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LKQ Corp. (LKQ)

Q2 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

Q2 HIGHLIGHTS

Operating Environments

- This morning, I will provide some high-level comments relative to our performance in the quarter, and then Varun will dive into the financial details and provide an update on our guidance before I come back with a few closing remarks
- Q2 2022 was one of the most unusual and complicated operating environments we've encountered maybe ever, but clearly since the financial crisis
- During the quarter, we were confronted with ongoing COVID risks and the issues associated with an uptick in positive cases in our workforce

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- Major labor constraints, ongoing supply chain disruptions, a challenging inflationary environment globally, as evidenced by June being the highest level of inflation the United States has seen in some 40 years, soaring energy prices, commodity price volatility, the unfortunate conflict in Ukraine and political unrest across the globe, and all of this has resulted in major volatility in the foreign exchange markets with the euro weakening materially in the quarter and reaching parity with the dollar in July

Performance

- I think I speak for all CEOs across all industries when I say the sheer number of crosscurrents and headwinds have created some very challenging business dynamics
- Yet, the LKQ team delivered another quarter of solid performance, driven by excellent focus and execution, exceeding many expectations both internally and externally
- I am very proud of the hard work and dedication demonstrated by our 45,000 employees that enabled our company to deliver on behalf of our stockholders and our customers during the quarter
    - I am equally proud of the team's commitment to effectively manage the dynamics of our business, which they can control, while not losing focus on growing the business, developing our people, and continuously looking for opportunities to generate leverage and synergies across our operating segments

Effective Management

- This effective management will serve the company well as we progress through the balance of 2022 and continue to confront many of the same headwinds
- Our confidence in our team's ability to manage through this environment is validated by the reaffirming of our 2022 guidance, which Varun will discuss shortly

Revenues

- Now on to the quarter
- Revenue for Q2 2022 was $3.3B, a decrease of 2.7% as compared to $3.4B in Q2 2021
- Parts and services organic revenue increased 3.8% on a reported basis and 4.2% on a per day basis
- The net impact of acquisitions and divestitures decreased revenue by 1% and foreign exchange rates decreased revenue by 5.6% for a total parts and services revenue decrease of 2.7% on a reported basis or 2.4% on a per day basis
- Other revenue fell 2.9%, driven by a decline in precious metal prices

Net Income and EPS

- Net income for the quarter was $420mm as compared to $305mm for the same period of last year
- Diluted EPS for the quarter was $1.49 as compared to $1.01 for the same period of 2021, an increase of 47.5%
    - These amounts reflect the $127mm gain on sale of the PGW Glass business in April or $0.45 per share
- On an adjusted basis, net income in the quarter was $307mm as compared to $340mm for the same period of 2021
- Adjusted diluted EPS for the quarter was $1.09 as compared to $1.13 for the same period last year, a 3.5% decrease
    - The adjusted results exclude the impact of the PGW sale

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North America

ORGANIC REVENUES AND PRICING INITIATIVES

- Now let's turn to some of the quarterly segment highlights
- In North America, organic revenue for parts and services for our North American segment increased 10.7% in the quarter on a y-over-y basis, which exceeded our expectations
    - This performance confirms the resiliency of our business model and our team's ability to effectively implement pricing initiatives to offset inflationary pressures

VOLUME

- As it relates to volume, during the quarter, we saw some weakness which was consistent with a 2.6% decrease in second quarter fuel consumption as measured by the US Department of Energy
- Additionally, vehicle miles traveled saw little y-over-y growth and Q2 growth was down relative to Q1
    - The largest pressure point in North America continues to be the aftermarket collision parts product line, which experienced reduced y-over-y volumes due to lower fulfillment rates associated with supply chain disruptions

AFTERMARKET SUPPLY CHAIN

- During the quarter, we benefited from some minor relief in the aftermarket supply chain relative to Q1, which translated into a very modest increase in our fill rates, with June aftermarket fill rates reaching the highest levels of 2022
- While we are still well below historical levels, we are encouraged by this modest positive trend in the supply chain, which is also evidenced by the decrease of spot container cost the market witnessed during the quarter, albeit the shipping costs are still multiples above pre-pandemic levels

SALVAGE COLLISION PART VOLUMES

- During the quarter, we were successful in getting a higher level of aftermarket collision parts shipped from Taiwan but most all of that inventory is still on the water and won't be received in our warehouses until late summer or early fall
- Our salvage collision part volumes were up a bit compared to last year as we were able to ship some of the aftermarket demand over to recycled parts
- Recycled and remanufactured mechanical part volumes were generally flat on a y-over-y basis

