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LKQ Corp. (LKQ)

Q1 2022 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

- As we enter 2022, who would have thought the world would experience events more traumatic than the pandemic we all have been living through? Just when everyone thought we had turned the corner and we're headed towards the new normal, in late February, Russian tanks rolled into Ukraine and everything changed overnight

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- In retrospect, issues related to tight labor markets, supply chain challenges, and inflationary pressures pale in comparison to the needless loss of human lives
- Yet out of the ashes, we are all able to watch the evening news and see true leadership and courage in action and incredible solidarity in a time of crisis
- Yes, I'm talking about the Ukrainian people
    - But the same is true for the 950 people in Ukraine who are LKQ associates
- These employees are truly remarkable
- So too are their colleagues in Poland, Hungary, Slovakia, and Romania, who welcomed hundreds of family members of our Ukrainian employees at the border to provide food, housing, medical assistance, and schooling to those fleeing the country
    - They are all defining what it means to be LKQ proud

Revenue and Profitability

- As to the business, we exceeded our expectations for Q1 in terms of both revenue and profitability, and this gives us confidence to increase our financial guidance for the year
- The key word in the economy of the past several quarters has been inflation
- During periods like this, companies have a choice
- Wait and see the impact and play defense, or anticipate the impact and play offense
- LKQ chose to play offense, and the benefits of doing so can be found in our results
    - This is particularly true with respect to the exceptional organic revenue growth achieved in our North American Wholesale and European segments, both of which benefited from strong demand for automotive products as mobility and claims volumes increased while pushing prices in an attempt to offset most of the inflationary pressures

Global LKQ Leadership Team

- Managing through this environment is hard, and I am extremely thankful for the efforts of the global LKQ leadership team, which is doing a terrific job of balancing the best interest of our customers, suppliers, employees, and shareholders
- Now, on to the quarter, revenue for Q1 2022 was $3.3B, an increase of 5.6% as compared to $3.2B in Q1 2021
- Total parts and services revenue increased 5.9% in Q1, comprised of organic revenue increases of 6.9%, plus the net impact of acquisitions and divestitures of 1.7%, offset by foreign exchange rates, which decreased revenue by 2.7%
- Net income for Q1 2022 was $269mm, as compared to $266mm for the same period of 2021, an increase of 1.1%

Diluted EPS

- Diluted EPS for the quarter was $0.94 as compared to $0.88 for the same period last year, an increase of 6.8%
- On an adjusted basis, net income in Q1 2022 was $287mm, compared to $286mm in the same period of 2021
- Adjusted diluted EPS for Q1 was $1 as compared to $0.94 for the same period of 2021, a 6.4% increase driven by a reduction in the average share count

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Self-Service Business

- Let's turn to some of the quarterly segment highlights
- And please note, this is Q1 separating the Self-Service business from the core North American Wholesale business

North America

- Turning to North America
- From slide 6, you'll note that organic revenue for parts and services in our North American Wholesale segment increased 13.6% in the quarter on a reported basis and 11.8% on a per-day basis
- During Q1, industry-wide, overall claim counts increased 12.2% vs Q1 of 2021

US DEPARTMENT OF ENERGY

- According to the US Department of Energy, during Q1 2022, US weekly supplied motor gasoline volume was approximately 4.9% above last year, but still 4.7% below Q1 2019 pre-pandemic
- And according to the Department of Transportation, highway miles driven during Q1 increased 4.9% above last year, but lagged 2019 levels by approximately 2.2%

Product Line Perspective

- From a product line perspective, recycled and remanufactured parts demonstrated higher growth, including gains in both volumes and price relative to last year
- On the aftermarket front, we have been successful in passing through inflationary cost increases despite the supply chain challenges which are causing volumes to be down relative both to last year and 2019

Headwind

- April has started off on a positive note following the pattern established in Q1
- We don't anticipate achieving double-digit revenue growth in our North America Wholesale operation for the rest of the year, but we expect it to be in the mid to high-single-digits
- In part due to headwinds from parts availability and more so due to labor constraints, during Q1, the national average scheduling backlog at collision repair shops reached 4.5 weeks, 2.5 times the length of the typical first quarter backlog
    - Additionally, since 2016, average vehicle repair cost have risen steadily every year, with the largest increases occurring in the past two years, reaching an all-time high in 2021
- Our parts provide a strong solution for shops and insurance carriers to manage cost

Supply Chain

- As we inevitably begin to witness some relief in the supply chain and a steadier flow of aftermarket product, the value proposition of our parts becomes even more attractive as shops continue to face headwinds related to labor cost and overall inflation
- As we indicated in our last call, this quarter, we began reporting Self-Service as a separate segment
    - This new segment provides investors with greater transparency into the commodities dynamic of our business

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Self-Service Operation

- Given the majority of our other revenue category, which primarily consist of scrap and precious metals, comes from our Self-Service operations
- Varun will cover more details on the margins of this segment shortly
- During Q1, total revenue for Self-Service was flat compared to last year, reflecting the relative softness in metals pricing
- Organic revenue for parts and services for the segment increased 14.6%, largely driven by price
- Also the average revenue per admission, a key productivity metric rose during Q1 2022 relative to 2021

