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LKQ Corp. (LKQ)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Joseph P. Boutross
Vice President-Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

- During this call, we will present both GAAP and non-GAAP financial measures
- A reconciliation of GAAP to non-GAAP measures is included in today's earnings press release and slide presentation

Dominick P. Zarcone
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- I will provide some high-level comments related to our performance in the quarter, and then Varun will dive into the financial details and discuss our 2021 outlook before I come back with a few closing remarks
- A year ago on this call, we mentioned the coronavirus a couple of times, mostly related to supply chain considerations

- With a year of hindsight, I can safely say that we, like the rest of the world, vastly underestimated the impact that COVID-19 would have on our way of life
- I want to express my condolences to all those who have suffered a personal loss due to this unfortunate pandemic, and my sincere thanks to all those on the front line, the doctors, nurses, first responders, teachers and all of those putting themselves at risk to serve their communities
- We simply cannot thank you enough
- During Q4, we faced the second wave of the pandemic and related restrictions on mobility; yet, we still produced very strong results which were materially ahead of our expectations when we chatted with you on our third quarter call

Key Initiatives

- As we mentioned at outset of 2020 and reiterated throughout the pandemic, we were focused on a few key initiatives
- I am proud to say our segment teams, again, embraced and executed on many of these initiatives, not only in Q4, but for all of 2020
- And let me restate our key initiatives, which continue to be central to our culture and our objectives as we've entered 2021
 - First, we will continue to integrate our businesses and simplify our operating model
 - Second, we will continue to focus on profitable revenue and sustainable margin expansion
 - Third, we will continue to drive high levels of cash flow, which in turn will give us the flexibility to maintain a balanced capital allocation strategy
 - And fourth, we will continue to invest in our future
- We have three market-leading businesses, and the benefit of the structure shined brightly during 2020
- Each business made significant progress on its goals
- And the diversity of markets and customers helped to balance out some of the ebbs and flows impacting any individual business

ESG Program

- Alongside these operating initiatives, the continued build-out of a comprehensive ESG program is a key focus for the organization on a go-forward basis
- We made tremendous progress
- I am pleased to announce that we will be releasing our inaugural Corporate Sustainability Report in Q2 this year
 - While this will be our first formal report, we have been an environmental leader since the day we were founded in 1998, as a salvage dismantler and recycler of passenger vehicles
- Today, we are the largest global recycler of vehicles, having processed over 810,000 cars and trucks in 2020
- While we are widely known for our recycling and environmental stewardship, we also have a long history of responsible and thoughtful social and governance practices, which we look forward to highlighting in the coming months

Q4 Results

- Now, on to the quarter
- As noted on slide 4, total revenue for Q4 was \$3B, a decline of 1.9% from the comparable period of 2019
- Parts and services organic revenue declined 5.2% in the quarter and 6.1% on a per-day basis

- Net income during Q4 was \$180mm, an increase of 29% y-over-y
- Diluted EPS for Q4 was \$0.59, an increase of 28% y-over-y
- On an adjusted basis, net income was \$212mm, an increase of 27% over 2019
- Adjusted diluted EPS for the quarter was \$0.69, an increase of 28% y-over-y
- So, let's turn to some of the quarterly segment highlights

Revenue Trends

- Slide 5 sets forth the monthly revenue trends from October through January, and it's quite clear that we didn't witness any change to the upside either in North America or in Europe
- There were simply no meaningful catalysts to reverse the ongoing constraints on mobility
- We are encouraged by the initial rollout of the vaccine in the US and certain parts of Europe, but there still remains uncertainty about virus resurgence, vaccine distribution, fiscal stimulus, and geopolitical risk
- As we begin to see the benefits of the vaccine come through and further relief from the stay-at-home mandates, we should see some positive movement in mobility
- We are cautiously optimistic that we may see a slight recovery in demand towards H2 this year

Organic Revenue

- As you will note from slide 6, organic revenue for parts and services for our North American segment declined 13.7% in the quarter
- While still down on a y-over-y basis, we continue to perform well in North America, especially when you consider that according to CCC, collision- and liability-related auto claims declined 27% in Q4
- Faced with y-over-y organic declines in parts and services revenue in each quarter of 2020, the North American team used its agility and decisiveness to protect the business by focusing on profitability, embracing various KPIs to drive efficiency, and aggressively right-sizing the cost structure to be aligned with the revenue trends
 - These actions contributed to North America having its highest annual EBITDA margins in the history of the company

European Segment

ORGANIC REVENUE

- Moving to our European segment, organic revenue for parts and services in Q4 declined 3.1%
- Demand trends softened sequentially in Q4 as a second wave of lockdown provisions were enacted across all of our European regions with larger impacts in November and December
- Most of our regional operations experienced similar revenue declines in the quarter, except for Italy which struggled
- As we articulated at our Investor Day in September of last year, we continue to execute on our 1 LKQ Europe program