VALUE PROPOSITION OF ALTERNATIVE PARTS AND COSTS

- The value proposition of alternative parts could not be more attractive as insurance carriers face loss pressures from increased parts cost, rising labor cost and technician shortages at the repair shops, broader supply chain issues, and decreased availability and increased cost of rental cars
- During the quarter, collision repair costs increased 11.6% y-over-y with cycle times still being over double their historical averages

VALUE PROPOSITION OF CAPA AND STATE FARM

- Recently, the value proposition of CAPA certified aftermarket parts is being recognized by the largest auto insurer in the United States, that being State Farm, through a small pilot program

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- On June 20, State Farm began an eight-week program where it introduced aftermarket bumper covers, headlights, and tail lights when preparing repair estimates and settling auto claims in the Oklahoma and Texas markets
- As you all know, State Farm historically has not utilized aftermarket collision parts
- We cannot predict the outcome of the pilot or estimate how this will impact State Farm's parts strategy going forward and neither should you
- That said, as with many things, the first test is the widest and the tallest, and we are cautiously optimistic that aftermarket parts could potentially become a larger portion of State Farm's parts spend over the long-term as they work through the outcomes of this pilot program

European Segment

ORGANIC REVENUES, OPERATIONS AND GROWTH

- Moving on to our European segment
- Organic revenue for parts and services in Q2 increased 4.2% on a reported basis and 4.9% on a per day basis
- Our regional operations continued to experience varying revenue performance in the quarter, but every geographic market was positive y-over-y with our Benelux, UK, Central and Eastern European, and salvage businesses being the top performers
    - Importantly, Italy realized y-over-y growth, which reflected the second consecutive quarter of positive revenue performance in that region

SALES, ORGANIC GROWTH AND REVENUES

- As mentioned last quarter, we halted all sales of parts into Russia when the war commenced
- This decision reduced same day organic growth for the European segment during Q2 by approximately one-half of 1%
    - Excluding the impact of the lost Russian revenue, same day organic growth in Europe was 5.4%
- When taken as a whole, the European volumes were down a bit during the quarter, but pricing was strong

1 LKQ EUROPE PROGRAM

- We continue to make great progress with our 1 LKQ Europe program
- Alongside solid organic growth, during the quarter, our European segment achieved double-digit segment EBITDA margins, which we represented incremental improvements both sequentially and y-over-y
    - Our European team's focus on pricing actions, private label branding, and procurement initiatives generated positive results in the quarter

PERFORMANCE

- As I've said before, the execution element of the 1 LKQ Europe program will be with us forever, and it will be the driving factor behind the productivity improvements in years to come
- Given all the current operating challenges in Europe, including the foreign exchange and geopolitical dynamics, I am very pleased with Europe's performance in the quarter

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Specialty Segment

ORGANIC REVENUES AND GROWTH

- Now let's move on to our Specialty segment
- Organic revenue for parts and services for Specialty declined 11.5% in the quarter, largely due to a tough y-over-y comp
- As you may recall, this segment reported 30% organic growth in Q2 last year
- So on a two-year stack, the annual revenue growth is still well into double-digits
    - Indeed, Specialty revenue in Q2 would have been a record for the team if not for the buoyant performance in 2021

RV PARTS CATEGORY AND SALES

- Our RV parts category performed better than the segment level growth as a whole during the quarter as demand for the majority of our RV parts offerings is driven more by the size of the RV park and not new RV unit volume
- That said, certain product groups such as towing that have some exposure to new unit volume underperformed in the quarter
- Also, some of the softness that the SEMA-related products faced in the quarter was due to a y-over-y decrease in light vehicle sales in the US.
- In particular, pickup truck sales were down nearly 12% in the quarter, an important vehicle category for our Specialty offerings

Self Service

ORGANIC REVENUES PRICES, COSTS AND OTHER REVENUES

- Now on to Self Service
- Organic revenue for parts and services for our Self Service segment increased 13.2%
- There were some softness towards the end of the quarter in precious metals prices, which also impacted segment EBITDA margins y-over-y
- Self Service also had increased vehicle procurement cost as we were challenged to source inventory
- The recent volatility in commodities further validates the rationale for breaking out this non-distribution Self Service business as a separate segment given it represents the vast majority of the other revenue category

