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LKQ Corp. (LKQ)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Joseph P. Boutross
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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

- This morning, I will provide some high-level comments related to our performance in the quarter, and then Varun will dive into the financial details, as well as our improved outlook for 2021, before I come back with a few closing remarks
- This was another quarter of significant operating progress, driven by excellent execution and improved business conditions
- I could not be prouder of the LKQ team

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- A few years ago, when we pivoted to operational excellence, we knew that there would be a transition period during which we would need to invest in our people and processes to improve the operating model

Cost Structure

- We also recognize that there would be difficult decisions needed to right-size the cost structure and drive efficiencies
- We undertook this shift with the expectation that we would come out the other side as a leaner, more nimble and stronger organization, one that could succeed in difficult conditions like we have seen with the pandemic over the past year, as well as thrive during the good times
- Those expectations are being realized
    - While I'm not ready to proclaim mission accomplished, I believe we have made tremendous progress in our operational excellence transition as evidenced by the continued outstanding results that we've delivered over the past year

Profitability and Cash Flow

- Record outcomes don't happen by accident, and the team has driven strong profitability and cash flow by, among other actions, applying a disciplined pricing approach, implementing permanent cost saving actions, including closing underperforming locations, consolidating delivery routes and reducing head count
- Tightening our operating policies to reduce waste and increase yield, such as harvesting more catalytic converters per car
- Actively engaging with our vendor partners to ensure that we are receiving attractive pricing and market payment terms, and monitoring our receivables so that we minimize past due balances

EPS and Segment EBITDA Margin

- Now on to the quarter
- We were able to produce yet another record quarter
- Indeed, each of the last four quarters results represents the highest EPS reported in the respective quarters, with Q2 of 2021 reflecting Q1 with over $1 of EPS and the highest segment EBITDA margins in over a decade
- Varun will dig into the margin details shortly

Revenue

- Revenue for Q2 2021 was $3.4B, an increase of 31% as compared to the $2.6B in Q2 2020
- In Q2, Parts & Services' organic revenue increased 22%, while the net impact of acquisitions and divestitures decreased revenue by 0.3% and foreign exchange rates increased revenue 5.4%
    - This creates a total Parts & Services revenue increase of 27%
- The organic revenue growth for the quarter reflects the annualization of the pandemic impact during Q2 of 2020

Net Income

- Net income for Q2 2021 was $305mm as compared to $119mm for the same period in 2020, an increase of 157%
- Diluted EPS for Q2 was $1.01 as compared to $0.39 for the same period last year, an increase of 159%

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- On an adjusted basis, net income in Q2 was $340mm compared to $161mm in the same period of 2020, a 111% increase
- Adjusted diluted EPS for Q2 was $1.13 as compared to $0.53 for the same period of 2020, a 113% increase

Monthly Revenue Trends

- Now, let's turn to some of the quarterly segment highlights
- Slide 5 of our presentation sets forth the monthly revenue trends for the quarter
- And as you can see, coming off the low base of Q2 2020, the growth rates improved significantly y-over-y for each of the segments with April and May being the most notable
- The vaccination rates in our key geographic markets is encouraging
- Europe, in particular, witnessed a solid increase in vaccinations throughout Q2, although it still lags the United States
- We, like many, are closely monitoring the Delta variant and the risk of policy actions potentially slowing economic growth if the variant were to rapidly spread

North America

- Turning to North America
- According to the US Department of Energy, fuel consumption for Q2 was 28% above the prior year and 5% below Q2 2019
- From slide 6, you will note that organic revenue for Parts and Services for our North American segment increased 19.7% in the quarter on a y-over-y basis
    - We're looking at our performance relative to collision and liability repairable claims data in the quarter
- Given the aberrations associated with the significant swings in 2020, we believe the most relevant comparison is to Q2 2019

Organic Revenue

- During Q2, organic revenue for Parts and Services for our North American segment declined about 9% on a per day basis relative to 2019, while repairable claims declined 15%
- So, another period of outperformance for our North American operations

North American Team

- I want to highlight a couple of examples of how the North American team continues to push the operational excellence initiatives
- In 2019, our North American team initiated a lean operating strategy based on the principle of doing more with less
- During the first step of this strategy, the team asked the simple question, what does winning look like? The answers to that question allowed the team to unify and develop several key performance indicators that were deployed in early 2020 prior to the pandemic and we immediately generated positive results