EXECUTIVE APPOINTMENT

- Of note, during 2020, we added significant talent to the European team, including new operating leaders in Italy, the Benelux region, and Central and Eastern Europe
- We recruited a new CFO and added new positions of Controller, Head of HR, VP of Strategy, and several other positions

SHARED SERVICES EFFORT

- Our shared services effort is progressing well with a new center located in Poland that should become operational in H2 2021
- And we are also currently leveraging our Bangalore captive
- Our pan-European ERP initial implementation was successfully completed at Rhiag Switzerland and we expect to go live with Rhiag Italy in mid-2021
- Our team is actively focused on driving permanent reductions in SG&A as available government support diminishes

VENDOR FINANCING PROGRAM

- Our vendor financing program is coming along really well and our LKQ Europe head office in Zug, Switzerland was occupied beginning of January 2021
- Lastly, on Europe, this time last year I mentioned that we began construction on our new Central Distribution Center, or CDC for our Fource business in the Benelux region

Logistical and Operational Phases

- Today, I am happy to report that the keys have just been turned over and our team is starting the logistical and operational phases of the build-out
- The logistical layout is expected to be completed in Q2 2021, after which LKQ Fource will enter the testing phase
- At the end of this year, we will begin using the shuttle system and the new software
- During 2022, we will begin to migrate the activities in the four existing distribution centers over to the new CDC
- As part of LKQ sustainability agenda, the roof of this new building is fully equipped with solar panels, making the building completely energy self-sufficient
- The building is also completely gas-free and will provide sufficient charging infrastructure for plenty of electric vehicles
- Additionally, the large number of windows in the building provides plenty of natural light, creating an attractive work environment for our team

Specialty Segment

ORGANIC REVENUE GROWTH

- Now, let's move on to the Specialty segment
- During Q4, Specialty reported organic revenue growth of 16.6%, performance well above our expectations and represents the highest quarterly organic revenue growth since the closing of our acquisition of Keystone Automotive Operations back in 2014
- A primary factor driving this tremendous performance is the ongoing demand for RV parts, a trend we anticipate will continue as the growth in new unit RV sales will result in a larger RV park, and that will inevitably need more replacement parts as those vehicles work through their life cycle
- No one is better positioned to take advantage of that opportunity than LKQ
- Also driving the performance was demand of our drop ship business and, consistent with the industry, strong demand for our [ph] Warn (13:00) products

CORPORATE DEVELOPMENT

- From a corporate development perspective, in 2020, our team did a fantastic job of focusing their efforts on rationalizing our asset base in divesting non-core assets
- In 2020, we completed four divestiture transactions, all of which related to European assets that came along with the 2018 STAHLGRUBER acquisition
- As you all know, vehicle technology continues to lead to more complex repairs

STRATEGIC ACQUISITIONS

- And to be positioned at the forefront of this trend, we have made strategic acquisitions in the diagnostics space
- Since acquiring Elite Electronics and VeTech Automotive Electronics in 2019, we have grown to become the largest US provider of mobile, onsite vehicle services to the automotive collision repairers, mechanical repairers and the national fleets
- This past January, we combined the two mobile automotive services together under a single brand known as Elitek Vehicle Services

MARKET SHARE AND BRAND AWARENESS

- We remain confident that we will continue to increase our market share and brand awareness within this unique and rapidly growing market
- And yet, we are just scratching the surface on the opportunities ahead during these exciting times for passenger and commercial vehicle design
- As the car park evolves, we have a tremendous opportunity to leverage our distribution network to increase our product and service offerings to capture the growth in hybrids and EVs

STRATEGY AND DEVELOPMENT TEAMS

- Our strategy and development teams continue to identify new markets and products to pursue, some of which we touched on during our Investor Day back in September
- No one, in my opinion, is better positioned to take advantage of those opportunities than LKQ, as we have the people, the network, the scale, and the capital to be successful

Varun Laroyia

Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Earnings

- While there is a lot to share from our fourth quarter results, full year 2020, and outlook for 2021, I'll keep my prepared comments brief as there is a lot more detail in the accompanying earnings presentation
- While 2020 proved to be an extremely challenging year, for a variety of reasons, LKQ's resilience shone through in tough times, as evidenced by the following highlights:
 - One, record high annual EPS, including the two highest quarterly results in the company's history, those being the third and Q4

- Two, record high annual segment EBITDA margin for North America and for the company since 2015
- Three, record FCF at well over \$1B, the first time we've exceeded \$1B, and now, the third in a row record FCF year in the company's history
- And finally, net leverage dropped to 1.9 times, the first time it's been below 2 times since 2015, which was well before the Rhiag, PGW, STAHLGRUBER and several other acquisitions