Revenue Trends

- Let's move on to the initial Q3 revenue trends
- Revenue for North America wholesale operation have gotten off to a solid start, but we don't anticipate it will continue at the double-digit growth rates experienced in H1
- Our European segment is also witnessing a good start with growth rates continuing at second quarter levels
- Lastly, Specialty revenue is slowly trending back towards prior year levels now that it has lapsed the incredibly strong growth rates experienced in H1 2021

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Supply Chain and Disruptions

- We are experiencing some level of supply chain shortages and disruptions across all of our segments
- These disruptions are creating product scarcity and freight delays that are resulting in meaningful availability pressures
- While supply chain challenges are also driving product inflation across all our segments, we have been very effective in passing along these higher costs as witnessed by our margin performance

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 that we stay ahead of any competitive pressures and help backfill the open positions with the best candidates we can attract
- Our focus on the total rewards received by LKQ employees, not just compensation, is helping us navigate the difficult labor markets

Corporate Development Perspective

- From a corporate development perspective, in Q2, we acquired four businesses
- In the United States, we acquired Bumblebee Batteries, another EV battery re-manufacturing operation
- In Europe, we acquired a workshop concept in the Netherlands, two very small former Hess Automotive branch locations in Germany, and the equity interest of our former JV partner in a small aftermarket parts business in Germany
- In addition to closing on the sale of our PGW business during the quarter, we also divested our equity interest in two small joint ventures

ESG Front

- Lastly, on the ESG front, on May 23, we released our 2021 Sustainability Report and unveiled our new brand identity, reflecting the company's transformation from a salvage dismantler and recycler to a leading global value-added and sustainable distributor of vehicle parts, accessories, and services
- LKQ is widely known and respected for our environmental stewardship
- But within our 2021 CSR, we provided a deeper understanding of our social impact initiatives and strong governance structure, both of which underpin the long-term strength and success of our business
    - This year's report is another step in evolving our holistic ESG focus across our global organization with new and robust disclosures and accomplishments

Women on Boards

- Also, during the quarter, 5050 Women on Boards, a leading education and advocacy campaign driving the movement towards gender balance and diversity on corporate boards recognized LKQ as a 3+ Company
    - This award acknowledges our efforts in understanding the importance and advantages of having a diverse board that ultimately benefits stockholders, customers, employees, and communities

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Varun Laroyia
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Operational Excellence Initiatives

- I'm excited to be able to report that we carried the momentum generated by our operational excellence initiatives through Q2 and produced another strong set of financial results
- As Nick described, there is a great deal of volatility in the markets related to inflation, supply chain challenges, exchange rate fluctuations, and commodity price movements on top of the geopolitical events and the ongoing pandemic
- All these factors could easily have become a distraction and taken our focus away from executing on our operational priorities
- I'm proud to say that the LKQ team did not let that happen and our second quarter results reflect this ability to stay on point

Investment-Grade Rating

- Let me start with some highlights of the last quarter
- As we announced in June, Moody's became the final of the three rating agencies to assign LKQ an investment-grade rating following previous upgrades by Fitch and S&P.
- We believe that we've taken the right actions over the last three years to strengthen our credit profile, and the Moody's upgrade to Baa3 with a stable outlook is further validation of our strategy

FCF AND INVENTORY

- As discussed last quarter, achieving an investment-grade rating opens opportunities to improve FCF over the upcoming years in addition to the immediate drop off in the liens to the credit facility following the covenant suspension
- With respect to FCF, we produced a healthy $288mm in the quarter, bringing the YTD figure to $638mm, and importantly, putting us on pace to achieve our full year guidance of $1B.
- I'm pleased that we were able to build our inventory toward the optimal level as shipping congestion eased a little bit, which resulted in a net cash outflow for the quarter of $162mm on the specific account

PGW Glass Sale and Share Repurchasing

- Strong FCF, along with the proceeds from the PGW Glass sale allowed us to return a significant amount of capital to shareholders
- We repurchased over 8mm shares for $404mm and paid a quarterly dividend totaling $70mm
    - In just the last 12 months, we have repurchased over 20mm shares for approximately $1.1B and paid $215mm in dividends
- In May, our board authorized a further $500mm increase to our share repurchase program to a total of $2.5B being authorized
    - We had about $600mm available as of the end of June, and we have remained active in the market in July

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Pre-Tax Gain on Sale and EPS

- As previously stated, in April, we completed the sale of the PGW Aftermarket Glass Distribution business for gross proceeds of $361mm
- We recognized the pre-tax gain on sale of $155mm or $127mm after-tax
- Our US GAAP EPS reflects the $0.45 gain, though we have deducted the gain from the calculation of adjusted diluted EPS.