European Segment

- Moving to our European segment, organic revenue for parts and services in Q1 increased 6.9% on a reported basis and 6% on a per-day basis
- As the largest pure-play distributor of automotive aftermarket parts in Europe, this is a tremendous start to 2022, even in the face of an extremely challenging geopolitical environment on the continent
- So, we are quite pleased with the organic growth in Europe
    - While different by market, overall consolidated organic growth were split evenly between volume and price

Apple Mobility Index

- According to the Apple Mobility Index, the trends in driving trips in our European markets was down earlier in the year due to normal seasonal patterns
- As we progressed through Q1, the index rebounded
- Encouragingly, despite all the fear of a dramatic drop-off in demand due to global macro headlines, at this point, we have not seen any noticeable shift in European mobility as we've entered Q2

Regional Operation

- Our regional operations experienced varying revenue performance in the quarter, but all posted positive growth with very solid y-over-y performance
- The UK and Benelux operations were particularly strong, with high-single-digit organic growth, while Germany and Central Europe, excluding Ukraine, posted mid-single-digit organic growth

Organic Growth

- Italy also demonstrated progress, posting positive organic growth for the first time in several quarters
- The Russian invasion of Ukraine had a direct impact on our revenue in late February and all of March, due to having to close certain branches that we operate in Ukraine
- And those that remained open, as you would assume, saw a significant drop in demand

European Organic Revenue Growth

- Also immediately following the invasion, we ceased all sales to Russian-based parts distributors
- We estimate the impact of the war on European organic revenue growth during the quarter was approximately 60BPS.
- And as these conditions continue, we anticipate the impact on our full-year European growth to be about 120BPS.

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- We continue to pay our Ukrainian employees, regardless of whether they are working, and we are supporting their families who have fled to neighboring countries

Assets

- As I've always said, our people are our most important assets
- And in Ukraine, the well-being of our people is our primary focus today
- Varun will provide some additional financial related details to this unfortunate situation shortly

Specialty Segment

- Now, let's move on to our Specialty segment
- Organic revenue for parts and services for our Specialty segment declined 8.3% in the quarter on a reported basis and 9.8% on a per-day basis, largely due to a very tough y-over-y comp
- You may recall, this segment reported 33% organic growth in Q1 of last year
    - So, on a two-year stack, the annual revenue growth is still well into double-digits
- We anticipate another tough comparison in Q2 against the 30% growth recorded in Q2 last year, with a positive recovery and a return to y-over-y organic growth in the back half of this year

ANNUAL RV EXPO

- A few other key highlights for Specialty during the quarter
- In Q1, Specialty hosted our annual big show, a customer event which is focused on SEMA-related parts
- And also hosted our annual RV Expo for our RV-focused customers
- Both events booked solid y-over-y increases in attendance and sales, suggesting good demand in the future

Specialty Team

- Also, in March, our Specialty team opened a 210,000 square foot distribution center in Orlando, Florida
- While it will create a very slight drag on near-term margins while it ramps up, this new distribution facility will help create higher revenue as it will service Florida and Georgia, both of which are very attractive markets for our RV and Marine-related product lines
- The supply chain continues to provide challenges, and we're doing our best to get the inventory needed to service customer demand
- During the quarter, key port cities in China were shut down for a while
    - This shifted container capacity to other countries like Taiwan, giving our North American team an opportunity to get some incremental inventory on the water

CONTAINER VOLUME

- March was the second best container volume that we've witnessed in 24 months
- We expect some of this benefit to continue into April and likely May, and this inventory should be at our warehouses by mid to late summer
- Once the China lockdowns reopen, we will likely see a regression back to the lane bottlenecks that we've endured over the past 12 months as the pent-up demand from China comes through

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EUROPE

- In Europe, product availability remained challenging through Q1 with backorders still running high
- But we are witnessing some signs of improvement as we enter Q2

ESG

- Turning to ESG, during Q1, we continued our environmental stewardship efforts by processing 193,000 vehicles, resulting in, among other things, the recycling of approximately 970,000 gallons of fuel; 562,000 gallons of waste oil; 501,000 tires; and 178,000 batteries
- During Q1, we also processed approximately 260,000 tons of scrap steel

NORTH AMERICA

- On the social front, during the quarter, we focused on some key initiatives around the financial and mental health well-being of our employees
- As an example, in North America, we implemented a profit sharing plan where we made a special contribution of $1,000 to the 401(k) accounts of all eligible team members
- Alongside this contribution, we provided services to educate our team on how to think about and plan for retirement

Initiatives

- From this initiative alone, we witnessed over 4,000 new 401(k) account openings
- We want all employees to benefit from our success and this plan allows us to reward and thank them for their relentless focus on results which made a huge impact on our 2021 performance
- In Europe, we launched a program called Inspire to Thrive that lets our team know that their mental well-being matters
- The goal of this program is multifaceted, including creating a supportive culture, addressing factors that may negatively affect mental well-being, addressing negative perceptions of mental well-being issues, providing support to colleagues suffering from mental health issues, and developing management skills to address issues when they arise
- Operationally, we believe this program will have many benefits, such as higher retention, reductions in sick leave, and enhanced productivity
- More importantly, however, it's simply the right thing to do for our team and helping them maximize their overall well-being