Adjusted EPS and Cash Flow

- To put these results in perspective, consider we beat the midpoint of our pre-COVID adjusted EPS and cash flow guidance, despite falling well short of our organic revenue growth range of 0.5% to 2.5%
- In dollar terms, that's over \$1B shortfall on revenue relative to our original guidance at the midpoint
- Our profitability and cash flow results are a testament to the ongoing margin and cash programs that we accelerated and actions we prioritized at the onset of the lockdown measures last March
- Now, we all know such outcomes don't happen by accident
- And so, a massive thank you to all my LKQ colleagues for their tireless efforts over the last year to deliver a truly outstanding outcome for our company, customers, suppliers and several other stakeholders, while persevering through the ongoing pandemic

North America

- I'll now cover Q4 financial highlights and liquidity before sharing our thoughts on the outlook for 2021
- As you can see on slide 11, North America continued to deliver in Q4, with segment EBITDA margin up 420BPS over the prior year and 60BPS sequentially
- Permanent cost savings in overhead expenses was the primary driver of the improvement
- And precious metal prices remained and gave us a healthy tailwind for the quarter with an estimated \$18mm y-over-y benefit on gross margin

Europe

- Moving over to slide 12, Europe produced another solid quarter with an 8.6% segment EBITDA margin, up 100BPS relative to a year ago, largely due to operating expense reductions
- Importantly, Europe generated an 8.9% segment EBITDA margin for H2, which is solidly above the 8% to 8.5% range provided at last September's Investor Day and represents good progress towards delivering on the 1 LKQ program
 - And these results include higher y-over-y transmission expenses
- Despite the negative effects of the second wave of COVID, at this time, we remain comfortable with our 2021 projection of segment EBITDA margin of 9.2% to 10.3% for the segment

Organic Growth, Gross Margin and Overhead Expenses

- With specialty on slide 13, Nick highlighted the impressive 16.6% organic growth in Q4
- Gross margin was down 40BPS owing to unfavorable movements in vendor and customer rebates, though, some of the fluctuation is timing as we had positive true-ups from Q4 activity a year ago and negative impacts this year with the volume increase
- Overhead expenses were favorable by 50BPS and would have been more without the negative effect of about 80BPS from incentive compensation adjustments

Cash Flow and Liquidity

- Now, on to cash flow and liquidity
- Q4 was yet another successful quarter for cash flow generation
- We added a further \$309mm in operating cash flows as we continued to benefit from the trade working capital programs we've been driving since 2018
- Benefits from receivables and payables offset the expected growth in inventory, although the inventory rebuild wasn't as high as previously anticipated due to supplier delivery challenges
- As shown on slide 14, operating cash flows were \$1.4B for the year and CapEx cash outlays were \$173mm
- The resulting FCF and cash on hand was used to pay down almost \$1.4B in debt for the year

FCF Conversion

- We're very pleased with the trend in EBITDA to FCF conversion, as presented on slide 15; though, as I previously highlighted, the 2020 ratio of 98% just isn't sustainable as we flexed inventory levels by over \$400mm to align with demand forecasts
- As growth returns, we plan to invest in inventory levels, though, largely offset by the ongoing vendor financing program to ensure we maintain our best-in-class service levels and fill rates

Liquidity Position

- On slide 16, you can see the progress we've made this year to strengthen our liquidity position
- I want to specifically highlight the net leverage ratio, which has decreased to 1.9 times from 2.6 times at the end of 2019 and is in line with our target net leverage of approximately 2 times
- We're very comfortable with our liquidity position, including the availability and cost of funds, and believe we are very well positioned in our pursuit of investment-grade metrics

Share Repurchase Program

- As mentioned last October, we restarted our share repurchase program after Q3 earnings call
- During the quarter, we repurchased roughly \$30mm of LKQ shares for a total investment of \$117mm for the year
- We had \$531mm available on our authorization as of the year end

Vaccine Rollout

- So, now, I will close with our thoughts on 2021
- As COVID uncertainties remain, we are not providing full financial guidance for the year at this time
- We will revisit this position as the year progresses and we have greater clarity on the vaccine rollout and its impact on the duration and severity of the pandemic
- We are comfortable providing the following statements, all of which are based on the assumption that:
 - One, extreme mobility restrictions beyond what are currently in place are not re-implemented in our major markets
 - And two, scrap and precious metal prices and foreign exchange rates continue near their recent levels

Parts and Services Revenue

- So, a few points to highlight
- First, we believe that parts and services revenue will be higher on a full year basis in 2021, though, down in Q1 relative to 2020
- We anticipate that the revenue recovery will accelerate as vaccines are distributed more broadly and mobility restrictions fall off, though, we do not expect to return to our 2019 annual revenue figure until sometime in 2022
- Please note that we'll have two fewer selling days in North America in 2021, one fewer in Q1 and the second in Q4, while Europe is flat with one fewer day in Q1, though that catches up in Q2

