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# LKQ Corp. (LKQ)

Q3 2021 Earnings Call

## CORPORATE PARTICIPANTS

**Joseph P. Boutross**  
*Vice President-Investor Relations*

**Varun Laroyia**  
*Chief Financial Officer & Executive Vice President*

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

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## OTHER PARTICIPANTS

**Bret Jordan**  
*Jefferies LLC*

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

**Stephanie Moore**  
*Truist Securities, Inc.*

**Daniel Imbro**  
*Stephens, Inc.*

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

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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
- The reconciliation of GAAP to non-GAAP measures is included in today's earnings press release and slide presentation

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

### BUSINESS HIGHLIGHTS

#### EPS and EBITDA Margin

- This was another quarter of significant operating progress at LKQ, driven by excellent execution in delivering solid financial performance, all while navigating the challenges with the supply chain and the current cost environment
- We were able to produce yet another record quarter and this represents the fifth consecutive quarter with the highest EPS reported in their respective quarters
- Q3 also reflects the second time we've been able to achieve more than \$1 of EPS on an adjusted basis, and reflects the highest third quarter segment EBITDA margin in the history of the company

- We are particularly pleased that our European business delivered its highest segment EBITDA level in over nine years, exceeding the 11% level
- Varun will dig into the margin details shortly
- While I recognize the listeners are primarily focused on the financial results, I know our performance is a reflection of the dedication and effort of our 45,000 team members around the globe who are working hard to serve our customers
- I hope you can appreciate that I am more excited about the performance of my team than the quarterly results as they are the key to continued excellence

#### Capital Allocation

- With respect to capital allocation, as you hopefully read from our press release issued this morning, I am very pleased to announce that our Board of Directors has declared the company's first-ever quarterly cash dividend
- This dividend declaration and our existing stock repurchase program are key components of our strategic plan to drive total long-term returns for our stockholders
- Our solid balance sheet and sustainable cash flow generation, coupled with our leading market positions across our operating segments, provide us with the opportunity to execute on that plan
- The quarterly dividend of \$0.25 per share will be paid on December 2, 2021, to stockholders of record at the close of business on November 11

#### Revenue, Net Income and Diluted EPS

- Now, on to the quarter
- Revenue for Q3 2021 was \$3.3B, an increase of 8.2% as compared to the \$3.0B in Q3 2020
- During Q3, total parts and services revenue increased 6% comprising organic growth of 4%, the net impact of acquisitions and divestitures increasing revenue by 0.5%, and foreign exchange rates increasing revenue by 1.5%
- Net income for Q3 2021 was \$284mm as compared to \$194mm for the same period last year, an increase of 46.4%
- Diluted EPS for Q3 was \$0.96 per share as compared to \$0.64 per share for the same period of 2020, an increase of 50%
- On an adjusted basis, net income in Q3 was \$300mm compared to \$228mm in the same period of 2020, a 31.6% increase
- Adjusted diluted EPS for Q3 was \$1.02 as compared to \$0.75 for the same period of 2020, a 36% increase
- Now, let's turn to some of the quarterly segment highlights

#### Growth and Vaccination Rates

- Slide 5 sets forth the revenue trends for the quarter
- And you can see growth rates improved y-over-y for all segments
- The vaccination rates in our key geographic markets continue to improve
- But as we progress throughout the quarter, we started to face headwinds related to the rise in the Delta variant, and also challenges with the aftermarket supply chain, both of which impacted organic growth across each of the segments

## NORTH AMERICA

- Turning to North America
- According to the US Department of Energy, fuel consumption for Q3 was 8.6% above the prior year and 1.3% below Q3 2019

## Organic Revenue

### NORTH AMERICAN SEGMENT

- From slide 6, you will note that organic revenue for parts and services for our North American segment increased 5.9% in the quarter on a y-over-y basis
- When looking at our performance relative to collision and liability repairable claims this quarter, given the aberrations associated with the significant swings in 2020, we believe the most relevant comparison is to Q3 2019
- During Q3, organic revenue for parts and services for our North American segment declined about 7% on a per day basis relative to 2019 levels, while repairable claims declined 10.6%, so it was another period of outperformance for our North American operations

### SALVAGE BUSINESS

- During Q3, our salvage business and the growth of our major mechanical product groups had solid performance
- Although fill rates have been challenged, we are witnessing a positive offset from our quote conversion rates on salvage products
- Importantly, as we progressed through Q3 and entered Q4, we've witnessed an increase in availability at the auctions and prices are moderating vs. what we experienced earlier in the year