EBITDA, Prices and Exchange Rates

- I'll now shift to the quarterly results
- As expected and previously communicated, precious metal prices were a drag on results y-over-y, generating $32mm negative effect on segment EBITDA and an $0.08 headwind on adjusted diluted EPS.
- Most of the impact related to the precious metals found in catalytic converters, the prices of which were near record levels in Q2 2021, roughly $20mm of the negative effect was reflected in the Self Service segment
- Exchange rates created a further headwind as the average rates for the euro and pound sterling decreased by 12% and 10% respectively, compared to Q2 of 2021
- The currency impact reduced segment EBITDA by $20mm and adjusted diluted EPS by $0.04 relative to last year
- And finally, not having the PGW business for the full quarter was a further $12mm headwind to segment EBITDA vs. the prior year

Gross Margins, prices and Overhead Expenses

- Keeping those external factors in mind, our second quarter results reflect a solid operating performance while gross margin decreased by 30BPS compared to a year ago, a 70 basis point negative effect came from the metals prices alone
- Benefits in pricing and mix partially offset the metals impact
- Overhead expenses, as a percentage of revenue, rose 60BPS y-over-y due to inflationary pressures
- Income taxes were booked at 25.3% for the year to-date period, a 20-basis point increase over our prior guidance, reflecting the shift in the geographic mix of US dollar earnings as impacted by the significant shift in FX rates since we spoke 90 days ago
- As Nick mentioned, diluted EPS was $1.49 for the quarter, including the $0.45 PGW gain and adjusted diluted EPS was $1.09

Wholesale North America

EBITDA MARGINS, GROSS MARGINS AND OVERHEAD EXPENSES

- I'll now turn to the segment operating results
- Starting on slide 8, Wholesale North America produced an EBITDA margin of 18.7% for the quarter, down 90BPS from the prior year period
- Gross margin declined by 80BPS.
- Inflationary increases in material and freight costs were offset by higher parts pricing and productivity initiatives
- Segment overhead expenses were roughly flat owing to lower personnel costs from incentive compensation and productivity initiatives to mitigate inflationary pressures

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Europe

GROSS MARGIN, EBITDA MARGINS AND OVERHEAD EXPENSES

- Europe reported a 10.8% EBITDA margin for the quarter, up 10BPS from the prior year period
- As you'll see on slide 9, gross margin improved by 80BPS, primarily from procurement initiatives and pricing
- Overhead expenses increased by 60BPS from higher personnel, freight, and fuel costs
- The segment's strong second quarter performance reinforces the team's expectation that they will deliver a double-digit margin for the full year

EBITDA Margins

- Moving to slide 10
- Specialty's EBITDA margin of 13.4% declined 150BPS compared to the prior year, mostly coming from a decrease in overhead expense leverage driven by an organic revenue decline of 11.5%, as they anniversary a very tough comp from the prior year when the business delivered over 30% organic revenue growth in the first and second quarters of 2021
- Inflationary pressures also grew overhead expenses higher including personnel, freight, and fuel expenses
    - The overhead expenses increases were partially offset by 60BPS of benefits from operating expense synergies, mostly generated from the SeaWide acquisition

Specialty

- To provide some context to the segment's performance, pre-pandemic in Q2 of 2019, Specialty reported a margin of 12.7%
- Since then, the team has made great progress on pricing and productivity, resulting in a 70-basis point improvement from Q2 2019 through to Q2 of 2022 in addition to growing the business by over $100mm in revenue

Self Service

EBITDA MARGINS AND COSTS

- Moving to Self Service
- Self Service reported an EBITDA margin of 15.3% for Q2 2022, a solid result for the segment, but below the heightened margin achieved a year ago
- The decrease in Self Service's margin in Q2 of 2022 was driven by movements in metal prices estimated as an 840-basis point negative effect y-over-y, higher car costs, and inflationary increases related to freight, fuel, and personnel expenses
- Q3 will be markedly tougher for the segment as the higher car costs from Q2 cycled through in a significantly lower pricing environment for metals before stabilizing in Q4
- I touched on liquidity and capital allocation in the highlights, so I'll reference a few other items of note
- As shown on slide 13, our YTD conversion ratio of FCF to EBITDA is roughly 70%, noting that the Glass proceeds and the gain-on-sale are not reflected in these figures
- There continue to be timing elements that will reverse over the course of the year and we are confident in our ability to generate sustainable FCF in line with expectations of converting EBITDA to FCF in the 55% to 60% range for the full year

