somewhat more understandable. So, while we're looking at the other categories, it's more looking at the cost side of things versus on the revenue optimization we're looking at top line. And I also said we have more than 20 different ERP systems today. So, while we have those different systems, we already started with some, what we call a big data initiative to understand what's really driving consumer and customer buying decisions.

And we certainly are doing that on a constant basis to better serve our customers, but also to make sure we optimize our margins and that's a lot of what's behind that column. And as on the other initiatives, we also have a span between what we consider as solid for our plans versus what we consider is an upside potential if things go really well and that is quite a respectable number between the 0.3% and 0.5%. So, this will continue to be pursued by our teams both on the analytical side, but also by the sales teams in the field.

Operator: Bret Jordan with Jefferies, your line is open.

Bret Jordan
Analyst, Jefferies LLC
Q

Hey. Good morning, guys.

Dominick P. Zarcone
President, Chief Executive Officer & Director, LKQ Corp.
A

Hey. Good morning, Bret.

Varun Laroyia
Chief Financial Officer & Executive Vice President, LKQ Corp.
A

Good morning.

Bret Jordan
Analyst, Jefferies LLC
Q

Hey. Quick question on the vendor financing. You're looking at $200 million coming out or adding to cash flow from the financing program by 2021. What does that imply for a total inventory balance? I guess, what's your target for accounts payable as a percentage of your inventory? How much can you bring inventory balances down as you consolidate the systems? And are there any sort of structural or legal limits to what you can do with payables in Europe versus what we see in the U.S. players in this space?

Varun Laroyia
Chief Financial Officer & Executive Vice President, LKQ Corp.
A

Hey, Bret. It's Varun. Let me try and answer that piece. So, yes, there are a couple of opportunities, I think, as I mentioned in my comments upfront. Stock level rationalization is a program that we have been following. And, in fact, if you go back to our second quarter earnings when I called out the improved cash flow that the enterprise delivered, Europe had also delivered a significant uptick, specifically related to the stock level rationalization, or the way I think I had called it was prudent purchasing program to take into account the softer macroeconomic conditions. So, that clearly is one aspect of it.

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From a vendor financing perspective, listen, we've always stated that we believe that Europe has a significant opportunity. And, clearly, we are in the infancy of getting it started. I think if you were to talk to the folks on the other side of the pond, which obviously have been going at it for upwards of 15-plus years, they've been at it for quite some time and certainly have some very attractive metrics associated with inventory versus payables.

We believe we can continue to raise the number from where we are today. Again, as I mentioned, some of the discussions we've had thus far have been very productive discussions. We expect to see not much of a uptick in the current fiscal year, but clearly in 2020 and 2021, as the program continues to ramp up, we believe that – we feel good about the numbers that we have put out out there.

Operator: [Operator Instructions] Chris Bottiglieri with Wolfe Research, your line is open.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

Hey, guys, good morning. So, first, I want to commend you on the level of transparency...

Dominick P. Zarcone
President, Chief Executive Officer & Director, LKQ Corp.

A

Hey. Good morning, Chris.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

Hey, good morning. So, first, I want to commend you guys on the level of disclosure on timeline and buckets and stuff like that. I think it's always good to see in a turnaround. And then, separately, I guess my questions are, can you talk about the 1.5% organic growth leverage point? That's kind of shockingly low, but candidly I'm not as tight on the European macro data. Can you just give us a sense of what [ph] wagers (00:45:45) are growing, healthcare, transportation cost just to assess that 1.5% leverage point?

And then related, it looks like you're assuming 10 to 60 basis points of margin improvement from organic growth. So, can you just connect the dots for me? Does that 2% organic growth midpoint then imply like 30 to 40 basis points of margin improvement? And then, I know this is a long question, but does that 2% include branch-level growth in it, because I would think the margins on that would probably be dilutive as you grow branches? And I can repeat these if you need to. Thank you.

Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Well, thank you. First of all, on the European perspective growth rate, what we've done on slide 13 is kind of relayed our expectations regarding organic growth, which obviously would be without acquisitions and pretty much keeping the same level of stores throughout Europe, which will be a balance between store closures and store openings and relate that to the situation how we see the European market.

On the market, you certainly have seen that the parc size has grown over the years 2013 to 2017 at 2% plus. We have another positive impact which is the increase of the average age of the fleet, which is older in Southern Europe and in Eastern Europe compared to Western Europe. That certainly is also something where I said earlier that might accelerate in the next years, depending on what new vehicle production will do.

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On the other hand, we have some negative factors. There is, of course, increasing competition with the OEMs trying to gain share, especially in the medium age categories for the vehicles, but we also have a migration of diesel vehicles out of the Western European markets as city driving bans come in for the lower emission level vehicles.