### DIAGNOSTIC AND CALIBRATION SERVICES BUSINESS

- Also, Elitek, our diagnostic and calibration services business, continued to exceed our expectations, with September being the highest monthly level of diagnostic scans since building out this business, a clear sign that shops and carriers are embracing this unique service offering
- For those on the call that will be attending the SEMA event next week, Elitek will have a presence at the show, so please come visit, and you can see why we are excited about this growth opportunity

### EUROPEAN SEGMENT

- Moving on to our European segment
- Organic revenue for parts and services in Q3 increased 0.1% on a reported basis and 0.3% on a per day basis
- When compared to Q3 2019, our European revenue was down just 1% on a per day basis
- So, we have made progress on getting back to pre-pandemic levels and are optimistic we will move ahead of the 2019 levels in the next quarter or two
- From an overall mobility perspective, virtually every European market experienced flat growth in the quarter, which we believe is a sign that the spike we witnessed in Q2, due to the reopening of the economy, subsided sequentially in Q3
- Our regional operations continued to experience varying revenue performance in the quarter

- Our Eastern European business had the strongest recovery, despite a very competitive pricing environment
- Germany and the Benelux markets also delivered well above total segment growth
- The drag in growth was primarily driven by negative growth in Italy, a market that continues to face very difficult conditions

#### NEW INNOVATION AND SERVICE CENTER

- Other items to note in Europe would include the fact that on September 6, we celebrated the grand opening of our new Innovation and Service Center in Katowice, Poland that began operations earlier in the quarter
- Also on October 1, just after the close of Q3, we acquired a company named HAMU, which operates nine locations in the Central Netherlands region
- With over 100 employees, HAMU is one of the largest independent automotive parts wholesalers in the Netherlands

#### SPECIALTY SEGMENT

- Now, let's move on to our Specialty segment, which again delivered solid performance during Q3 by reporting organic revenue growth on a same-day basis of 13.7%
- As witnessed in H1, the drivers of this ongoing performance continue to be strong demand for parts related to RVs and light trucks, as well as our drop-ship business
- On October 1, we finalized the acquisition of Seawide Marine Distribution, a nationwide electronics wholesale distributor that supplies electrical and electronic products for the marine, outdoor and personal navigation markets
  - This acquisition is consistent with the strategy of entering adjacent markets that Bill Rogers highlighted during our 2020 Investor Day
- Marine products overlap nicely with our RV and towing product portfolio
- Importantly, Seawide now has the benefit of leveraging our network of eight specialty distribution centers and over 40 cross-docks that are strategically located to provide next-day service throughout North America
- According to the National Marine Manufacturers Association, the total addressable market for the wholesale products Seawide offers is over \$3B.

#### RV Industry Association Distributor of the Year

- Lastly, I want to acknowledge and congratulate the specialty team for being recognized as the RV Industry Association Distributor of the Year at the recent 2021 RV Aftermarket Conference in Atlanta, a tremendous accomplishment
- In addition to the HAMU and Seawide Marine acquisitions, other corporate development transactions included divesting all of our equity interest in a very small joint venture in the UK and acquiring a business in the United States that remanufactures torque converters, a product used in the remanufacturing of automatic transmissions

#### Global Supply Chain

- The global supply chain continues to be under duress

- It is widely known that today a record number of ships are anchored off the coast of California waiting for port lanes to unload containers, some of which hold our aftermarket inventory, and are eventually headed to LKQ facilities
- High demand for oversea products, congestions within the ports and at the rail hubs, and a severe shortage of truck drivers has led to delays and increased costs for ocean and land freight both in North America and in Europe
- The recent initiatives across the globe to begin tackling components of these route issues such as the measures implemented by the port of Los Angeles on October 12 are encouraging
- But we expect overarching supply chain issues to persist in the near to midterm
- We are doing our best to effectively navigate the difficult environment
- And we are hopeful that we won't be talking about the supply chain challenges in reading Draconian headlines on a daily basis at this time next year

#### INFLATIONARY PRESSURES

- 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 to help backfill the open positions with the best candidates we can attract

#### ESG Efforts

- Now, a brief update on some of our ongoing ESG efforts
- During the quarter, we established the LKQ Cares ESG Advisory Committee, which is comprised of key leaders across our company
- The purpose of the committee is to support and provide advice regarding LKQ Corporation's ongoing commitment to environmental matters, social responsibility, corporate governance, and many other public policies relevant to our company
- Additionally, with inclusion being a core value at LKQ, I am excited to announce that LKQ has joined the Second Chance Business Coalition, a nationwide effort to create economic opportunity for approximately 78mm Americans trying to get back on their feet and contribute to society
- We are proud to be alongside 35 other large public and private companies that also believe that supporting those seeking a second chance in life not only provides opportunities for the individual, but also for their families and for their communities
- It's simply the right thing to do