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Inventory

- We have made further progress in rebuilding our inventory levels to achieve our fill rates targets
- As you can see on slides 31 and 32, we have increased inventory in three of our four segments since December of 2021
- Specialty was flat through December but was in a stronger position than our other segments and thus hasn't required a similar inventory build
    - We remain confident that our inventory positions will enable each segment to continue to offer best-in-class availability and service reliability relative to our competitors

Capital Allocation and Net Leverage Ratio

- Moving on to capital allocation
- We paid down our debt balance by $248mm in the quarter
- Our net leverage ratio came in at 1.2 times EBITDA and interest coverage exceeds 30 times
- It's worth noting that our net leverage ratio of 1.2 times is in line with the June 2021 figure despite the use of $1.3B for share repurchases and dividend payments over the last 12 months
    - As our earnings release of this morning indicated, the board has approved a quarterly cash dividend of $0.25 per share, which will be paid on September 1 to stockholders of record as of August 11

GUIDANCE

- I will wrap up my prepared comments with our updated thoughts on projected 2022 results
- Our guidance assumes there are no significant negative developments related to the COVID-19 in our major markets, scrap and precious metal prices hold near average June prices, and the Ukraine-Russia conflict does not escalate further
- On foreign exchange, our guidance includes recent European rates with the balance of year rates for the euro of $1.02 and the pound sterling at $1.20

Revenues and EPS

- Starting with the revenue outlook
- We remain comfortable with our revenue outlook and are holding our organic parts and services growth range between 4.5% and 6.5%
- We are projecting full year adjusted diluted EPS in the range of $3.85, up to $4.05 with a midpoint of $3.95
- We have narrowed the range as we are halfway through the year but maintain the midpoint of our prior guidance

Operational Benefits

- To understand why we held the midpoint, please refer to slide 18 in the presentation, which bridges our prior and current guidance figures
- We generated operational benefits in Q2 and expect further upside in H2
- The total operational improvement is $0.11 which highlights the resilience of the business in difficult trading conditions

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Ukraine-Russia Conflict

- While the Ukraine-Russia conflict is still a negative on a full year basis, we have seen better-than-expected results as areas of the country reopen with fighting concentrated in the Eastern part of Ukraine
    - We are honored to be able to support critical mobility needs in the country where feasible and are very proud of the work being done by our colleagues in Ukraine

Capital Allocation

- Capital allocation is also a benefit of $0.03 relative to our prior guidance, primarily related to timing
- Note that we are including share repurchases through the week ended the 22nd of July in our guidance and as in prior periods not assume any further retail purchases for the balance of the year
    - That's the good news mostly tied to the areas directly under our control

FX Rates

- And then there are the negatives which are primarily external factors
- Headwinds from the weakening FX rates I mentioned earlier contribute $0.06 reduction relative to prior guidance
- Declining metals prices are expected to have an additional negative $0.07 impact primarily in Q3 as we turn cars purchased in the first and second quarters when metals prices were higher at a lower projected scrap and precious metal prices
- FX rates and metals prices can move significantly over time
    - We may have further upside or downside if the actual figures play out differently than we have assumed in our guidance

FCF

- 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
- We haven't increased the minimum given the negative exchange rate effects and the projected tax payment for the PGW gain, which in the aggregate are estimated to be approximately $50mm
- We expect to overcome both factors to meet or exceed the $1B estimate

Dominick P. Zarcone

President, Chief Executive Officer & Director

CLOSING REMARKS

Culture and Objectives

- Let me restate our key initiatives, which are central to our culture and our objectives
- First, integrate our businesses and simplify our operating model
- Second, focus on profitable revenue growth and sustainable margin expansion
- Third, drive high levels of cash flow, which in turn will give us the flexibility to maintain a balanced capital allocation strategy
- And fourth, to continue to invest in our future