Strategy

- We are now in the second phase of this strategy which is systematically implementing a lean road map to optimize those KPIs

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- We are transitioning the team to a daily management system which addresses safety, quality, delivery, and our customers
    - This system is improving our communication and accountability while driving root cause and corrective actions along with sustainable sharing of best practices

Salvage Procurement Team

- In Q2, our salvage procurement team began utilizing artificial intelligence to optimize the procurement of the salvaged vehicles we bid on at auction
- This artificial intelligence uses computer vision, a technology that allows algorithms to reason based on images to assess the specific damage on each vehicle and to determine which parts can be recycled and reused
    - This technology enhances the human element of our procurement processes to further improve our part yield per vehicle and to advance the quality standards of each part
- Additionally, during the quarter, our Elitek business expanded its services beyond onsite mobile diagnostics and repair to also include remote automotive diagnostics and remote programming

European Segment

- Moving on to our European segment
- Organic revenue for parts and services in Q2 increased 20.7% on a reported basis and 19.2% on a same-day basis
- When compared to 2019, our European revenue was down about 2% on a per-day basis
- Our regional operations continued to experience varying revenue performance in the quarter, but each market was positive on a y-over-y basis

UK Business

- Our UK business had the strongest recovery largely due to our favorable inventory availability relative to the competition, and we are confident we are gaining share in the UK market
- I'm also pleased to say that we are witnessing some modest market recovery in Italy, a market that was dramatically impacted by the pandemic
- But it continues to remain a drag on the revenue growth and margins for the overall segment

European Margin

- As you can see from the significant expansion in the European margins, we are making excellent progress on our 1 LKQ Europe program
- Since September 2019, when we first announced the program, the European EBIDTA margins have increased about 300BPS from 7.7% in Q2 2019 to 10.7% in Q2 2021
- In reality, there have been two distinct components to this effort
- One is organizational and relates to creating a fully centralized pan-European leadership team and functional structure
- The other is execution related which focuses on the key initiatives outlined in prior communications such as procurement, logistics, and local projects

Organizational Transformation

- Over the past two years, we have been working both components simultaneously

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- And I'm happy to announce that we have completed the organizational transformation
- We now have all the right people in the right seats in a streamlined structure that reflects a single business as opposed to a collection of independent businesses
- The execution element will be with us forever and will be the driving factor behind the continued productivity improvements in the years to come

Force CDC Project

- A few other items to note in Europe would include, that during the first week of July, we began onboarding the first group of about 25 employees for our innovation and service center in Katowice, Poland
- The Force CDC project in The Netherlands remains on-track and the start of that major warehouse operation is planned for March 2022
- And our ERP implementation at Rhiag in Italy went live on July 5
- Some of you may have noted that on July 14, the European Commission came forward with the Fit for 55 proposal, which accelerates and details plans for a greener economy and reducing net emissions in Europe by at least 55% by 2030 compared to 1990

European Segment

- As a leader in the circular economy and the largest vehicle on parts recycler worldwide, LKQ embraces the global effort to reduce CO2 emissions
- Our European segment, and also Mekonomen, where we have a 26% stake, are first movers in supporting our customers for service and repair of hybrid and electrical vehicles
- According to ACEA, the Manufacturing – Automobile Manufacturing Association of Europe – banning a specific technology is not the sole and rational way forward
- And internal combustion engines, including hybrids, need to play a role in the transition to zero emissions

Specialty Segment

- Now let's move on to our Specialty segment, which, again, knocked the cover off the ball during Q2, by reporting organic revenue growth of 30.1%
- Specialty had a record breaking quarter in terms of revenue, EBITDA dollars, and EBITDA percentages
- As witness in Q1, the drivers of this tremendous performance continued to be the strong ongoing demand for parts related to RVs and light trucks combined with a very disciplined approach to controlling cost
    - We also believe that the stimulus checks benefited the Specialty business in the quarter

Pricing Environment

- Across all of our segments, we are experiencing some level of supply chain shortages and disruptions
- These disruptions are creating product scarcity and freight delays that are resulting in meaningful availability pressures in certain product lines
- The supply chain challenges are also driving product inflation, which in turn, is generating the most robust pricing environment we've seen in years
- Across all of our segments, we have been very effective in passing along these costs as witnessed by our margin performance

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Wage Structure and Turnover Rate