#### Awards

- Lastly, as you may have read, we are both humbled and honored that LKQ North America has been recognized by WorkBuzz, an independent global employee engagement firm, as a 5-Star Employer after receiving positive feedback from our first ever employee engagement survey
- Part of our mission statement is to build strong partnerships with our employees and the communities in which we operate
  - And this award validates that our inclusive and engaged teams are proudly carrying this mission forward

## Varun Laroyia

*Chief Financial Officer & Executive Vice President*

### FINANCIAL HIGHLIGHTS

#### FCF and EBITDA

- Our third quarter results reflect continued evidence of the benefits of the operational excellence initiatives we instituted a few years ago
- The record profitability and continued robust FCF just don't happen by accident
- The team's focus on getting the fundamentals right, continuous improvement and winning each day has driven these strong results under what are incredibly challenging conditions with a congested supply chain and strong inflationary pressures
- I'd like to start with a few highlights before getting into the details
- As you heard from Nick, Europe achieved segment EBITDA of 11.5% for the quarter
- This gives us the confidence to narrow the full year segment EBITDA range for 2021 further to 9.8%, up to 10.3%, effectively lifting the floor by a further 30BPS.
- Specialty delivered yet another excellent organic revenue quarter at 13.7%, despite the ongoing supply chain challenges
  - This is the fourth consecutive quarter of robust double-digit organic revenue growth for the segment

#### Cash Flow, Share Repurchase Program and Dividend

- Cash flow generation remains strong and the conversion ratio relative to earnings continues to be above our long-term expectation, despite a challenging environment
- The share repurchase program carried on with a further 4.3mm shares purchased in the quarter, bringing the YTD total to 12mm shares and the program to date of 29.3mm shares repurchased
- And finally, the initiation of a regular quarterly dividend reflects the confidence in our strategy and the strength of our business, underscoring our commitment to deliver long-term value to our stockholders

#### Revenue, EBITDA & Gross Margin, Cash Flow and EPS

- Now, I'll move to the consolidated financial results
- As Nick described, Q3 was another successful quarter with growth in revenue, EBITDA margin, cash flow and EPS
- Gross margin was again a highlight for the quarter, increasing 150BPS relative to the prior year
- We continue to feel pressure on input costs across each of our segments, which we have been able to mitigate the effects by being nimble to adjust to the new reality of higher input costs by adjusting pricing
- Gross margin also benefited from the tailwinds of commodity prices although at a much lower level than we've seen in prior quarters

#### CAR COSTS

- Car costs remain relatively high and, with the moderation of precious metal prices in the quarter as seen on slide 27, the benefits dipped relative to H1

- We estimate that scrap steel and precious metal prices added roughly \$12mm in segment EBITDA and \$0.03 in adjusted EPS relative to last year
- As a reminder, this benefit is well below the \$57mm in segment EBITDA and \$0.14 in adjusted EPS for metal prices experienced in Q2 2021

#### OVERHEAD EXPENSES

- Overhead expenses as a percentage of revenue increased 50BPS y-over-y, largely driven by personnel costs
- The tight labor market has pushed wages higher in many of our markets
- Additionally, strong performance across all three segments is contributing to increased levels of incentive compensation in 2021, which represents 30BPS of higher expense
- Other overhead expenses are slightly favorable as we're offsetting inflation in freight and fuel through operating efficiencies and leverage from higher scrap and core revenue

#### SEGMENT OPERATING RESULTS

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##### North America

- I'll now turn to the segment operating results
- Starting on slide 10, North America produced an EBITDA margin of 17.3% for the quarter, down 30BPS from a year ago

#### GROSS MARGIN, EXPENSES AND EBITDA

- Gross margin was favorable by 60BPS, primarily coming out of the ongoing margin initiatives in the wholesale business and improved pricing
- Self-service increased gross margin dollars compared to 2020, but generated a lower margin percentage due to an increase in car cost and moderating metal prices
- Segment overhead expenses increased by 100BPS, with the largest change owing to personnel expenses
- Roughly half of the increase is attributable to wages and temporary labor with the remainder in higher incentive compensation
- At the segment EBITDA line, the metals prices benefit noted previously generated 20BPS of improvement relative to last year
- I previously mentioned Europe's strong margin for the quarter, and slide 11 shows the details
- Adjusted gross margin increased by 240BPS to the highest level in recent years, primarily owing to better net pricing, while overhead expenses grew by 30BPS, driven by higher wages and incentive compensation

##### Specialty

- Moving to slide 12
- Specialty grew EBITDA dollars, though experienced 100BPS of dilution in margin
- The primary factors contributing to the decrease are, one, higher incentive compensation; inflationary pressures in the segment's own operations, which are behind the 30 basis point decrease in gross margin; and finally, duplicative cost associated with acquisitions done in the current FY, which we expect

to be transitory as the team integrates the acquired businesses over the remainder of the year, and into early 2022