And on the other hand, of course, we have taken some kind of conservatism when you look at our 1.5% in our growth expectations, but we have also tried to give you an idea about what we believe is the upper end with 2.5%. So, within that lower and higher range, we believe our business is going to grow, not taking into account any unforeseeable impacts that we could see from some of the trade relationship that might be a threat to the European export industry from Brexit and from other political or economical factors that are beyond our influence.

If you look at the impact on our EBITDA that we have disclosed from this growth to be between 0.1% and 0.6%, we believe that is a good representation of the elasticity of our earnings depending on our growth rate. Certainly, one of the things that we have to take into account on an increasingly volatile economic environment is that we, as part of our program, will work on the resilience of our company towards unforeseeable changes, also lessons learned from 2019. So, we will work on continuous reduction of our fixed cost structures to make the company more reactive in case there is an economic change in our environment.

Operator: Daniel Imbro with Stephens, your line is open.

Daniel Imbro
Analyst, Stephens, Inc.

Q

Yes. Thanks guys for taking the follow-up. I had a question on procurement. It looks like you guys have taken up that opportunity versus a year ago. Can you just talk about what's driving those savings? Are you just going to suppliers and leveraging scale? Or is there going to be any benefit from the vendor financing program? Just some color there would be great. Thanks.

Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Yeah. Thank you, Daniel. It's one of the most important questions that is keeping us busy at the moment because, like I said, when you put all the LKQ activities in Europe together, we get to a remarkable size in terms of the buying volumes that we have which, like I also said, in our view, is quite comparable to the purchasing volumes that the OEMs have for their after sales demands.

And, therefore, we have a wide number of activities also connected to the consolidation of our assortment. So, we will reduce the number of varieties and part numbers that are fitting the same vehicle application to reduce our staff, but also create value for our suppliers because they can run bigger production lots and share that value, to a large extent, with us. But there is more things that will happen. We believe that we don't need that large number of suppliers that we have when you combine everything together that the companies acquired by LKQ have in their current supplier portfolio.

And we will also develop the processes and the techniques how we procure our products, and that will also be certainly one of the key enablers to deliver the procurement savings that we are having in the plan that we presented today. In total, we believe the suppliers that work closely with us and that consider LKQ a strategic partner for the future and that will also work on their internal cost efficiencies will see considerable growth with LKQ. But suppliers that don't meet those criteria certainly will have to figure out how they are going to maintain their aftermarket volumes, if LKQ becomes a less important partner for them.

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Operator: Bret Jordan with Jefferies, your line is open.

Bret Jordan
Analyst, Jefferies LLC

Q

Yeah. A follow-up question, I guess you commented about market share gains over time being an incremental driver of the top line. Could you talk about what you're seeing? Obviously, GPC has made some acquisitions both into Germany and the Benelux. So, as far as either other competitors and maybe some of the smaller competitor activity as far as pricing competition, is everybody acting rational, is Brexit likely to be a disruption, maybe sort of how you're measuring market share and what you're seeing as far as recent shifts go.

Arnd Franz
Chief Operating Officer-LKQ Europe, LKQ Corp.

A

Yeah. Thank you, Bret, for the question. I believe although Europe is a continent, we still have very different developments if you look at individual markets and, of course, in some markets we even have currencies that impact how we look at things. But, in general, I think we can say that the strength of LKQ has played out in this downturn that we've seen in 2019, especially in the UK, in Germany, and to some extent also in Eastern Europe versus we've seen quite a lot of pressure in Italy both on volume and on price. So, that's the current situation.

Overall in Europe, I believe LKQ has gained share, like I said before. And we will continuously monitor and also drive that with a very, very consistent behavior in front of our customers. For us excellence in execution and customer service is the key driver to maintain and expanding our market share. And we will certainly see a lot of good things coming from the integration of our LKQ processes and organization over the next years.

Operator: I will now turn the call back over to Nick Zarcone for closing comments.

Dominick P. Zarcone
President, Chief Executive Officer & Director, LKQ Corp.

Well, first and foremost, we'd like to thank everybody on the call for your time and attention here this morning. Again, our goal was to provide some additional information about our European business. So, you can gain comfort that the plans and programs that we have in front of us will come to fruition. We are very optimistic about the future of our European business. There is no doubt. We need to execute. We need to execute, but we are highly confident that we can achieve the plans that we've outlined here today.

As you can tell, Arnd brings a unique perspective and we are certainly delighted to have him on our team, but it's important to keep in mind that it's not one person who is going to make this happen, but really the power of the broader leadership team here in Europe and the unique position that we have in the marketplace. And with that combination, we are quite optimistic about the future of the European business.

So, again, we'd like to thank you for your time and attention. Hopefully, this conversation was constructive and given you a better sense as to where we're headed as an organization, particularly in Europe, and we'd look forward to continuing the conversation with you in the future. So, with that, we will bring the call to a close. Thank you.

Operator: This concludes the LKQ Corporation's European segment update call. We thank you for your participation. You may now disconnect.

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