- Alongside supply chain inflationary pressures, like many businesses across the globe, we are facing wage inflation and increased competition for labor
- We are constantly looking at our wage structure and turnover rates across all of our segments to ensure we stay ahead of any competitive pressures and help backfill the open positions with the best candidates we can attract

Corporate Development Perspective

- From a corporate development perspective in Q2, we acquired the business and assets of Green Bean Battery, a hybrid battery reconditioner and installer
- Also in Q2, Warn acquired Fabtech Industries, a leading manufacturer of aftermarket suspensions for light trucks and SUVs
- Fabtech brands, which include Dirt Logic and Stealth Shocks, are widely recognized premium offerings in the off-road racing and performance segments, and are a tremendous complement to our line of Warn products
- Both of these small tuck-in acquisitions represent our ongoing effort to evolve our product offerings to match the changes taking place in the car park and to leverage our robust networks across all segments to sell deeper into existing and prospective customers

New AA Rating

- Lastly, I am proud to announce that during Q2, MSCI increased LKQ's ESG rating from single-A to AA, which is the second increase in the past two years
- This new AA rating places us in the top 19% of our index group
- Also, earlier this month, ISS significantly increased our social and governance quick score ratings
- Please refer to slide 18 which highlights our environmental stewardship in the quarter

Varun Laroyia

Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Investment Grade Credit Metrics

- Before I cover the financial results, I want to highlight a number of significant events and accomplishments related to our capital allocation over the recent past
- With the pivot to operational excellence in 2018, our approach to balance sheet and capital allocation moved towards targeting investment grade credit metrics
- This strategy placed an emphasis on generating strong sustainable FCF, maintaining a conservative leverage position, and deploying capital to the highest return opportunities
- I'm very pleased to report that we have made remarkable progress on all measures, and getting the validation of an investment-grade rating from Fitch this past May is a tremendous achievement for the organization

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Operating Cash Flow

- Looking back at the last 36 months, starting just after we completed the STAHLGRUBER acquisition, we have produced $3.8B in operating cash flow which supports a nearly 80% conversion rate of FCF relative to EBITDA
- As shown on slide 14 of the presentation, we've used these funds to repay $2.1B of debt, which resulted in delivering the balance sheet from a 3.1 times net leverage as of June 2018 to 1.2 times as of June of 2021
    - Additionally, we have repurchased over $800mm of LKQ stock at an average price of approximately $33 per share, or roughly 35% below the current share price

CapEx

- We have not sacrificed investment in the business during this period, with roughly $660mm of CapExs invested to support our growth and operate more efficiently
- Transitioning from the consolidation phase of the company's evolution, acquisitions have been a relatively small part of the capital allocation, though we remain committed to targeted tuck-in acquisitions that deliver high synergies or critical capabilities

Cash on Hand

- Our actions of the last three years have put the company in a very strong liquidity position, which has allowed us to complete the following during Q2
- First, we've delivered a further $411mm in operating cash flows as we converted 79% of our EBITDA into cash
- We redeemed the €0.75B 2026 Euro notes on April 1, the earliest available redemption date, with funds from our lower cost revolver as well as cash on hand
- We repaid the full amount of the remaining term loan of approximately $320mm ahead of schedule, again, using funds from the revolver and cash on hand
- And we repurchased $304mm of LKQ stock, our highest level of quarterly purchases to date

Liquidity

- With our debt transactions, we reduced overall liquidity by utilizing available capacity on the revolver
- We believe future cash flow needs can be supported by this smaller facility, so we eliminated the term loan and moved more funds to the revolver, which in turn will lower borrowing costs even further

Share Repurchasing

- We continue to believe that LKQ shares represent good value, and our repurchases reflect that belief
- As shown on slide 17, we have continued to purchase shares under our 10b5-1 plan in July with an additional $100mm invested through last Friday
    - Since we were nearing $1B authorization, we went to our board of directors for an increase in the total authorization to $2B.
- The board approved the expansion, and we now have the ability to repurchase a further $1B through October of 2024

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Q2 RESULTS

Gross Margin

- Now, I'll move to the financial results
- As Nick described, Q2 was a very successful quarter with positive contributions coming from revenue growth, gross margin expansion and operating expense leverage
- Gross margin was a highlight for the quarter, increasing 270BPS relative to the prior year or 250BPS on an adjusted basis
- The margin improvement is more noteworthy as it came in a period in which input costs rose across each of our segments
- We remain disciplined in our pricing, and as a distributor, we have been able to pass through the higher input costs coming from the supply chain