Revenue Growth, Margin, Operating Expense and EPS

- The second point I'd like to highlight is, with revenue growth and the ongoing benefit of our margin and operating expense programs, we expect our 2021 adjusted diluted EPS will be above the comparable figure for 2020
- With that in mind, we are projecting an adjusted diluted EPS range of \$2.65 to \$2.85 with a midpoint of \$2.75
- On a GAAP EPS basis, this would be \$2.40 to \$2.60
- Given the momentum of our European business in H2 2020, exceeding the upper end of the range provided last September, we are reaffirming the outlook for the European 2021 segment EBITDA margin range of 9.2% to 10.3%

FCF and Inventory Levels

- Four, we project the FCF for the full year 2021 will be a minimum of \$800mm
- While the absolute number is lower than the 2020 figure, we've been very clear throughout this past year that 2020 was a strange year for cash generation as a result of the pandemic
- As we aligned inventory levels to forecasted demand, our stock levels declined by well over \$400mm, which in turn produced a significant cash inflow
- However, we are going to give some of the inflow back in 2021 as we replenish our inventory levels to support the anticipated revenue growth
- Some of the investment in inventory will be offset by improvements in days payables, resulting from vendor financing program, which we expect to yield more significant benefits in 2021 and in line with the target we had set out in September of 2019 when we launched the 1 LKQ program

CapEx

- And finally, on CapEx, we plan to get back to our normal levels of 2% to 2.25% of revenue
- All of these factors will produce a lower FCF amount than 2020, but importantly will still put us within our target conversion range of 55% to 60% for FCF to EBITDA, widely considered to be best-in-class for industrial distribution companies

Dominick P. Zarcone

President, Chief Executive Officer & Director

CLOSING REMARKS.....

- In closing, if you asked me in late March 2020, after the onset of the pandemic, to predict the financial results that we would achieve in 2020 and how would we end up the year, I would likely have not even come close to guessing at such a remarkable outcome
- But the one thing I never questioned are the capabilities of my team
 - These results are a clear testament of the pride, dedication, resiliency and capabilities of the LKQ team members across the globe
- One famous college football coach said, ability is what you're capable of doing, motivation determines what you do, but it's the attitude that determines how well you do it
- Despite the challenges and unknowns we faced, it is the positive nothing-will-stop-us attitude that our 44,000 dedicated team members bring to work each day, and that carried us through the headwinds of 2020
- It simultaneously generated favorable outcomes that allowed us to reach certain key milestones
- We right-sized the North American segment and generated record margins
- We made solid progress on our 1 LKQ Europe program and generated higher H2 margins than projected at our September 2020 Investor Day
- The uniqueness of our diversified portfolio of businesses allowed us to benefit from the rise in demand for RV replacement parts
- We effectively managed our working capital and generated almost \$1.3B in FCF, an annual record for the company
- And the excellent FCF allowed us to pay down a record \$1.4B of debt, reducing our leverage ratio below 2 times
- We continued our talent acquisition initiatives by adding individuals to key roles across our broad and diversified portfolio of businesses
- We made good progress on our global sustainability programs and we continue to provide the best-in-class customer service in spite of the pandemic, and importantly, all while focusing on the health and safety of our team
- As I've said both internally and externally, we will come out of this pandemic period a stronger, better organization, further solidifying our market-leading positions

QUESTION AND ANSWER SECTION

Craig R. Kennison

Robert W. Baird & Co., Inc.

Q

My question is on inflation here. Just curious how your business is set up to absorb inflation and where you see your most important sensitivities, whether it's gas prices, metals, or other factors.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

Good morning, Craig.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Good morning, Craig.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

It's Varun out there. Absolutely. I think it's a great question and I'd say, over the past couple of months, we've certainly seen inflation move up, whether it be ocean freight, which we know is running at record highs at the moment. We know wages. Here in the US, it's difficult to find delivery drivers. So, I think you kind of get the message in terms of the inflationary pressures that are building up, and also with oil prices now moving up in the higher \$50s, close to \$60 a barrel in any case. And so, we have navigated, as you know, not just this past quarter, but I'd say starting 2018 when we put in place our margin programs and, obviously, kind of accelerated our OpEx programs, in conjunction with the cash programs. Our teams have navigated those inflationary pressures pretty darn well. We're proud of what they do and we believe we have the ability to continue to drive a number of the permanent cost reductions that our North America business has taken the lead on, but I do know that our European team is also following up with.

So, long story short, yes. Are there inflationary pressures? Absolutely. Are we well set up to undertake those inflationary pressures? Yes, up to a certain point. It really depends in terms of what kind of comes through over the next, call it, several weeks as such. But we do expect a number of these inflationary pressures to begin to ease up, for example, in ocean freight as the empties get back to the appropriate positions, back out in Asia and things along those lines.

Nick, anything to add from your end?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

No, I think that was great, Varun.