PGW Glass Business

- Lastly, from a corporate development perspective, during the quarter, we entered into a transaction to sell our PGW Glass business
- While a fundamentally solid in operation, we had come to the conclusion that LKQ was not the best owner of this business, and the margins were always going to be dilutive to the overall North American segment margins
    - This transaction closed last week and we are extremely pleased with the outcome
- As we enter Q2, we are witnessing a healthy pipeline of potential tuck-in acquisitions and since April 1, we have closed on two small European transactions

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Varun Laroyia
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Performance

- While I am excited to be able to present another strong set of financial results, and I'll cover the details on the quarter shortly, I want to begin with comments on a very eventful start to 2022
- As you know, LKQ entered the year with momentum coming off record revenue and profitability in 2021, but also anticipating challenges from the Omicron surge, supply chain constraints, inflationary pressures, and volatile commodity prices
    - These factors created headwinds in the quarter and we've had to react quickly to counteract the effects
- While there is more work to be done to improve our inventory availability and manage the cost pressures, we are comfortable with the direction we are headed, and importantly are positioned relative to the competition

Ukraine-Russia Conflict

- The Ukraine-Russia conflict has been a further source of volatility, both with its direct impact on our business and the indirect effects on currencies and commodity prices
- As Nick mentioned, our revenue at risk owing to the conflict isn't material, but we experienced a negative effect of about $0.01 in Q1, and expect a further $0.05 headwind relative to our original EPS guidance over the balance of the year due to the ongoing conflict

Segment EBITDA and Adjusted Diluted EPS

- Please note that the impacts associated with lost revenue and other indirect effects of the conflict are not being considered for adjustment in our calculations of segment EBITDA and adjusted diluted EPS.
- Direct impacts related to asset write-downs and/or reserves are being excluded from the calculations of these metrics
- Q1 exclusion totaled roughly $6mm

Metals Prices

- As expected, scrap steel and precious metal prices were a drag on results y-over-y, though prices were better than projected in the quarter and thus, the negative impact was less severe than anticipated
- Compared to Q1 of 2021, metals prices generated $32mm negative effect on segment EBITDA and $0.08 impact on adjusted EPS.
- As discussed in Q4 call, we are now presenting the Self-Service operating unit as a reportable segment to provide investors with greater visibility into our operating results

Wholesale North America Segment

- I hope that you have had an opportunity to review our Form 8-K filed with the SEC on Monday, the 25 of April, which shows the segment financial information recast under the new presentation

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- As noted in prior calls, Self-Service generates a large portion of its revenue from scrap steel and the precious metals in catalytic converters, which makes its results more volatile than the Wholesale North America segment
- Of the $0.08 negative y-over-y impact from metals, approximately two-thirds is derived from the Self-Service segment

PGW Aftermarket Glass Distribution Business

- Last week, we completed the sale of our PGW aftermarket glass distribution business for gross proceeds of $362mm
- PGW generated almost $400mm of revenue and its EBITDA margin was approximately 10% in 2021
- By divesting PGW, we'll see an improvement in EBITDA margin as the business generated a lower margin than the Wholesale North America segment
- We intend to use excess cash to repurchase shares in the coming months, though, given the timing of the transaction will be dilutive to full year 2022 EPS by approximately $0.04, which is built into our updated guidance

Share Count Reduction

- The full year share count reduction benefit in 2023 will further mitigate the lost PGW earnings
- While we expect to report a gain on sale, our US GAAP EPS outlook does not include a gain, as the amount has not been finalized
- Any gain would be deducted from US GAAP EPS in the calculation of adjusted diluted EPS.

S&P Upgraded LKQ

- Finally, S&P upgraded LKQ to BBB- with a stable outlook last week, achieving an investment-grade rating from S&P in addition to the same from Fitch ratings a year ago, is a tremendous accomplishment for the organization and is a testament to our operational excellence program launched in 2019
- This program has supported the consistent operating performance, robust cash flows, and resilient business model that S&P cited as reasons for the upgrade
- The immediate implication of the upgrade is that collateral requirements fall off our senior secured revolving credit facility

FCF

- And over time, we expect the added flexibility to allow the company to drive even higher levels of FCF to invest in growing our business and returning capital to stockholders
- Specifically, there will be opportunities to extend vendor payment terms and increase payables, and we expect this benefit to come through over the next few years

Q1 RESULTS

Revenue, Net Income, and EPS

- I'll now shift to the quarterly results
- Our first quarter results reflect a solid start to the year with improving revenue, net income, and EPS year-on-year despite the negative impact of metals, challenges related to inflation and the global supply chain,

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the Omicron variant, the ongoing conflict in the Ukraine, and foreign exchange volatility owing to a stronger US dollar

Self-Service Margin

- Gross margin decreased by 30BPS compared to Q1 from 2021, with 40BPS negative effect coming from the Self-Service margin, which declined owing to metals
- Overhead expenses, as a percentage of revenue, rose 80BPS y-over-y with higher bad debt expense and inflationary increases in vehicle, freight and fuel expenses
- Income taxes in Q1 2022 were booked at 25.1% consistent with our prior guidance
- And finally, as Nick mentioned, diluted EPS was $0.94 for the quarter and adjusted diluted EPS was $1 even