Tailwind

- Gross margin also benefited from the tailwinds of commodity prices
- As you can see on slide 28, scrap steel and precious metal prices, which have been mostly favorable over the last year, provided additional benefits this quarter
- We estimate that scrap steel and precious metal prices added roughly $57mm in segment EBITDA and approximately $0.14 per share in adjusted diluted EPS relative to last year
    - While we started to annualize some of our permanent cost reductions that had been enacted in 2020, there was still an incremental benefit in Q2

SG&A Expenses

- Our SG&A expenses as a percentage of revenue showed the favorable leverage effects of the cost actions and the other revenue growth, dropping to 26.2% in the quarter or 190BPS better than Q2 of 2020
- Even with the tailwinds related to commodity prices, the largest share of the y-over-y increase in adjusted diluted EPS related to operating performance
- I'll now turn to that operating performance with our segment highlights

North America

- Starting on slide 10, North America produced its highest segment EBITDA margin in the company's history at 20.8%
- Q2 is the fourth consecutive quarter that we've been able to make this statement
- The primary factors behind the improvement are similar to the last few quarters, as the segment continued to benefit from ongoing gross margin initiatives and permanent cost reductions
- We are still driving costs out of the business, and we currently estimate the permanent cost savings to be $105mm, $25mm increase relative to the figure shared in last September's Investor Day presentation
    - Additionally, the commodity pricing benefits on gross margin and operating leverage I mentioned earlier are seen here, helping to drive the North American margins above our long-term expectations

Europe

- As seen on slide 11, Europe reported a 10.7% segment EBITDA margin, which represented a 330 basis point improvement over last year

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- With a YTD margin at 10.2%, we are on track to deliver on our margin goals
- Europe is benefiting from the revenue recovery, improved net pricing and cost containment actions taken in the last year

Operating Plan

- Moving to slide 12
- Specialty continues to execute its operating plan extremely well
- Similar to Q1, Specialty generated significant revenue growth in the quarter without sacrificing margin and continued to effectively manage operating expenses
- The segment EBITDA margin of 14.9% is the highest quarterly figure since the business was acquired in 2014

Savings

- We are also delivering meaningful savings from our focus on the capital structure
- The early redemption of the 2026 Euro Notes created interest expense savings
- Additionally, deploying FCF to debt pay-downs and share repurchases generated interest expense savings and an EPS benefit from a reduced share count
- We estimate that these factors added approximately $0.03 per share to our second quarter results
    - Additionally, Mekonomen's solid performance and other investment income improvement generated another $0.02 of y-over-y growth
- Given the improved expectation of full-year profitability, we decreased our projected effective tax rate in our outlook from 26.5% to 26.25%, which had a nominal benefit on the quarter

COVID Impact

- So to recap, our adjusted EPS of $1.13 is $0.60 increase from Q2 of 2020, which was a low comparable given the pronounced COVID impact last year
- The commodity benefits along with the increases attributable to investments, the tax rate, our capital deployment, and a slight tailwind from foreign exchange produced about $0.20 of the improvement
- The remaining $0.40 comes from our operating performance, focusing on profitable revenue growth, enhancing gross margins, and controlling our overhead costs
- And this should be the key takeaway when considering Q2 results

Exchange Rate

- I will wrap up my prepared comments with our updated thoughts on 2021
- Consistent with the level of detail we have provided in recent quarters, we are comfortable making the following statements, all of which assume that additional mobility restrictions beyond what are currently in place are not implemented in our major markets, foreign exchange rates hold near recent level, and scrap and precious metal prices trend lower in H2

Core North America and European Segment

- Number one, we believe that our parts and services revenue will be higher than 2020 on a full-year basis
- And we will continue to recover in our core North America and European segments in H2, as mobility trends benefit from further progress on vaccination rates

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H2 Growth Rate

- We expect H2 growth rates to decline relative to what we reported in the most recent quarter, as the pandemic effects were not as severe in H2 2020 for our business
- While we expect demand for our Specialty products will remain strong
- We anticipate the growth rates to be lower than H1 due to H2 seasonality and the expected end of the stimulus program
- As discussed previously, we will have two fewer selling days in North America in 2021 with one having occurred in Q1, and the second to occur in Q4, while Europe is flat for the year overall with one day shifting from Q1 to Q2

outperformance

- Second, with another excellent quarter in Q2, we are projecting full-year adjusted diluted EPS in the range of $3.55 to $3.75 with a midpoint of $3.65
- This is an increase of $0.55 or 18% at the midpoint over our most recent prior guidance
    - This increase reflects the outperformance in Q2, in addition to higher anticipated results in H2, as we expect the benefits of our ongoing margin and operating expense programs and our strategic cash deployment to outweigh strong inflationary headwinds related to labor, freight, fuel, and inventory costs being experienced throughout the industry