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Operating Environment

- As you can see from our results, we are committed to driving these metrics forward regardless of the operating environment
- We are doing our very best to effectively manage the items which are under our control so as to offset the headwinds which are largely outside of our control
    - And for that, I offer a tremendous thank you to our team members across the globe that make it happen each and every day
- They define what it means to be LKQ proud

QUESTION AND ANSWER SECTION

Scott L. Stember
MKM Partners LLC

Q

First question, I'm just going to jump right to State Farm. Obviously, they left the market more than 20 years ago and they've come back in, dipping their toe in. Can you maybe just size this up vs. prior attempts of them going back in the market? How real this feels and how tangible and how big this could be if it really does come to fruition?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

So let's put everything in perspective. Great question, Scott. State Farm is the largest automobile insurance company in the United States of America. They have roughly an 18% market share. They stopped using aftermarket collision parts back in the late 1990s as a result of some policy language that certain of their customers took issue with. It had nothing to do with the actual parts. It just had to do with policy language. And they stayed on the sidelines really throughout the entirety of their litigation which lasted for 20 years. And in 2019, they finally settled that suit for about $250mm which is a drop in the bucket, right? That was [ph] 2 years (36:02) ago.

And over the last three years, people have been wondering, now that that was settled, are they going to come back. State Farm is a very thoughtful, very conservative organization, and they move pretty slowly. And this is just a pilot. It's a 8-week pilot in two states with three product lines. That said, it is encouraging and this is really the first time outside of some pilots with chrome bumpers for pickup trucks that they are actively looking at the market and evaluating the utilization of a broader array of parts. The reality is if they were to turn it on completely all at once which we don't think they will do, we think this is going to, again, in classic State Farm fashion, this will draw out fairly slowly over time. There is the potential of an 18% increase in aftermarket demand because they're 18% in the marketplace.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

We don't anticipate any impact on our 2022 or 2023 results because again, this will probably play out over a longer period.

Scott L. Stember
MKM Partners LLC

Q

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And just going back to North America, you talked about in June, you saw some encouraging results from a fulfillment standpoint. Could you just give a little bit more detail on that?

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

Certainly. Historically, our fulfillment rates in North America have been well into the mid-90% range. And coming out of the pandemic with all the supply chain issues and the like, we fell below 90%. We picked up a couple of percentage points in the month of June, which was good. We're still well below where we want to be, well below where we used to be. But the fact that we're moving up is encouraging. And I would say a lot of that has to do with the aftermarket product, which as I indicated in my prepared comments is the one product line that has been most affected by the supply chain challenges.

The volume of aftermarket parts is down. Pricing is very strong, but the volume is down. And we have a lot of inventory on the water as I mentioned. We were very successful in getting containers filled in/on ships in Q2. Given the supply chain, we won't see that until late summer or early fall. But with that, we believe we will be in a good position to continue to drive fulfillment rates back north. We do not believe we're going to get back to plus 95%, but we're moving in the right direction.

Scott L. Stember
MKM Partners LLC
Q

And just lastly, you are 4.5% to 6.5% parts and service organic growth rate has not changed. But has the composition by segment changed?

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

Not materially. Europe is right on track where we would expect them to be. As I indicated, North America in Q1 and Q2, ran ahead of our expectations. And so there's a little bit more of a shift in impact from the North American business. The Specialty business, as we've seen, given the monster comps that we had last year was down I think 15% in Q1, 11% in Q2. We're trending in the right direction. Again, we've only got 20-some days of data on Q3. We're closing the gap in. And our goal would be by the end of the year to be a lot closer to prior year number. So maybe a little bit of shift from -out of specialty and into North America, but again, comfortable with that 4.5% to 6.5% range.

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

First question just on inflation. Nick, can you characterize the rate of inflation in your cost structure and whether that's easing at all.

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

It's almost impossible to put a single number on inflation because it's coming at us from so many different corners at different rates. Fuel expenses are up dramatically. I mean, gas used to be $3.50 a gallon. During the quarter, it hit as high as over $5 a gallon. Now it's easing back a little bit, but that's not the 9% inflation that the rest of the – that's being published about the United States inflationary factors, right. Labor rates are up significantly.

The good news was in June, for example, we didn't have to go to the spot market for containership at all. It was all under contract. And so while it's still above where it was pre-pandemic, it wasn't quite as bad as we had

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feared. So it really varies almost by category of expense and by location. The experience in North America is different than in Europe. But overall, all of our costs are up. The cost of goods is up. All the SG&A expenses are up. Almost nothing is down other than what we can do to have productivity measures to reduce the consumption of SG&A type items. But it's a big headwind. There's no doubt about it.