Wholesale North America

- I'll now turn to the segment operating results
- Starting on slide 9, Wholesale North America produced an EBITDA margin of 18.1% for the quarter, down 30BPS from the prior-year period
- Gross margin was roughly flat as pricing improvements were offset by unfavorable impacts from metals which had a negative 70-basis-point effect in Q1

Segment Overhead Expenses

- Segment overhead expenses increased by 50BPS with the negative effects from inflation on personnel and freight costs
- We've previously communicated our expectation for the North American margin to run in the mid-to-high 16s-percent without the metals effects
- With the new segment breakout and the sale of the glass business, we now believe that Wholesale North America EBITDA margin should run approximately 70BPS higher after normalizing for metals effects

EBITDA Margin

- Europe reported an 8.8% EBITDA margin for the quarter, down 80BPS from the prior-year period
- As you can see on slide 10, the margin decrease was attributable to movements in both gross margin and overhead expenses with negative effects from inflation, higher bad debt expense, and effects from the Ukraine-Russia conflict
- As mentioned, we anticipate a negative impact on Europe from lost revenue related to the conflict though the team believes they can deliver a double-digit margin for the full year

Specialty Gross Margin

- Moving to slide 11, Specialty gross margin grew 110BPS with benefits from net pricing and mix more than offsetting a 90 basis point negative effect from acquisitions, primarily SeaWide
- Overhead expenses increased by 190BPS, driven by personnel cost inflation and higher vehicle fuel and freight costs
- The overhead expense increases were partially offset by 60BPS of benefits from operating expense synergies and leverage, mostly generated from the SeaWide acquisition
    - While the Specialty EBITDA margin of 12.6% is down relative to the prior year, it's important to acknowledge the progress the business has made over the last three years

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Pre-Pandemic

- Pre-pandemic, in Q1 2019, Specialty reported a segment EBITDA margin of 10.7%
- The team has done a fine job rationalizing the cost structure and protecting its product margin, resulting in a 190 basis point improvement from Q1 of 2019 through to Q1 of 2022
- Self-Service reported an EBITDA margin of 20% for Q1 2022, a strong results for the segment, but below the record margin achieved last year

Self-Service

- As you saw in the Form 8-K with the recast historical segment results, Self-Service's margins can vary significantly depending on metals prices
- Since the beginning of 2019, we've seen a low point for the margin at 6.3% in Q3 2019, and in high point of 27.9% in Q1 of 2021
    - While there are performance elements that we control, for example, car buying, product pricing and labor efficiency, the Self-Service business results are driven by trends in scrap steel and precious metals prices
- When prices are moving higher, especially when it occurs rapidly, we'll see strong margins in this business
- And we'll see the downside when prices go the other direction
- We believe that breaking up Self-Service will provide greater clarity to investors
- With that background, the decrease in Self-Service's margins in Q1 of 2022 is driven by movements in metals prices and car costs, estimated at an 1,100BPS negative effect, partially offset by improved pricing

Liquidity and Capital Allocation

- Shifting to liquidity and capital allocation
- We sustained the positive momentum we've built in recent years around cash flow generation with FCF of approximately $350mm in Q1
- At the conversion ratio of almost 80% of EBITDA, we are delivering FCF above our long-term expectation
- For sure, there are some timing elements that will reverse over the course of the year
- And we are confident in our ability to generate significant and sustainable FCF in line with expectations of converting EBITDA to FCF in the 55% to 60% range for the full year
    - We are cautiously optimistic about the progress we have made with inventory procurement, access to aftermarket products and cars at auction improved relative to the same period in 2021
- And we were able to deploy more cash to build inventory

Inventory Spend

- As shown on slide 24, we increased our inventory spend and purchased more salvage vehicles than we did in Q1 2021
- And as you can see on slides 25 and 26, our inventory levels have increased in all four segments relative to December, excluding the impacts of the held-for-sale reclassification and foreign currency translation

Wholesale North America Inventory

- As of the 31st of March, the Wholesale North America inventory excludes approximately $100mm of glass inventory, which is presented in the held-for-sale asset line on the balance sheet

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- We remain confident that our inventory position will enable each segment to continue to offer best-in-class availability and service relative to our competitors despite the ongoing supply chain challenges

Capital Spending

- Our capital spending for the quarter of $59mm was in line with our expectation; and following our balanced capital allocation philosophy, we repurchased 2.7mm shares in the quarter for $144mm and issued our quarterly dividend with $71mm payment in the month of March
- We also paid down our debt balance by approximately $53mm in the quarter
- Our net leverage ratio came in at 1.3 times EBITDA and interest coverage exceeds 30 times, compared to the credit facility requirements of 4 times and 3 times, respectively

Credit Metrics

- In short, we are very comfortable with our credit metrics which support our investment-grade rating
- As our earnings release of this morning indicated, the board has approved the quarterly cash dividend of $0.25 per share, which will be paid in June to stockholders on record as of the 19th of May

GUIDANCE

Ukraine-Russia Conflict

- And finally, I will wrap up my prepared comments with our updated thoughts on 2022
- Our guidance assumes that there are no significant negative developments related to COVID-19 in our major markets, scrap and precious metal prices hold near the average for Q1, and the Ukraine-Russia conflict continues without further escalation
- On foreign exchange, rates have been moving rapidly in recent days, with the euro hitting a five-year low on Wednesday