#### INTEREST EXPENSE AND INCOME

- Similar to H1 2021, we are also delivering benefits from our focus on the capital structure
- The early redemption of the 2026 euro notes in April of this year created interest expense savings, additionally, deploying FCF to debt paydowns and share repurchases, generated interest expense savings and an EPS benefit from a reduced share count
- We estimate that these factors added roughly \$0.06 per share to our third quarter results
- And based on the characteristics of these initiatives, are expected to continue to deliver over multiple periods
- Additionally, income from our equity method and other investments generated a further \$0.02 of y-over-y growth

#### Tax Rate and Adjusted EPS

- Given the improved expectation for full year profitability, we decreased our projected effective tax rate in our outlook from 26.25% to 25.75%, which contributed to \$0.04 per share y-over-y benefit in Q3
- So to recap, our adjusted EPS of \$1.02 is \$0.27 increase over Q3 2020
- The commodity benefits, as previously stated, were \$0.03; investments generated a further \$0.02; the tax rate, our capital deployment and a slight tailwind from foreign exchange produced about \$0.10 of the improvement
  - The remaining \$0.12 comes from our operating performance, by far the single-largest contributor to the results

#### Liquidity and Capital Allocation

- Shifting to liquidity and capital allocation
- We continued the trend of robust cash flow generation in Q3 with \$429mm of operating cash flow and \$384mm of FCF
- Our conversion of EBITDA to FCF was a very strong 84%, roughly in line with a YTD ratio as seen on slide 14
- Our operating cash flows were driven by cash earnings and favorable movement in trade working capital balances
- Payables represented an inflow for the quarter as we benefit from extended payment terms, including our European vendor financing initiative

#### INVENTORY

- Inventory was an outflow of \$60mm for the quarter
- But similar to Q2, we were unable to increase our purchasing to the desired level, owing to the supply chain issues that are affecting many sectors of the economy
- We are actively working to rebuild inventory levels and we believe that our excellent relationships with suppliers and liquidity on hand puts us in a good position to acquire the needed inventory when supply chain congestion finally eases
- We deployed the FCF to repurchase 4.3mm shares in the quarter for \$219mm, acquired two tuck-in businesses for \$37mm, and repaid \$23mm in outstanding borrowings

## NET LEVERAGE RATIO

- Our net leverage ratio dropped to 1.1 times EBITDA and interest coverage now exceeds 24 times compared to the credit facility requirements of 4.25 times and 3 times, respectively
- Or said differently, at this point in time, we do not need to devote further capital towards paying debt and as you saw in Q3 results also
- With \$1.6B in availability on our credit facility and approximately \$400mm in cash, we have over \$2B in liquidity to fund our strategic objectives

## Liquidity

- The liquidity amount is roughly \$800mm below our December 31, 2020 figure, reflecting the use of liquidity to redeem the 2026 €0.75B euro notes, prepay our outstanding term loan balance of \$319mm, as well as the termination of the \$110mm receivable securitization program earlier this year in July
- We felt comfortable reducing the overall capacity, owing to our ability to sustainably generate robust FCF
- As you can imagine, we have carefully considered our liquidity position and future cash flow generation prospects in reaching the decision to initiate the quarterly cash dividend
- We are confident in the company's ability to convert earnings to FCF in a ratio of 55% to 60% on a long-term basis, which provides us with sufficient cash to fund a dividend, while continuing to repurchase shares, reinvest in the business, and make accretive acquisitions

## Dividend and Share Repurchase Program

- Initiating a dividend is an important milestone in the company's history and reflects the board and the management team's confidence in our near and long-term prospects
- The decision to pay a dividend is consistent with and does not change our approach to capital allocation, which prioritizes growth investments and returns excess cash to shareholders to enhance their returns
- Our share repurchase program will run in tandem with the dividend program as part of our balanced approach to capital allocation

## GUIDANCE

- I will wrap up my prepared comments with our updated thoughts on the full year 2021
- Consistent with the level of detail we have provided in recent quarters, we are comfortable making the following statements, all of which that assume that there are no significant negative developments related to the COVID-19 in our major markets, or foreign exchange rates and scrap and precious metal prices hold near recent levels in the remainder of the year

## Adjusted Diluted EPS, Margin and Operating Expense

- The first statement being with yet another excellent quarter in Q3, we are projecting full year adjusted diluted EPS in the range of \$3.78 to \$3.88 with a midpoint of \$3.83
- This is an increase of \$0.18, or 5% at the midpoint over our prior quarter guidance, and an increase of \$1.08 or 39% relative to our original 2021 full year guidance
- The increases reflect the benefits of our ongoing margin and operating expense programs, and our strategic cash deployment, which have allowed us to mitigate strong inflationary headwinds related to labor, freight, fuel and inventory costs prevalent throughout the industry