Net Income

- And third, I began my comments by noting the significant progress we've made on our capital allocation strategy, including outstanding cash flow generation in Q2
- With this in mind, along with the higher projected net income for the year, we are raising our FCF guidance to a range of $950mm to $1.050B, with $1B at the midpoint

Inventory

- We still anticipate an inventory build in the back half of the year ahead of the traditionally strong Q1 and Q2 seasonal demand
- In the interim, our teams, with the active support of vendor partners, continue to expertly navigate the situation to ensure that we have the right parts in the right places to best serve our customers
- And finally, the European payables optimization program remains on track and will help to partially offset the impact of the inventory build on cash flow

Dominick P. Zarcone

President, Chief Executive Officer & Director

Q2 HIGHLIGHTS

Key Initiatives

- Let me restate our key initiatives, which continue to be central to our culture and our objectives
    - First, we will continue to integrate our businesses and simplify the operating model
    - Second, we will continue to focus on profitable revenue growth and sustainable margin expansion

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  - Third, we will continue to drive high levels of cash flow, which in turn, give us the flexibility to maintain a balanced capital allocation strategy
  - And fourth, we will continue to invest in our future
- As you can see from our results, our company executed on each of these initiatives in Q2
- And for that I offer a tremendous thank you to each of our 43,000-plus team members across the globe that make it happen each and every day
  - They define what it means to be LKQ proud

QUESTION AND ANSWER SECTION

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

Q

Lots of goodness to work with here, but I'll focus on your credit profile and the implications for cash flow. Varun, what are the implications of an investment grade rating from Fitch on your vendor terms? I guess I'm wondering will the Fitch decision cause any immediate change to your payable terms with key vendors which would be a positive for cash flow.

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Good morning, Craig. Great question and great to hear from you. Yes, incredibly pleased with the company really firing on all cylinders across revenue, margin, but also FCF conversion coming through, and then also the way we have deployed it.

With regards to your specific question about the recent investment grade rating initiation by Fitch, in itself, it makes no change to either a credit facility or for that matter, vendor terms. But if you go back, and this is a public document, and go through our credit facility agreement, within that piece, we have a prewired clause, which essentially states that if one of the two currently named rating agencies were to make LKQ and award them – award us a investment grade rating – the liens of our senior secured facility drop off. And that, as you can imagine, is a significant number, which, of course, is just under $3.5B credit facility. So that's one piece, where the liens drop off and it becomes unsecured.

The second piece is within the credit facility, we have a current ceiling that our indebtedness to – for trade payables – cannot exceed 180 days. So again, just to recap, the Fitch decision in itself does not change anything today, but clearly, being one of the three key rating agencies out there, one of them has this view of us. I have no doubt that given the ongoing discussions with the other two rating agencies, they too will come around. I don't believe it's a question of if, it's more a question of when.

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

Q

Got it. So, just so I'm clear, you need one of the other two to make a change in order to trigger some of those changes in your contracts.

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

That is correct.

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Daniel Imbro
Stephens, Inc.

Q

I want to start in North America, Varun. Obviously, the gross margin was really strong and part of it, you noted, is driven by metals. So, can you talk about how the team handled that strong revenue growth with the lower head count? Have you been able to keep out as many of the expenses that you anticipated? And have there been any hiccups in hiring when you need to, given the employment backdrop?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Daniel, good morning. Yes, it is Varun here. And listen, it's an excellent question. Before I get to the specifics of answering your question, I just want to make sure that all of our 43-plus thousand associates globally are given a big shout-out. What our field teams have done globally from branch to a warehouse to a dismantling yard has just been nothing short of phenomenal. Our success – LKQ's success – is directly attributable to our field teams. The last 17, 18 months have not been easy, but they are the ones that have kept this company humming along and really exceeding everyone's expectations and putting up yet another record quarter.