EUROPEAN RATE

- Our guidance includes weakening European rates in Q2, followed by a recovery in H2
- We've dialed in a full-year average rate for the euro at $1.09 and the pound sterling at $1.30
    - Since current rates are below these figures, we have about $0.03 of risk over the balance of the year if rates hold at their current levels
- Having said that, with the strong start to the year, we are increasing our organic parts and services revenue growth expectation to between 4.5% and 6.5%
- We are projecting full-year adjusted diluted EPS in the range of $3.80 to $4.10 with a midpoint of $3.95
    - This is an increase of $0.08 compared to the prior midpoint
- The raise is primarily attributable to our first quarter performance as the balance of year has mostly offsetting effects, as shown on slide 19 of the earnings deck

Organic Growth

- Related to benefits due to organic growth and related operating performance, metals prices above our original forecasts and share repurchases, offset by headwinds from lost earnings tied to the glass disposal in April, weakening FX rates and the impact of the Ukraine- Russia conflict

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- Please note that the share repurchase benefit is attributable both to the shares that we purchased in Q1, which will give us a benefit of roughly $0.03 on a full year basis, and the anticipated repurchases from the proceeds of the glass sale of approximately $0.05
    - While there are lots of puts and takes in the forecasted numbers, I want to specifically highlight the operating performance component

Operational Excellence Initiatives

- As I previously stated, our operational excellence initiatives have created a significantly stronger and more resilient business, which is helping us to improve operating results despite the current inflationary environment and supply chain challenges
- And finally, we remain on track to deliver at least $1B of FCF for the year, achieving strong free cash conversion in line with our expectations for the business

Dominick P. Zarcone

President, Chief Executive Officer & Director

Q1 HIGHLIGHTS

Performance

- We believe our unique competitive position across all of our operating segments continues to translate into strong results for our company during difficult conditions
- I am extremely proud of how our team of 46,000 employees tackled the headwinds we've faced over the past two years, which subsequently positioned us well as we entered 2022
- Our strong first quarter performance and raising our guidance for 2022 is a true validation of our confidence and commitment to creating long-term value for our stockholders
- And again, I would like to acknowledge the bravery and courage of our Ukrainian team as they operate in an unthinkable environment
- Our thoughts and hearts are with you all

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QUESTION AND ANSWER SECTION

Bret Jordan
Jefferies LLC

Q

Varun, now that you've got the investment-grade rating and you called out the opportunity to extend payment terms, do you have any better visibility as to how far you might be able to extend them here? I mean, obviously, you've got a – you have the rating now. So have you had conversations around those terms?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Yes, absolutely. And, Bret, thank you for raising that piece and acknowledging LKQ is now an investment-grade company. It's taken a lot of time and the overall pivot to operational excellence has certainly been looking at every aspect of our business, income statement, functions, and also the overall balance sheet. Yes, we do anticipate several hundred million upside related to getting the investment grade. However, it will not happen overnight. If you think about our European vendor financing program, which is coming along incredibly well, we still have a gap.

And really what we do is we benchmark ourselves given the product assortment with, say, what the folks here in the US are doing, right? And so, in terms of even being able to get to a 1 to 1 with regards to APE offset by inventory or inventory offset by APE, we have a gap, a significant gap, and that runs into a fair bit. So again, it won't happen overnight. We obviously do have these contractual negotiations with our vendors. On an annual basis, the team is moving in the right direction. And so, we really don't see it in the short term, i.e. within 2022. But I think from 2023 onwards, we certainly will see that piece continue to climb further.

Bret Jordan
Jefferies LLC

Q

Okay. And then a quick question. I think you said March was one of the best shipping volume months in the last couple years. But is there a way to quantify your North American aftermarket in stock levels? Where you are on inventory fill vs. target?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Bret, this is Nick. Thanks for the question. Our fill rates are not where we would like them to be. We tend to run well into the 90s. We are not in the 90s today. We're probably in the mid-to-high 80s. So, there's progress to be made. It all relates to the supply chain challenges. Again, it has nothing to do with our suppliers being able to produce the product. It all has to do with transporting the product from Taiwan into the US and Canada.

Again, we got some incremental containers on the water in March. We're hoping for a few incremental containers in April, May as well. But it takes – with the port congestion and transportation issues here in the US, we won't see any of that inventory until mid to late summer. When that hits, it should help a little bit.

From a fulfillment perspective, we do not believe that it's going to take us back to our historical levels, but it will help. What we do feel very confident about is our fulfillment levels are the best in the industry, even with the challenges that we are facing. The reality is our smaller competitors are struggling to get product. And from overall perspective, from a competitive perspective, we think we're still leading the pack.

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

Q

On the Wholesale side, just to dig a little deeper. Total volumes weren't down, just the mixing side, whether it was new aftermarket vs. a recycled/remanufactured, is that correct?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

That's correct. We had good volume growth in our salvage products, our recycled products, particularly as it relates to mechanical parts. Transmissions were particularly strong. We had great growth from a volume perspective and our remanufactured products; again, largely engines and transmissions. It was the aftermarket collision parts where we saw volumes down. And, of course, that's the largest share of our North American revenue.