Craig R. Kennison

Robert W. Baird & Co., Inc.

Q

Thanks, guys.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

And, Craig, if there's any follow-up questions, would be happy to kind of take it now, or if you'd like to get back in the queue, we can certainly take it there also.

Scott L. Stember

C.L. King & Associates, Inc.

Q

Maybe talk about the North American business. I know that much of this is based on miles driven and people getting out and mobility. But when we look out the window, the weather has been quite awful the last six weeks. I'm trying to figure out whether you guys have seen any change in demand there and if you think that maybe there could be a potential tail to that as we go from the first and into Q2.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Great question, Scott. And again, the weather has been nasty, particularly the last couple of weeks. And I'm actually sitting in Austin because I got iced in, going back to Sunday. The reality is our business is very much driven by total miles driven. And as you saw in the chart we included in the earnings deck, kind of the revenue trends not just for Q4, but also for January. And you could see that January kind of picked off where December left off – or picked up where December left off, right. So, until there is a really meaningful movement in mobility, we think we're going to be kind of in this level of activity.

Ultimately – and we've gotten a number of questions in the past about what's going to drive an increase in mobility. And clearly, getting through the pandemic and people getting out of their homes and returning to their daily lives will be the biggest impact. We don't believe that everyone is going to work from home forever. We don't think everybody on this call is going to permanently be working from home.

And while we've all become fairly efficient and productive in the working from home, there's clearly a lack of community that is hard on organizations. And we may not get back to 100% of folks being back in the office, but we do think a number of folks will get back into the office. We think kids are going to get back into school.

And when all that happens, we think the use of public transportation will remain depressed for a longer period of time, just because of the safety issues related to the virus and the like. So as some of those workers begin to head into the office or back into their workplaces, those who took public transportation may opt to take private transportation, which means instead of hopping on a train or a bus, they're going to hop in a car.

So, we're cautiously optimistic that miles driven will move back north and that will help our business. Clearly, with the ice storms and the like that have hit the last couple of weeks throughout the United States, that should ultimately create demand for our business. I will tell you, here in Texas, based on the news stories of the pileups in Dallas and Austin and Houston, that's probably going to create a bigger opportunity from a salvage buying perspective than a parts perspective, because a lot of those cars are just totaled when they hit ice going 40 miles an hour. But again, we're cautiously optimistic that we will get back to more normal levels of miles driven, which will lead to a more normal level of demand. It's going to take some time. We don't think it's going to just pop back in the second or third quarter. But hopefully, by 2022, we'll be back at historical levels of miles driven.

Scott L. Stember

C.L. King & Associates, Inc.

Q

Got it. And then, last question on the specialty side, you talked about RVs really leading the way. I get that's more retail driven, but you also last year expanded your warranty program. Could you talk about how that contributed and how that probably will contribute even more as we move through the next year or two? More RVs on the road, many of which potentially hastily built and just opportunities on that side.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Absolutely. I mean, there was and has been, I think as everyone knows, a massive shift in discretionary spending away from things like restaurants and lodging and air travel, theaters, sporting events, all those group events, right? And outdoor recreation and camping has absolutely been a huge beneficiary of that shift in discretionary spending. Our RV business, historically, has not been tied to the RV SAAR in any particular year, but has been very highly correlated to campground spending.

In 2020, the OEMs produced about 425,000 RV units, which was a great year. The expectation for 2021 is over 0.5mm units, will be all-time record high. The key there is that the size of a park, the number of RVs in the park is expanding. And that's great for the specialty business as all those incremental units that will be on the road for years and years to come will create demand for the parts that we sell.

So even if the SAAR ultimately settles down over the next two or three years, the units are still going to be on the road and that larger base is going to provide a great opportunity for us to sell specialty parts for many years to come. So, the growth may ultimately slow down. We don't think we're going to continue to grow at 16% y-over-y, like we did in Q4, but we don't anticipate substantial declines in the overall revenue base.

Bret Jordan

Jefferies LLC

Q

Sort of a big picture question here around parts demand for EVs. And obviously, Europe's got a jump on us. [ph] You did (38:41) a lot of business in Norway. But could you talk a little bit about how you see the different parts vs. internal combustion or what this does to demand down the road, long term?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Sure. And it's a great question, obviously, one that's been kind of floating around the industry now for the better part of the year. The reality is we believe that the supply chain, really the manufacturers of the EV parts, will ultimately look pretty much the same as the supply chain for internal combustion engine parts. Now, there's going to be a lot of overlap in suppliers. And we fully anticipate that some of the bigger vendors, like Bosch or Continental or Schaeffler will absolutely develop parts for electric vehicles. And while they're going to start with the OEMs as their focus, what they know today is that their current aftermarket business makes better profit margins than their OE parts business. And so, it won't be long before they take that OE manufacturing capacity and start making parts for the aftermarket. We have very strong relationships with all those vendors. They know we've got the leading distribution capabilities, at least as it relates to Europe, and it's a natural fit for us to do business together.