#### Operational Performance and Share Count

- While we expect our operational performance in Q4 to play out roughly in line with prior guidance, we are projecting a negative impact of roughly \$0.02 per share resulting from metal prices as these move lower going into Q4
- As you think about the comparison to Q4 2020, we are forecasting \$0.07 per share negative y-over-y effect related to sequential movements in metal prices
- Additionally, having one fewer selling day in the North America and Specialty segments in Q4 2021 creates a further \$0.02 headwind
- A lower share count and tax rates in 2021 should mitigate some of the y-over-y headwinds

#### EBITDA Margin

- The second statement I would like to share with everyone is we are narrowing the range for full year European segment EBITDA margin to 9.8%, up to 10.3%, effectively raising the floor by a further 30BPS, similar to what we did roughly 90 days ago following Q2 earnings

#### FCF

- And finally, we continue to generate outstanding FCF through strong profitability and judicious use of trade working capital
- With this in mind, along with higher projected net income for the year, we are raising our FCF guidance to a range of \$1.15B to \$1.3B with \$1.225B at the midpoint
- Despite the supply chain challenges, we still anticipate an inventory increase in Q4 ahead of the traditionally strong Q1 and Q2 seasonal demand although not to the level assumed in the prior guidance as a portion of the bill would likely be deferred into 2022

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### **Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

#### CLOSING REMARKS

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- 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 our operating model
- Second, we will continue to focus on profitable revenue growth 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, as always, we will continue to invest in our future
- As Henry Ford once said, obstacles are those frightful things you see when you take your eyes off of your goal. 2021 continues to be a year where our global teams have never lost sight of our shared goal of deriving long-term value for our stockholders
- And for that, I offer a heartfelt thank you to each of our 45,000 plus team members that make it happen each and every day

## QUESTION AND ANSWER SECTION

**Bret Jordan**

*Jefferies LLC*

Q

When you think about the Elitek business and I guess the incremental margin, you own the hardware. I guess scans would have a fairly high incremental margin. How do you see that business sort of shaping out from a longer term contribution? I guess what sort of size and maybe what the margin profile might be, if you think out a year or two or three?

**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Yeah, great question, Bret. When we first started thinking about services as a nice adjacency to our parts distribution business, and that came back in 2017, part of the reason it was so attractive is because services businesses have significantly higher margins, and I will tell you that our Elitek margins are well ahead of our parts distribution margins, and it requires relatively little capital. So, the return on invested capital is very attractive, very attractive. Again, this is still a relatively small business for us, kind of, in and around that \$50mm range. But our goal is to grow it very, very rapidly, not by orders of 5% or 10% a year, but our goal would be to multiply the size of the business over the next several years. It'll probably never be \$1B or \$2B business for us, but it's a great adjacency at really attractive margins and, probably most importantly, a really good return on invested capital.

**Bret Jordan**

*Jefferies LLC*

Q

Okay. And a quick question. One of your peers in Europe was commenting about share shifts and maybe share gains particularly around the UK market. Do you see anything changing over there from a competitive landscape? Are smaller players giving up share at a higher rate or maybe you give us some color there?

**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Sure. Overall, Bret, I will tell you we are incredibly pleased, incredibly pleased with how our UK business performed in the quarter. There's no great data with respect to share on a quarterly basis. But we are absolutely sensing – and this goes across pretty much all of our businesses, not just the UK – that small distributors are getting squeezed right now. And the larger, more well-capitalized market participants are doing much better. Our revenue was not overly robust in Q3 in the UK, but our margins hit an all-time high since we acquired ECP back in 2011. And we continue to be the market share leader in the UK by a wide margin. We think we're going to continue to keep that position into perpetuity, and we are very happy with our third quarter performance and long-term outlook for the business over there.

**Stephanie Moore**

*Truist Securities, Inc.*

Q

I wanted to touch a little bit – I know in your prepared remarks -and Varun specifically stated that a lot of the margin improvement in Europe was pricing driven. But I was also – I know that there's a lot of moving pieces at the current moment as you kind of work through your One LKQ. So maybe just give us an update on where we stand today, has anything was accelerated vs. prior plans and how we should think about progression as we go into Q4 in terms of some of these initiatives and has COVID has kind of gotten in the way of any of those things.