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

Q

Okay. But the good news is you're able to shift around even if fulfillment came down. That's part of your competitive advantage is you're able to shift around to support volume.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

We're the only folks who have the ability to sell recycled product if we don't have the aftermarket product in-house.

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

Q

Got it. And then, Varun, on the guidance, so that everything goes up except the FCF. I'm assuming, vs. February, you're planning on spending more on inventory and that's the difference. And what is that delta?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Well, listen, it's – well, inventory certainly, as we've said, we're trying to build that piece up and we're making some good progress. In Q1, Michael, every segment of ours, so all four segments, were actually able to generate more inventory and secure more inventory. I think when you look at the numbers specifically, North America was up, Specialty was up, Self-Service was up as was Europe. In the case of Europe, obviously, the stronger dollar clipped the translation piece of it and also in North America, with the held-for-sale classification for PGW, it seems as if it did not grew but that also grew.

But with regards to free cash specifically, any inventory increase we see ourselves being able to offset with our payables program. But really if you think about why has free cash not kind of gone up despite all of the $0.08 raise on a full-year basis. From a cash perspective, it really is from a receivables perspective.

With the strong organic growth that we are now forecasting, from a midpoint of between 3% to 5% previously and now taking that up by 150BPS in both the bottom-end and the top-end receivables. And that's a good problem to have because, with higher economic activity, we see higher receivables coming through. We saw that come through in Q1 also. And so it'll just be a cycle more than anything else that economic activity will raise receivables. But in terms of inventory, yes, it will go up but we believe we can offset that with payables.

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Daniel Imbro
Stephens, Inc.

Q

Nick, I wanted to ask – you mentioned during your prepared remarks but given the inflationary environment, are you seeing insurance companies opt more often for alternative parts? Are we seeing or do you expect the APU finally take a meaningful step higher? And I guess while we're on that topic, how State Farm are progressing or are they still increasing their alternative part usage? And what does that mean for your North American Wholesale road?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yes. So at this point in time, based on the backlog that I mentioned in the repair shops, the insurance companies just want to get parts on the car. And whether it's an aftermarket part or recycled part or quite frankly, an OEM part, because every day that that car is in the shop, they're generally paying a rental car fee and – which greatly increases their prices. So it's not that they're trying to aggressively move to a higher APU, given the inflationary environment, it's because – it's whatever part is available.

We do believe, as I mentioned in my formal comments, that once the supply chain kind of works its way through and some of the challenges we have from a fulfillment perspective begin to normalize, that our product set provides a great opportunity for shops and for insurance carriers to lower their overall cost. And they can use the price benefit that we have relative to OEM pricing to help offset some of their other inflationary cost.

Daniel Imbro
Stephens, Inc.

Q

Got it. That's helpful. And then, I guess, I also want to just follow-up on the competitions side. You just mentioned the smaller guys are struggling with inventory. Do you expect – I mean, how does that play out? Or they're going to not be able to compete longer term, and they start using price to try to gain share back? Just kind of trying to think through what the derivative impacts are of the smaller guys continuing to struggle to keep up with you.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Our sense is that at some point in time and we can't put a timeframe on it, Daniel. At some point in time, the supply chain will balance itself out and that will obviously help us, and it will help the smaller folks as well. Nobody is trying to buy volume these days because there's a shortage of product. And so pricing is strong. So, we don't anticipate anybody, not us, not our smaller competitors are trying to buy volume through price, because when there's not enough inventory to go around to begin with, that would not be a smart move, right?

They will continue to compete. We will continue to compete. We think we've got significant advantages from a product breadth perspective, from a product depth perspective, and from a service capability. And that's how we're going to continue to compete and grow our market share in the months and quarters to come.

Stephanie Moore
Truist Securities, Inc.

Q

I wanted to touch on the European margin expectations for the year. Clearly, some headwinds that I think were not originally expected, but still looks like we'll continue to move forward with nice double-digit margins. So maybe just talk through levers that you've been able to pull on your end to offset some of these headwinds, as well as maybe give us an update on where we stand on the 1 LKQ Program?

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Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Stephanie, let me start off with the European margin piece of it and then, Nick will pick up on where we are with the 1 LKQ Europe Program. Yes, listen, in terms of where European margins came in, slightly softer, but I think it's fair to know the fact that the Ukraine-Russia conflict was not anticipated. So, that certainly has clipped the margin trajectory of the business in Q1. There was the odd customer bankruptcy also.

But really, on a full-year basis, for balance of year, the team, all of us, we are very confident of being able to hit what we have put out there from a public commitment perspective of hitting our sustainable double-digit margins. And so while Q1 kind of clipped it for about just over a penny in the Ukraine-Russia conflict, on a full-year basis, we think it will kind of clip us for about 6%. So, there's another 5% yet to go. And that's really what you see in the earnings deck where we've given a walk from the prior original guidance to what we're now suggesting.

But in terms of how the business is progressing, the organic growth is coming through strongly. And we expect the operational side of things with the higher organic revenue growth that Europe has put up and really what it continues to forecast, which again is not all price, it's actually a good mix of volume and price and which is actually incredibly heartening.