Secondly, a lot of the conversion over the next 10 years or so, Bret, on electrification is going to come through hybrids. And a hybrid, as you know, is a combination of an internal combustion engine and electric motor. And the opportunity for LKQ there is two-fold. First, there's all sorts of new part types that we're going to be able to sell, things like battery coolant pumps and cooling fans, electric air conditioning compressors, electric-driven motor inverter coolers, I mean just a whole new set of products that we can ultimately distribute. And then, what we also

know is that hybrid parts, related to the internal combustion engine side of the powertrain, are more expensive than similar parts in a non-hybrid car. So, like an AC compressor for a hybrid vehicle – and we talked about this during our Investor Day back in September – can be three times as expensive as an AC compressor for a normal – just internal combustion engine car. A coolant pump can be five or six times more expensive. So, we think there's a good opportunity for us to distribute those parts as well, and they're higher-value parts.

And then lastly, we think the big opportunity, ultimately, as it relates to EVs, is the battery. Just like the engine, it's the most valuable part of a car that has an internal combustion engine, the battery is the most valuable part on a EV. And batteries have a finite life. They're not going to go on forever. The car's going to be around a lot longer than that initial battery and so there will be opportunities, we believe, for us to remanufacture EV batteries, because generally it's not the whole battery that goes bad at once, but it's just a couple of cells, and it's going to be too expensive to replace the whole battery. So, we think there's just a bundle of good opportunities for us in the future as it relates to the electrification of the car park.

Bret Jordan

Jefferies LLC

Q

Thanks for that. And a question on the technology as well, sort of your scanning and diagnostics program that you just talked about, could you sort of talk about the revenue expectations and maybe the margin structure of a more service-based business, like Elitek?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Yeah. So, this industry is nascent. It's pretty small. The typical competitor is somewhere between 6 and 12 technicians that have banded together to provide services to the marketplace. Okay? Our business is just shy of the \$50mm mark today and it's growing. The great thing about the services business is it has better EBITDA margins than our North American parts business. And so, that should help as that business continues to grow. Now, we're not going to be able to grow that business by – necessarily through acquisition to gain significant scale, because like I said, most of these operators are tiny – they're tiny. So, we will buy and look to buy, perhaps, some of the larger groups, even though that's still pretty small, and roll out on a greenfield basis by really educating technicians and then putting them out in the field as part of our Elitek service offering. So, we're excited about the business.

Stephanie Benjamin

Truist Securities, Inc.

Q

I wanted to touch on – you kind of brought up at the beginning of your prepared remarks that, really, Q4 exceeded your expectations and even kind of how you outlined things the last time we spoke. We'd love to hear some color about what moved in your direction during the quarter and kind of how you're seeing things trend out in the beginning of 2021. Thanks.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Sure. Great question. The revenue didn't help us. And if you go back to that page where we laid out the last four months, you can see that, save for the specialty group which just rocked during Q4, the revenue in both North America and Europe were down pretty consistently from the prior year levels. Obviously, Europe is doing better than North America because of our collision focus here. So, really, it wasn't revenue that led to the outperformance, Stephanie. It was our operating margins. We had good improvement on the gross margin line. And while on a consolidated basis it looks like gross margins came in a couple of basis points, that's just the mix

shift, because the North American business has margins north of 46%, the specialty business has margins around 28%, and yet the high-margin business kind of falling 13% and the low margin – gross margin business growing 16%. So, you shouldn't take anything from that at all.

The key is the operating leverage that we got out of the business. Each of our segments worked hard to get the cost structure to reflect the current state of demand. And we're very proud of what our folks have done. Unfortunately, a lot of that has come on the backs of labor. We are down substantially from a total number of employees today vs. where we were a year ago. But that's just what it took to right-size the business, and those are permanent reductions. We're going to be very cautious to add people and/or expense back to the SG&A line until we see the revenue rebound. And then, we will need to add some people back to keep our customer service levels where they need to be. So, think about the intense focus on controlling our cost because we're in an environment where we don't necessarily control our revenue.

Gary Frank Prestopino

Barrington Research Associates, Inc.



A couple of questions here. Varun, what is your priority for your FCF? I assume, it would be paying down debt this year.

Varun Laroyia

Chief Financial Officer & Executive Vice President



Yeah. I think it's a great question, Gary. Simply put, if you kind of go back to our Investor Day presentation from September, so probably about what, five, six months ago, we were very clear in terms of we expected our FCF generation, on a sustainable basis, to kind of continue. We've kind of reset the overall business model. So, that kind of starting off is a great option to have as a business.