**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Yeah. Great question. We would probably characterize it – since the World Series is going on, use a baseball analogy. We're probably in the fourth inning in the One LKQ Europe program. We stated back in 2019 and then again at our Investor Day in 2020 that our midterm goal was to get annual margins, not quarterly margins, but annual margins in and around that 11% range. We think we can do better than that on a longer term basis. We've gone from effectively 8% when we announced the whole program, margins in Europe, to what we think can be, as Varun indicated, pretty close to 10% this year. And so, yeah, we would think we're in about the fourth inning.

COVID clearly has thrown everybody some curveballs. It has thrown us some curveballs. Some things just got delayed a little bit. Other things got accelerated. Originally, the Innovation and Service Center in Katowice, Poland was later in our plan. We actually pulled that forward. That – really think about that as a shared service center, where you're moving some administrative activities to a much lower cost marketplace. And so, that's gotten pulled forward. The ERP implementation got pushed back effectively by a quarter or two. But we still have a lot of runway to go on our program. There's a lot of initiatives that are still in the forefront that we need to execute on. But, overall, we are extremely pleased with our progress thus far and confident in our ability to get to the longer term goals.

**Stephanie Moore**

*Truist Securities, Inc.*

Q

Great. And then, talking about the supply chain disruption and I agree there's always a new headline every day. I think you made the point and particularly with the FCF, unable to purchase some of the inventory to meet desired demand levels that you would like in the quarter, but you're working with your partners now. I mean, is this a function of us just taking longer and it's just being more the ability to kind of have that flexibility that it's just not arriving as quickly? Or are you having to use other modes of transportation? I would love just to get more color as you manage just the current situation?

**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Yeah. The big issue with the supply chain – and this is not unique to LKQ, it's not unique to our industry, right? The fact of the matter is, out in California, there's 80 ships anchored waiting for a berth in the ports. If you did that on a national basis, I think you're somewhere around 100 ships. Many of those ships have our containers sitting on it, right?

And it's not just an issue with the ports. The reality is there's a lot of data out there that's showing that there's just not enough truckers turning up to get the containers out of the ports. There's a severe shortage of drivers. Most folks estimate this country is down about 80,000 truck drivers. The warehouses, where the containers ultimately need to go, are clogged. And importantly, containers get put on a chassis, which is then connected to the tractor of the semi-tractor combination. There is a severe shortage of chassis available. So, the supply chain is a bit of a mess completely.

And so, yes, it's taking much longer for us to get our product, say, from Taiwan into the United States. It's costing us some more money. It's important to recognize that the inventory is ours when it hits the port in Taiwan. So, that's our inventory, not the supplier's inventory, sitting out on the water. And so, we're being very thoughtful as to putting in advance orders, making sure we can do whatever we can to get the inventory that we need. The bad news is, we're not – we don't have the inventory levels that we prefer. The good news is we think we're doing significantly better than our small competitors.

I mean – think about it. We're doing 16,000 containers a year, that's about 300 a week, from the Far East for our North American aftermarket parts business. Our small competitors, they'd be lucky if they bring in 300 a year or even 50 a year. So, we feel we're – from a fulfillment rate basis, we're doing much better than the small competitors. And we know that because there have been a few smaller folks basically waving the white flag and asking if we'd be interested in buying their business. So, again, it's going to be a challenge going forward. We think we're doing a pretty effective job of managing our way through that challenge.

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**Craig R. Kennison**

*Robert W. Baird & Co., Inc.*

Q

Just to follow up, Nick, on your last point with respect to looking at small businesses to acquire, would there be any case to make that you could buy them for something close to the value of their inventory just to help with your own fulfillment rates?

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**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Well, in many of the cases, the only thing of value to us would be their inventory. We don't need additional warehouses in the United States. We don't need more fleet. Clearly, we've all shared the same customers, so inventory would be particularly attractive.

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**Craig R. Kennison**

*Robert W. Baird & Co., Inc.*

Q

Okay. And then, I guess I wanted to ask a question about the Innovation Center in Poland, which we watched the video on that earlier this quarter. But could you just give us a feel for the kind of tools or applications that you would expect to develop and how those tools kind of improve your moat in Europe?

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**Varun Laroyia**

*Chief Financial Officer & Executive Vice President*

A

Hey, Craig. Good morning. It's Varun out here. Let me take this one. So, actually, the Innovation Center is effectively what we had talked about as part of the One LKQ Europe program of setting up a lower-cost shared service center, no different to global business services at other companies within the industry, but also among broader companies having a lower-cost back office to do commoditized transaction processing. But also in the case of Poland, we believe there is some good digital and technology talent. And that really is the background to what we're trying to do from a Katowice perspective.

As you know, we obviously have Bangalore, and now putting up another center certainly gives us the geographic breadth, language capabilities, not just to do some of the more, I'd say, regularly expected back office activities, but also to invest in things such as digital. We clearly know that while B2B and the different market, the do-it-for-me market is clearly the biggest piece serving Europe but there is some adjacency associated with B2C. And being able to do some of that back office work and the technology work out of Katowice in Poland, which does have talent, we believe there is some goodness associated with it. That really is the backdrop to the Katowice, Poland Innovation Center.