And the same thing as Nick mentioned about North America, they are the ones that do have good product availability. We would like to have some more. But in terms of our investments that we have been making, those are certainly beginning to bear fruit and really shows the resiliency of the business that we've built up on both sides of the pond. But again, Nick, if anything else you'd like to add from a 1 LKQ Europe perspective?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. The 1 LKQ Europe Program is right on track. Organizationally, we've gotten that behind us now for several quarters. Arnd has his full team in place. Wonderful set of management talent. The individual platforms are working together much more on a day in day out basis. We're getting the benefits that we were hoping to achieve from a procurement perspective. There's still room to go there. We're not remotely done. There is still room to go.

And the focus in the future is getting a little bit better labor efficiency by consolidating some of the roles in our shared service centers, whether that's in Southern Poland or in Bangalore. We think there's some further opportunity there. And then the IT rollout, that's going to be, like we said originally, that was going to be kind of a four-year journey. We're a couple of years into it, but it's right on track and just about on budget, so we're really pleased there.

Stephanie Moore
Truist Securities, Inc.

Q

Great. Thank you. That's very helpful. And then maybe lastly for me, if you wanted to just touch on kind of a longer-term view as the vehicle dynamic changes across the globe, changing from ICE to EVs, and how you think you're positioned with some just recent investments that you've made?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. So, there is no doubt that there are changes to the car park, both in North America and Europe, but they are evolutionary, very evolutionary, they are not revolutionary. The reality is the impact of EVs probably won't be felt until well into the 2030's. And our goal and if you were to read some of the materials we put out there for our

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European business, the goal is to be, first, as it relates to being able to supply repair shops with parts for electric vehicles, EV first.

And Arnd and the team are putting plans in place to do that. We suspect that most everybody in Europe, folks like us, is trying to figure out a way to support electric vehicles, because they will grow from being 2% or 3% of the car park to maybe 10% of the car park over the next 10 years. And it's going to be a real opportunity. We don't view it as a huge threat. We view it more as an opportunity to expand the product set and to provide our customers with even a broader array of products.

Same in North America, though I think the EV shift is going to be a little bit slower here in North America. And just like we've made the acquisition of a battery remanufacturing business, we're in the process of buying a second battery technology-related business. Again, these are small, nascent operations, but they will give us key technology that we will need as we move forward to provide a good set of products and services to our customers.

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

Q

I wanted to follow up, Nick, on 1 LKQ Europe. Could you just shed a little more light on the progress you are making on your private label program in Europe?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Sure. So, the first thing we did, Craig, on our private label front is we had to rationalize and consolidate all the various brands, because when you take a look at all the companies we had acquired in Europe, essentially, we had 90 different private label brands that we had bought along the way. And there's no need for us to have 90 different brands. So, we have rationalized that out significantly.

We have put all of our private label product activity and the growth of that business under a leadership of a single person on a pan-European basis. We refer to it as our Components business. And we have an individual who came out of the STAHLGRUBER organization that is focused on growing that business across the European platform. Some countries are ahead like the UK. We have the highest penetration of owned brand or private label products.

In other countries, like in Germany, it's significantly lower. Our goal is to raise the total, so they have a higher penetration in each of the countries in which we operate. And it's not going to happen overnight. Part of it is making sure that the private label product that we put out there is extremely high quality because, ultimately, the customers will not react well with low-quality product. So, we're working with all of our vendors to make sure we have great quality product. And then the goal is in each of the countries where we operate to get the percentage of private label revenue up.

When we do that, okay, private label is less expensive and very price competitive for the customer. And so that will have a little bit of an impact on revenue, but the margins are significantly better. And that's all part of the thought process.

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

Q

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And just as a follow up. First, are you willing to share like the percentage of private label today and what that margin differential looks like? And then second, do you need to make investments in a single, unified European private label brand, or will there be multiple brands in multiple countries?

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

We will probably have multiple brands, but we are consolidating it down significantly from what we started with. And we do have a brand called the [ph] Emotiv (57:07) that we have in the very, very early stages. Maybe not even – maybe kind of batting practice warm ups where we're starting to roll that brand out across the European platform. We have not disclosed our private label penetration in Europe. Again, we are the highest in the UK and probably the lowest in Germany and all the other countries are somewhere in between. In total today, it's probably around 10%.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Hey, now that you've got this investment grade on your debt, I mean, would you say that your priorities could shift to more aggressive share repurchases overall? I mean, is there a real need to continue to pay down debt as you have done?

Varun Laroyia
Chief Financial Officer & Executive Vice President
A

Great question, Gary. And good morning. No. I don't think anything really changes on a day to day basis. If you think as to we've been operating with investment-grade credit metrics now for probably six quarters, right. And so from that perspective, debt is well kind of arguably under leveraged at this point of time. But kind of following our balance allocation product – capital allocation policy, we've been kind of talking about the fact that we are not prioritizing debt paydowns at this point in time.

With the investment-grade rating that comes through, I think there was a previous question on the call also. Over time, doesn't happen overnight, but as we go renegotiate client – vendor partner contracts, that higher level of trade payable days certainly lifts and that certainly will release a few hundred million dollars of incremental FCF over the next few years.

With debt levels arguably below where they need to be, we're happy with what the overall debt leverage is. So, nothing really changes because we've been operating at those metrics for quite some time. The key piece really is that we continue to look for opportunities to grow our business. Organic is obviously that much better. Seeing the level of organic revenue growth coming through our businesses is incredibly heartening. So, that really is the key focus, making sure that we provide all the capital required to continue to stretch out our lead from an organic perspective.