Yes, you're right. With regards to our North America margins, at 20.8% in the current quarter or 19.9% in Q1, this is higher than what our long-term expectation has been. As I've been very clear, both in Q1 and now most recently in my prepared comments, precious metals have been a benefit and we estimate – and if you go to see slide 28 in the earnings deck – we've actually given transparency in terms of how scrap metal and precious metal prices have been trading and really what level of benefit has come through. We estimate roughly 350BPS of that 20.8% margin that North America has put up, is directly attributable to scrap and precious metal prices.

Even if you were to take that piece out, the business has still delivered well north of 17 points. And so, that really is what gives us a lot of comfort. Could we have done better? Perhaps. But there are inflationary pressures. I'd say the single biggest challenge at this point of time, not just for LKQ but I'd say across the entire industry here in the United States has been labor. And labor essentially, whether it be availability or whether it be the cost to get that labor, it is leading to congestion at ports. It's leading to higher freight costs because delivery drivers are incredibly difficult to find. But that has been the key piece.

And that's why I come back full circle in terms of giving a massive shout out to our field teams. We have been running short. With regards to labor availability, we have taken wages up also just to make sure that we are market competitive. But we have got branch managers, plant managers, DMs going and making deliveries because we want to make sure that while we have the right part of the right place we continue to serve our customers. Without customers, we really don't have a business. And just want to make sure that that is heard loud and clear. Our field folks have done an outstanding job.

Daniel Imbro
Stephens, Inc.

Q

That's great. That's really helpful color. And then just a follow-up on the North American margin, obviously, you're right, metal prices you called out at $51mm I think in EBITDA. But does that part of was also raising your cogs in North America? If I look at the slide, I think self-service cost was up 53%, salvage vehicles are up 37%. So if metal prices roll over, should there be some natural offset in that as your cost to acquire vehicles at auction would go down as well?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

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Yes. Absolutely. Yes. I think that's what we've kind of said in the earnings call, that salvage prices have been running pretty high for quite some time. But again, it's partly to do with where the dollar has been trading, so lots of export traders has been taking place. As we know, there has been a shortage of chips and so, OEM sales have come down and as a result used car prices have been up. Precious metals are up. That is certainly flowing through our COGS also. There is no doubt about it.

Brian Joseph Butler
Stifel, Nicolaus & Co., Inc.
Q

First one, just kind of on that point of the labor and kind of the inflation, could you maybe just kind of rank where you see it? I mean, it looks like labor is at the top but where on – and kind of put in perspective on magnitude – where does freight and fuel fall below that on the inflation pressures?

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

Yeah. I would put that in probably that order, labor first because you have to remember that over 60% of our operating expenses ultimately come back to people. It's the biggest portion of the – of – on the P&L, the biggest expense. And so – and we have 43,000-plus people around the globe. So, that's number one.

Second would be freight, and that not only relates to ocean freight which is up significantly, but also the domestic freight whether it be in the US or in in Europe. And then, some people put fuel as part of freight. We try and separate it out. Obviously, if you can track oil prices, they've been up as well. I'd point you to page 7 of our deck which kind of sorts out where we have saved money over the past year or so, and most of the savings has been in on the people side and then secondly on the delivery side, and then finally kind of facilities and the like. So, again, I would put it in that order of think about people, freight, and then fuel.

Brian Joseph Butler
Stifel, Nicolaus & Co., Inc.
Q

Okay. That's helpful. And then just my follow-up, when you think about the M&A pipeline and your focus has been recently on kind of the operational excellence, can you give a little color on where that M&A pipeline stands and what might be targeted in the next year or two what assets you're still looking at?

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

Absolutely. So, I mean, we are always looking for ways to add to our strength as an organization and whether that comes in acquiring in new geographies where we don't have a presence, whether it comes from acquiring new product lines or new skill sets. Obviously, the focus currently is on kind of newer technologies, right? So, we've made a number of acquisitions over the last year in the whole diagnostics and calibration space, and we're building up a very nice business there.

As you know – and we mentioned in the call – the Green Bean acquisition in Q2 that relates to battery technologies. And again, we all know that ultimately, battery, being able to service and deal with EV batteries, whether it's hybrids or battery – electric vehicle batteries is going to become important. So, you should expect additional investment in that area. So, anything we can do to evolve our product and service set – and the services is a key component there – relative to the evolution of the car park, that's what we're going to do. And so, you should expect that you will see additional acquisitions, probably smaller, because particularly in these newer technologies, there are no big companies out there to buy. So, we can, again, make sure that we are on the cutting edge, as it relates to what we can provide our customers.