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**Brian Joseph Butler**

*Stifel, Nicolaus & Co., Inc.*

Q

Just can we circle back on the metal and – both scrap and precious? When we think about what's kind of – maybe what's embedded in the full year guidance and how that compares to, I guess, historical levels that typically have been a little bit lower?

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**Varun Laroyia**

*Chief Financial Officer & Executive Vice President*

A

Brian, it's Varun out here. Let me take that one. So, yes, within – in Q3, as I called out, the total metals benefit both scrap and catalytic converters, so precious metal, was about \$12mm or roughly about \$0.03 within the \$1.02 of adjusted EPS. Relative to what we experienced in H1, if you recall in Q1, it was \$34mm upside. In Q2, it was roughly \$57mm. So, significant upside.

But really what we saw come through was, starting in September, we saw scrap metal prices, but also more to the point, precious metal prices began to drop pretty significantly. And so, that is despite the fact that those metal prices were dropping, car costs remained relatively high. And so, the overall metals benefit was muted. And, really, what we've seen exiting September as we've shown in slide number 27 also for the benefit of everybody, you see that bigger slide begin to take place in September.

And so, from a Q4 forecast perspective, we are actually, as of now, anticipating there to be a negative impact from metals pricing rather than an ongoing benefit. So, if you think about H1 vs. H2, in H1, we said we'd pretty much got close to, I'd say, \$90mm of EBITDA from metals, be it precious or scrap. In Q3, it was about \$12mm, which kind of gives you a YTD of about \$103mm. And in Q4, we see an unwind of anything up to \$30mm taking place. So that way to think about it, clearly, it's a volatile market as of now. Things are changing on a daily, weekly basis, but that's how we think about the metals pricing, which underpins our forecast that we provided.

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**Brian Joseph Butler**

*Stifel, Nicolaus & Co., Inc.*

Q

All right. That's very helpful. And then shifting gears, can we talk about collision repair? And with the supply chain disruptions that you're seeing, has there been a greater demand for recycled parts and just kind of what trends you're seeing there may be on price in the attractiveness of those items?

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**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Yes, Brian. This is Nick. You've hit the nail on the head. Obviously, the aftermarket part availability is constrained a bit because of all the supply chain challenges we've already talked about. Salvage parts come from the local markets, right? We buy total loss vehicles locally, we dismantle them locally, and then we can distribute on a local basis. And there absolutely has been a bit of a shift. And I would say this primarily benefits us relative to anybody else, because we are the only company that can offer both salvage and recycled product and the aftermarket collision parts.

And so, we have absolutely have seen our – the growth in our salvage business in the quarter and actually for the last few quarters have been well above the growth in the revenue trends in the aftermarket product. And part of that is due to the strong mechanical business, engines and transmissions, that we talked about in our formal comments and part of it is this ability to, in certain times, a shift of the customer from an aftermarket product that we may not have an inventory to a salvage product that we can get to them same day or next day. So the salvage business has been very good. And again, we're the only company in this country that offers both product lines.

**Brian Joseph Butler**

*Stifel, Nicolaus & Co., Inc.*

Q

Perfect. And then, if I could maybe just ask one last one, when you look at the replacement parts cost for EV vehicle vs. internal combustion, what brands are you still seeing there? I mean is it still EV parts continue to be more expensive or, as we're seeing more EVs out there, are those prices coming down for the replacement parts?

**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Yeah. No. Broadly, we are – we're maybe in the top of the first inning in the whole EV marketplace and the transition and the like, so there are no big trends. There are no shifts. What we will tell you is that when you look at hybrid electric vehicles and battery electrical vehicles, technical service parts command anywhere from a 2x to 6x premium relative to their comparable internal combustion engine counterparts.

And there is the number of reason for that. One is the technical complexity, not just with batteries, but also with the electrification of components previously belt-driven such as air conditioning, compressors and water pumps. For an example, this is just one example, a 2013 Prius with an electric water pump, that water pump sells for 3 times the value of a 2013 Corolla that has belt-driven water pump. In the UK, for example, a 2017 Golf with an internal combustion engine, that water pump sells for about £77. The Lexus hybrid EV, the water pump is £278. And so, yes, the EV parts are much more expensive. We think that's going to continue to be the case for a long, long time and that's why we are doing what we can. We're at the initial stages of gearing up our ability to distribute those EV-related parts. The reality is the aftermarket for EV vehicle parts is nascent, but there's nobody in a better position to distribute those parts than LKQ.