And as and when opportunities come up to do some corp dev activities, we'll certainly do that. But again, we're not going out there whale fishing or elephant hunting. It's basically high synergy tuck-ins, building up incremental adjacencies, critical capabilities. And then, whatever is the excess free cash, yes, having a share repurchase program is incredibly helpful.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

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Okay. Thank you. And then, last question. Nick, you mentioned that because of supply chain issues, some aftermarket parts, particularly on collision repair, are in short supply. Are you starting to see or because of this, a shift where salvage parts are being substituted for what could have been more of an aftermarket part usage just because of this issue in supply chains?

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

Yes, totally. Yes, absolutely. I mean, every time we have a customer on the phone, if we do not have the aftermarket part in stock, but we do have a recycled part in stock, we try and cross-sell. Again, we're the only company that can do that, because we're the only company that offers both recycled and aftermarket parts. And our salespeople have the inventory screens for both product sets right in front of them when they're talking to their customers. So, we try and cross-sell every opportunity we have.

Varun Laroyia
Chief Financial Officer & Executive Vice President
A

But Gary, also I think it is fair to say, it really shows the power of what we've built up out here. No one at this level of size and scale has the dual sourcing strategy of kind of aftermarkets and recycled parts. And so, that really is where we've been investing a lot. Our salvage recycled business has been doing an outstanding job. And as you kind of saw from the slides in the earnings deck, we're certainly investing more, whether it be buying dirt to kind of set up our salvage yards, or for that matter, making sure that we continue to be a very active player in the salvage market with regards to the number of total-loss vehicles that we're purchasing, that business is rock solid.

Ryan Brinkman
JPMorgan Securities LLC
Q

You mentioned getting ahead of inflation as opposed to waiting to see what impact might be. I'm just curious what measures you may have taken, whether it's primarily passing along higher costs or maybe proactively taking pricing in anticipation of higher future costs. Maybe it's a combination of pricing and cost containment efforts. And then as you are taking price, presumably you're testing the elasticity of demand for various different products in different markets, and I'd be interested what you might be learning in terms of the customers' ability or willingness to pay higher prices for the various different products that you distribute.

So, for example, are you seeing greater ability to pass along price for more non-discretionary products relative to discretionary products, or are you better able to raise price for higher-end products vs. lower-end products, or is it the other way around, or whatever insights you might be gleaning as you go through this process?

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

Yeah. So, a lot of questions there, Ryan. The reality is, again, we did – I wouldn't say that we took prices up in anticipation of higher cost later, not that we were ahead of it, but we didn't wait to see our costs to go up and then, do prices. I'd say I think we timed it pretty well. Again, it's a very competitive market out there and at the end of the day, your ability to push price ultimately is dependent upon overall market pricing.

Like I said, supply is short. That's true with all different types of parts. And so, nobody out there is leading with price as a way to buy volume, right? Everyone, I think, is trying to hold their prices tight. Again, we knew inflation was coming, it was no surprise and so, we weren't shy. The reality is no customer likes prices to go up, just like nobody listening to this call likes to pay more for anything, right? But the reality is governments around the world have $32 trillion of capital into the marketplace as a result of the pandemic.

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And when you have more units of currency chasing a fixed basket of goods and services, prices go up. And there's not probably a country in the world that hasn't seen the negative impact of inflation. And if you don't stay on top of it, you fall behind and you never catch up. And we made a conscious decision not to come out of the box behind the curve.

Yeah. So I'm not – I don't want to imply that we're leading the curve, but we're staying constant. I think we're doing a good job of matching the ability to push prices along with the higher cost. And look, everyone knows that shipping containers from the far east into North America is up five to six-fold from where it was a couple of years ago. That's not 6% or 7% inflation, right. That's significantly more. Labor is up more along the lines of normal inflationary statistics that you've read.

And so, we have moved prices up. And we've had customers who haven't been happy, but they understand that, right, because they know what's going on in their own businesses as well. And there is no free lunch. And we're a humble distributor and we have no intention of getting caught holding the inflation bag, if you will. It's not our job to fund the parts and services industry in the automotive repair marketplace.

And so, we're going to do what we can to protect ourselves from inflationary pressures. There haven't been huge differences between kind of the type of parts that we've been able to move price along. Again, we've done our best to move it along on all types of parts. Again, every market's a little bit different. Every country is a little bit different depending on overall competitive dynamics and the like.

The inflationary pressures in the US are higher than in Europe. That doesn't mean that there – Europe doesn't have inflationary pressures. They absolutely do. But we see it a little bit more intense here in the US than overseas.

Dominick P. Zarcone

President, Chief Executive Officer & Director

Q1 HIGHLIGHTS

Performance

- I think, as everyone knows, we're hosting our Investor Day on June 1, and we would hope to be able to see most of you there in Nashville
- We're hosting at our National – on our North American headquarters, and it will be a live event
    - We understand that some of you may not be able to find your way to Nashville
- And for those, the event will also be virtual in nature
- It will be telecast and you'll have the ability to come in via the Internet
- Again, that's June 1 in Nashville
- And then again, absolutely, we'll be speaking with everyone in late July when we report second quarter results.

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