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Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Yeah. And, Brian, this is very consistent with what we've been talking about for quite some time, including at our Investor Day, that M&A, while it may seem that the pace of M&A has slowed down, not really. Really, the focus has been different. Rather than going whale hunting, as the European segment was built up, the focus has really been, as Nick said, the focus has been on high synergy tuck-ins and building critical capabilities and that focus remains.

Bret Jordan
Jefferies LLC

Q

Hey. On the payables, if you do get a second rating agency that tip your way, what would be, sort of, the shorter-term impact? I think you're close to 50% accounts payable inventory. But what kind of step up would you see if you got two investment grades?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Great question, Bret. The biggest uplift really will be from our European business, and just given the nature of the European business and how we compare that from a payables optimization program, relative to, say, the big four here on the hard part site in North America. Our North American business per se, we have some opportunity, but if you think of the salvage business, whether self-serve or full-serve, it's just a different business model, right?

So, if you think about the size and scale of our European business, which at this point of time, is roughly half of the company, that really is where the opportunity is. And we certainly see that there's further upside out there, not just with the fact that we would get the investment grade rating at some point of time. And so, the 180-day ceiling obviously gets lifted; that's more of a tactical piece. But more on an ongoing basis, as the team how that continues its active discussions with a number of our vendor partners, the focus really had been let's get through the top 40 and then the team continues to go further down the chain as part of the overall supply rationalization discussions, making sure that we continue to get COGS at attractive prices, but also at what we believe to be market convention terms.

Bret Jordan
Jefferies LLC

Q

Okay. Thanks. And I guess quick question on supply chain. Is the disruption and sort of inventory availability actually a positive for you in the sense that you're gaining share as others are – maybe OEs are less available? And I guess do you have anything anecdotal on what percentage of repairs are now alternative parts in North America?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. Bret, great question. Obviously, the supply chain, not just in our industry but in most industries, is under duress at the moment. For us, it really depends on actually the business and the product line because there's significant differences across the LKQ platform. Like in salvage there's no impact because all that product is here and it's easy for us to get at the auctions.

Our aftermarket business here, however, most of the aftermarket collision product for the whole industry, not just us, comes out of Taiwan. And it's not an issue related to our ability to procure the product. The manufacturers have the ability to stamp out the parts. The issue is getting it from the warehouses in Taiwan to the warehouses in

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Tampa or Toledo or Topeka or wherever we need them here in the US. And everyone knows what's going on, the issues related to container capacity. Port congestion is a major issue. I mean, we've got ships sitting on the water just waiting to be unloaded. There's a lack of capacity to unload the ships. There's a shortage of drivers to do the drayage within the ports, that meaning moving the cans around. And then, there's a shortage of trucking capacity to actually get the containers from the ports to our locations.

So, what's that doing? It's extending the timeframe of how long it takes us to get product, and it's costing a little bit more money. The good news is the vast majority of our ocean freight is under contract, at least for quite some time now, and going into the future. Spot rates, as you know, are up anywhere from six to eightfold. The good news is, again, we're under contract. We bring in in 15,000 containers a year. That's 300 containers a week. And I wouldn't want to be a company that's importing 300 containers a year or 50 containers a year which many of our smaller competitors are dealing with. So we don't have the inventory that we want but we can. But we can – we're making it work. And clearly, we think we're in a better position than most of the small players out in the marketplace.

Now, you move over to Specialty and it's different. Yes, they bring some product in from the Far East. And we're dealing with the exact same issues as in the aftermarket in North America. But they also source the majority of their product domestically or at least within North America. And there, the real issue is the capacity of the manufacturers who simply cannot keep up with demand. We would like to have more inventory in our Specialty group. We've said in the past quarters – and this quarter was true as well – we've probably lost some revenue because we didn't have product on the shelves. But again, as the largest distributor in what we do, we are doing much better than the smaller competitors.

And Europe's somewhere in between, Bret. I mean, the reality is they import less product from Asia than we do in our North American collision business. But they are also experiencing some tight supplies on certain products that are produced within the EU. So, it's creating issues but we think we're doing a pretty good job of managing through.

Stephanie Moore
Truist Securities, Inc.

Q

I wanted to touch on the European margin performance and expectations kind of implied in H2, obviously, of the record and pretty tremendous Q2 result. But if you just kind of back into even your updated guidance, it does account for a bit of a slowdown in the back half off of Q2 levels, but admittedly nice improvement y-over-y. So, I'd love to get some color just as you kind of updated your guidance what your thoughts are for the back half in terms of the margin performance, and why there should be some kind of slowdown from Q2. Just any puts and takes there would be helpful. Thank you.