We've always said that the key priority is investing in our own business. So, CapExs will be kind of priority number one. Following that, we've said high synergy tuck-ins and building up critical capabilities. There was a question earlier on the call about scanning and diagnostics. That is a business that we are investing heavily into. Again, as Nick said, they're very small transactions 6 to 12 technicians on a market-by-market basis. So, certainly, wherever we have the ability, we're certainly acquiring those, but really also supplementing it with CapExs to kind of expand that specific service.

We do not have any large platform transactions on the horizon. We do not see we need those at this point of time, which essentially leads us to a point where the excess FCF really would go towards either debt pay down, although as you've seen, we've certainly made a tremendous amount of progress paying down on \$1.4B in 2020. We are well within our target leverage at this point of time, so really it becomes the highest return on capital opportunities. And we still believe that our shares are undervalued. And we certainly see no reason given the authorization we have from the board to be able to repurchase our stock.

Gary Frank Prestopino

Barrington Research Associates, Inc.



Okay. Thank you. And then, just lastly, in terms of what you've done with the cost structure and what you can do, obviously, in the future, as you move from an acquisition growth strategy to more of just integrating and bettering your operations. Every year, I would assume you're really pushing your divisional heads to get the costs down. And I – just wonder, where is the biggest component of costs going to come out in the future for the company? And I assume you're going through a program every year of we need to get our costs better in line on an annual basis.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

Absolutely, Gary. It's Varun out here. Two years ago, as you rightly pointed out, we pivoted to an operational excellence mode. And ever since that, we've essentially been driving productivity through integration. And these programs, you really see in terms of how our North America business has taken the lead on that front. Just look at fourth quarter operating expenses, I mean, that business, yes, we certainly had challenges in terms of what the VMT has been, and so collision rates have come down. But as we think about how our collision business has performed relative to the data we're getting in from CCC, we are performing much better than what the repairable claims are out there. So, that's kind of good. But really, it is the productivity piece of it that our North America leadership team has just done an outstanding job.

You then kind of move over to, say, for example, the next large component of our overall business, and that's in Europe. And Europe also has kind of begun to make some progress. There, we certainly saw some operating expenses come down in Q4. There's a lot more productivity to go get out there. And that really is the overall 1 LKQ program. We need to make investments out there, for example, in the European ERP program, setting up a back office, for example. But really, the longer-term productivity really is from our European business, and that is something that we know our European team has a laser-like focus in making sure that they certainly follow. From within the portfolio of companies, as we share best practices between our businesses and our divisions, I know our North America leadership team has spent time with our European team also.

It's one thing, Nick and I kind of pushing and pulling certain levers. But as the peers speak with one another, largely, it's a very similar business. It's a distribution business and that certainly has helped a lot also. But, yes, you're right. Overall, productivity programs, every business of ours, every function of ours has productivity programs to essentially offset the inflationary pressures that typically come around in any case. But it's the nimbleness and the agility that we are tremendously proud of and that really came through in spades with the onset of the pandemic. I hope that responds to your question.

Daniel Imbro

Stephens, Inc.

Q

I wanted to start on a broader supply chain question. Obviously, you mentioned maritime rates are much higher. There's a problem getting things over from overseas. How has that impacted your aftermarket supply here in North America? And related to that, with limited supply at auction and potentially disruptions in the aftermarket side, do you think your supply chain can support the anticipated return to growth in North America or could that be a pinch point this year as we look forward?

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

Yeah. Listen, Daniel, good morning to you. It's Varun out here. I think it's a great question. We've got tremendous vendor partners on the aftermarket side of the business. They have been tremendously supportive, not just now, but ever since we got into the business. So, that is kind of one thing.

With regards to kind of ocean freight and the challenges associated with it, whether it be the number of carriers that are moored outside of the Port of LA – Long Beach, for example, or for that matter, getting those empty cans back to Asia to kind of get refilled and come over. We have long-term contracts with vessel providers, but also with certain brokers. So, we are still being able to get space – while we're having to pay up for it, we're still being able to get space for – on those carriers.

And then, the other one, as you probably know, is LKQ has always had a class-leading inventory and fill rates. And so, we've made sure that we always have the product. Yes, there are certain areas where we're having to run local or shuttles between within the region, for example. So, we won't kind of ship something from, say, New England to California. But say, within the region, we are kind of making sure that our fill rates remain. So, we do have the inventory. It may not always be in the right part, but we've certainly learned a lot over the past few years in terms of making sure our fill rates remain. But at the same time, we're not kind of taking on excessive costs associated with it.

Over time, we know that the Chinese New Year had kind of caused a certain splurge in terms of the amount of ocean freight that was coming over. We expect that to abate a little in the coming weeks and months. But clearly, that is a risk. But as I said previously, we have product. We have more product on the way. In any case, we think this will even itself out as we return to a growth mode, starting Q2, which is largely kind of easy comps, but really getting back to growth in H2.

Daniel Imbro

Stephens, Inc.