**Daniel Imbro**

*Stephens, Inc.*

Q

I've got a couple of quick questions. One on the follow-up on pricing, I don't think you just mentioned it there, but obviously pricing – the OEMs took it up during the quarter. Can you quantify maybe how much inflation you saw in North America here? And then longer term related to price, now that the OEMs took up price and they saw that you guys followed very rationally, is there may be a backdrop that the OEMs become more rational taking up price going forward, knowing that you're going to follow and maybe the whole market can be more rational at passing through some of these costs in North America?

**Varun Laroyia**

*Chief Financial Officer & Executive Vice President*

A

Daniel, let me answer that one. With regards to inflationary pressures, let's be clear about it. No one is immune to them at this point of time. Okay? It's not just us. It's not just the OEMs. It's across every pretty much sector across the economy. So that's kind of point number one. It's just a fact of life at this point of time.

The second one is, yes, folks that are acting on a rational basis, they're trying to protect margins. You've obviously seen two of the three big OEMs report in the last 48 hours. And as to what they've been talking about with regards to chip shortages and as to what's happening to new car sales and stuff. But, yes, there's less discounting taking place within their markets also. And, obviously, I think you follow some of the auto retailers also, so in terms of what's happening out there.

So, at this point of time, given the scarcity of being able to get product and given the supply chain challenges, we expect folks are acting on a rational basis, because no one really knows as of now how long the supply chain

congestion is expected to last. So, if someone does want to not act on a rational basis for a week, two weeks, a month or quarter, at some point of time, it'll come back and bite them. And it is no different to what we at LKQ did when the pandemic initially struck in Q1 of 2020, move incredibly fast to kind of take care of what we could control, which was our cost structure. And that, obviously, has now morphed into inflation and also supply chain congestion. So, we expect folks will be acting on a rational basis, because no one really knows how long this is going to continue to last.

And so, what the OEMs may or may not do? Listen, I can't speculate sitting out here. That is their call. We do know that what we at LKQ do and what we plan to do, given the market conditions. The key in all of this is to be nimble, is to be agile and to be dynamic and be able to react as an organization at a relatively short notice. And just really happy with the way but things continue to do that.

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**Daniel Imbro**

*Stephens, Inc.*

Q

Yeah. That makes sense. And then a follow-up on personnel expenses, Varun. I think in your prepared comments, you noted that North America and Europe felt some pressure from temporary labor. Obviously, what you just said is over the last 18 months, you guys took out a bunch of cost, a bunch of duplicative positions. Can you maybe talk about how transitory you view these labor headwinds, how you're navigating the backdrop and whether you're having to add back any of those costs or is this just something to do with the demand you're seeing today?

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**Dominick P. Zarcone**

*President, Chief Executive Officer & Director*

A

Varun?

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**Varun Laroyia**

*Chief Financial Officer & Executive Vice President*

A

Yeah, no, absolutely. And great question out there, Daniel. Yes, listen, 18 months ago, when the pandemic initially struck, it was a case of ensuring that our balance sheet and our cost structure was aligned to what the new demand forecast realities were, okay. And so as a distribution business, we were able to move quick. And as that dragged on, I think before the end of Q2 2020, we'd actually moved those temporary reductions into permanent reductions. And I think folks appreciated what we did.

At this point of time, it is all demand related whether it be in Europe, whether it be in North America or, for that matter, in our Specialty segment. So – and that piece is being exacerbated by the fact that there's just a real shortage of talent. Nick talked about, say, for example, on the delivery side. It's the same thing across the business because as of now, folks have kind of moved on to online in a pretty big way. And so, warehouse demand, warehouse folk demand has been strong. And so, from that perspective and the talent and the labor shortages, we're having to pay up, and we will do so because that is the kind of core of our business.

So, with regards to it being transitory or not, this is where the reality is. Unlike commodity prices, fuel or metals or whatever it is, they could be in a certain spikes and troughs within their cycle. Wages are notoriously sticky. Once you've been paying at a certain rate, you can't go back three months or six months later and say, oh, actually, you know what, now, there's a different situation. Now, this is what we will be doing. That is just not the way to drive trust in, what we call, our single most valuable asset. So that is not what we do.

Yes, what we do do is, here at LKQ, we have a very strong value proposition for being part of the LKQ family, whether it'd be our retirement plan offerings, whether it'd be our healthcare benefits, the tuition reimbursement, the scholarships and many of those kind of pieces. And, yes, we are also doing certain one-off items, all in all to try and ensure that the entire overall base doesn't move into the future, literally, dollar for dollar. So there are certain elements which we believe are going to drive talent retention rather than someone wanting to move just for the next extra \$1 or \$2 as such, but that's really how we're thinking about it

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