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Good morning, Stephanie. It's Varun out here. Let me take that question. So first of all, really pleased with how our European business continues to perform. If you go back, when we initiated the One LKQ Europe program and formally give margin targets, we basically called for exiting sustainable double-digit margins at the end of 2021. That was in September of 2019. Amazing how fast time goes by, but we are now in the last six months of that three-year journey. And the way the team has navigated these incredibly choppy and turbulent times with a pandemic thrown in for good measure has been nothing short of phenomenal. Really pleased with the team out there. As you obviously have made out, we do have a number of relatively new leaders out there also. But really, the point being in terms of the talent that we needed, we have out there at this point of time, very optimistic about the future also.

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More to the point about your specific question about a slowdown in H2, not really. If you actually go back and see the European business historically and, obviously, take out 2020 because that was the pandemic year or at least and it's still continuing. But if you go back historically, Q1 and Q2 typically are strong. Q3 is also relatively strong. But then Q4 is typically seasonally the weakest for our European business. So, it really is kind of seasonal is what we are thinking about in terms of how we are forecasting that European business more than anything else as of now.

There obviously are a lot of flip-flop measures taking place, is the country open, is the country not open. Yesterday morning, the United Kingdom said that EU and US travelers that have had the double jab would be welcome without a quarantine. One never knows whether that continues or not. About four weeks ago, we held our European Leadership Conference. That was held virtually. All of our platform leaders that were on the Continent did make it into our European headquarters in Switzerland, with the exception of our UK leadership team.

And again, that just tells you in terms of what's happening out there. But overall, the way the program is coming along, how the team is executing, we feel good about it. And that is essentially what has led us to H1 performance, but also gives us the confidence to be able to lift the floor on the 9.2% up to 10.3%, up by about 30BPS to a 9.5% to a 10.3% full-year segment EBITDA margin for the European business.

Let me kind of just – one final piece – also say these numbers include roughly about 20BPS to 30BPS of transformation expenses, and at times it is easy to overlook those pieces but that is also a drag. But that is the way we have been reporting it. So, that number that I just quoted includes at least in H1 a 20BPS drag. You can obviously take that away. And clearly, we do expect to accelerate the transformation efforts in H2.

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

And, Stephanie, some of this...

Stephanie Moore Q
Truist Securities, Inc.

Great.

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

...some of the seasonality just goes along with holiday patterns. Obviously, August tend to be a very soft month in this industry as people are on vacation in Europe. And then once you get to the holidays, things really shut down really after the – pretty close to H2 December.

Gary Frank Prestopino Q
Barrington Research Associates, Inc.

Nick, could you give me those statistics on the collision claims in the quarter from CCC? I couldn't write it down fast enough. Do you have that?

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

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Absolutely. So, we think that the best way to look at it, given the total disruption in 2020, is to compare our organic growth to cause collision claims, actually in Q2 2019 which was a normal year, CCC, when comparing 2021 to 2019, it was down 15%, 1-5%, and LKQ organic was down 9%.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. 9%. Thank you.

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

Yeah.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

And then just in terms of – you guys have done a lot of great work on getting the OpEx down and all of that. As the business starts growing again, when things do return to normal, I mean, can you run the business in a somewhat more of a growth mode like, say, 4% to 7% while holding the personnel expenses as a percent of sales at that 15.6%? Or as you grow, you've got to add more people?

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

Well, there's no doubt that as we grow from a overall dollar perspective, and that means more deliveries, more trucks on the road, more people in the warehouse, we can't just grow revenue and not add back any head count. But I've been pretty straightforward with all of my direct reports, that we need to see the revenue rebound prior to bringing and adding personnel, or any, really, any real expense, back on to the P&L.

And so, we think that on a – take North America – that an ongoing basis, we've reset sustainable margins in the high-16%s. And if you recall, 2018, we are at 12.7%; 2019, we are at 13.7%; at our Analyst Day in 2020, we – we're directing people to be north of 15%. Last quarter, we told people in the low-16%s; and here, we're telling people on a permanent basis, long term, when you take out all the ancillary ups and downs related to metals and the like, high 16%s is a good target.

And so – and we anticipate that we're going to have to bring some level of expense back to allow us to have the capacity to grow our revenue base.

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