Q

Great. That's helpful. And then as a related – oh.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Daniel, we just think we're better positioned than the typical competitor out there, given the size and scale. We got some breadth of the inventory coming into this, this time where shipping is an issue. We'll be able to work our inventory to be a competitive advantage.

Daniel Imbro

Stephens, Inc.

Q

That's helpful. Thanks, Nick. And then, the related follow-up to that would be a follow-up on an earlier question on inflation. Obviously, cost inflation is coming and we just talked about it happening. Are you seeing any signs of being able to pass that through on like-for-like pricing amidst that cost inflation? And if not, what do you think it's going to take to see that revenue tailwind return, considering cost pressures right now still pretty broad? Thanks.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

Yeah. Listen, again, just to kind of add to what I had answered earlier on the call, Daniel. We have a dynamic pricing model, okay. And we certainly make sure that while we have a certain threshold or at least a ceiling associated where OEM parts are, clearly if those kind of begin to move, that would certainly help. But we do know that our teams are doing a fantastic job on the pricing side. As I said previously also, our salvage business has been doing really well. From an aftermarket perspective, there is limited supply in the market. We do have the product. And listen, we want to kind of help everybody, specifically the carriers and our customers, to making sure we get the right parts at the right time.

So, associated with kind of having the product, the second one clearly is making sure that we are that much more productive. The cost that we've been able to take out, initially what was temporarily in Q2 and kind of then switching that into permanent cost reductions, that is certainly working out well for the entire enterprise. But obviously, we can't wait for kind of growth to return. It certainly helps us get more of our folks back in the field. But as of now, we are happy with the way our teams are navigating the various puts and takes that are out there.

Brian Joseph Butler

Stifel, Nicolaus & Co., Inc.

Q

Just the first one on the cash flow and the outlook of the minimum kind of \$800mm, coming from the \$1.3B that you saw in 2020, can you maybe break out the buckets that go from the \$1.3B to the \$800mm? Obviously, inventory is a piece of it. You talked about DSOs, there's a little bit of an offset in CapEx, but could you give a little bit more color on that?

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

Yeah. Listen, it's actually very simple and it was in my prepared comments. During 2020, we essentially realigned our inventory base with what demand projections were. Our inventory balances came down by over \$400mm and that really is the kind of delta between, call it, the \$1.3B and the minimum \$800mm that we're talking about.

Brian Joseph Butler

Stifel, Nicolaus & Co., Inc.

Q

So, it's all inventory is really it, and I'm guessing a little bit of CapEx.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

CapEx is about \$100mm, yeah. It's basically inventory about over \$400mm and CapEx is about \$100mm. I mean, that's basically your kind of \$500mm right there from the \$1.3B to the \$800mm.

Brian Joseph Butler

Stifel, Nicolaus & Co., Inc.

Q

Okay. That's good. And then follow-up, just on kind of the pace of the growth kind of going into or through 2021, I expect first quarter remains kind of weak based on the January revenue that you showed. But how should we think about that kind pace of growth for second quarter and then into H2?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Yeah. Great question. So as you indicated, we are anticipating Q1 is going to be down y-over-y largely because we started off last January and February of 2020 very strong. And obviously, you can see the January numbers are down. February will be down and then March is a easier comparison. Second quarter will, obviously, be up, because even if we just stay at these levels of revenue, the revenue came off so dramatically in Q2 of last year, second quarter will be up. And then, the third and fourth quarters, those are obviously the hard to predict, they're further away. We're anticipating a little bit of upward movement on a y-over-y basis. But again, not back fully to 2019 kind of levels.

Brian Joseph Butler

Stifel, Nicolaus & Co., Inc.

Q

Great. Thank you.

Varun Laroyia

Chief Financial Officer & Executive Vice President

A

And just one additional piece to kind of highlight. We do have one less selling day in Q1 across the entire enterprise. So, in North America, there's one fewer selling day in Q1, a second fewer selling day in Q4. And in

Europe, we have one fewer selling day in Q1. But we make up that day in Q2 for the European business. So, just to kind of think about this is something that we've talked about previously and just want to make sure that you have that into your models.

Dominick P. Zarcone

President, Chief Executive Officer & Director

CLOSING REMARKS

- Well, as always, we greatly appreciate your time and attention
- We know this is a very busy, for everybody on the call, earnings season. Lot going on
- We appreciate your listening to our story
- We are incredibly proud of what we've been able to deliver in 2020, particularly given all the challenges that companies around the globe have had to deal with, and we had our fair share of challenges as well. The team, I could not be more proud of. They came through beyond any expectations. And I could not be more proud to work alongside all of them
- We look forward to chatting with everybody at the end of April when we will announce our first quarter results. And again, it's going to be more of the same
- We're going to keep our head down
- We're going to drive as much revenue out of the market that we can. But it's really going to be a more focus on keeping our costs under control and generating cash

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