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

Q

Just the first one, can we talk about the trade working capital opportunity and how should we think about or model kind of how the trade working benefit plays out in H2 2022?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

but also over the past few years for the entire organization out here. It is a key element of the revised annual cash incentive program since 2019 and just tremendously proud of the shoulder that every single individual across the enterprise has put into it. Clearly, as you see, we're happy with the inventory build as some of the supply chain congestions ease. Again, it is all relatively speaking. It certainly isn't back to pre-pandemic levels. But if you think about where we've been over the past couple of years, Q2 was a good quarter for us to be able to pick up inventory in our businesses. And that certainly is what we had to do to ensure that we have the right part available at the right place and at the right time. So that really has been the key for us.

As you think about H2, similar to what we've done in H1, we don't believe that we need to build up inventory levels significantly above where we currently are. But as you know, we typically do, do an inventory build in Q4 because of the seasonality of the overall business coming out the winter season in Q1 and Q2. So we do expect to build up some inventory towards the back end of the year. But the single biggest piece that you can think about is the tables offset and you certainly saw that in Q2 also. While there was inventory build, we certainly had a nice move on our accounts payable balances to offset that.

And then the final piece really within trade working capital is receivable and on the back of some strong organic revenue growth, North America, as you would have seen on slide number 5, reporting a 10.7% organic revenue growth rate, Europe at 4.2% on a constant currency basis at 4.6%, we do expect receivable balances to move up. And I'm perfectly okay with that as long as our teams continue to manage the past due receivables. And so from that perspective, if the only big build up is on the receivables side, that's okay, that's the sign of a good, healthy, growing business.

So, overall, while we've had a good solid start in the first six months with the free cash at about $638mm, we feel comfortable about hitting the minimum $1B that we have committed. You do need to note that with the FX challenges from a European perspective, the free cash that gets translated back into US dollars, that obviously is lowered as a result of that, number one. But the other piece really is, if you think about the PGW divestiture that we did in Q2, there are taxes to be paid, estimated taxes to be paid in Q3. Those two elements, as I mentioned in my prepared comments, amount to about $50mm. We'll overcome that. And hence, we're still kind of maintaining our minimum of $1B of free cash for the full year.

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

Q

My second question was on kind of looking at – can you talk a little bit about price and volume mix when you look at the US and the EU for the parts and service business for Q2?

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Dominick P. Zarcone
President, Chief Executive Officer & Director

A

As we tried to indicate in our prepared comments, a lot of the organic growth, no surprise, given the inflationary environment that we're dealing with, has come through price. The volume question, again, like the inflationary question, it really depends literally business by businesses, product line by product line. In North America, the aftermarket product volumes were down. Salvage collision volumes were actually up because we're able to transfer some of that demand for aftermarket product into salvage product. The salvage mechanical side of things were kind of flattish. We had some uptick in the reman business. And so net-net, we were down in North America, but some things were down, some things were up. Same in Europe, you really have to go geography by geography. We had some of our businesses where the volumes were up low single-digits, which is great. We had other areas where volumes were down, say, 1% or 1.25%. But pricing was very strong again. And specialty, with the 11.5% decline in organic, volumes were down. But again, that's relative to the monster comp.

So, it really depends business by business, geography by geography. I believe our teams are doing a great job of managing. We're always trying to get the most volume that we can, because ultimately, that's important to sustaining the business. But equally as important, particularly these days, is making sure that we're covering the inflationary pressures through our pricing actions. And so we believe the team is doing a nice job of balancing those two objectives.

Daniel Imbro
Stephens, Inc.

Q

I want to start on the North American Wholesale side. So, obviously, the State Farm developments feel like they're positive for growth. But I also want to ask on pricing. I think most of the quarter was driven by pricing. Are we still seeing OEMs raise prices further, Varun? And as you look to the back half and maybe into next year, I mean, would the expectation be that given just the broader inflationary backdrop, these pricing increases continue or is there a risk that pricing flows will continue to have to come down on the OEM side?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

The OEs, they don't just increase all the prices on all their parts every month. That's not how they operate. They're very selective in how they're pricing their parts. Some prices go up significantly. Some prices don't go up at all. And obviously, all the OEMs kind of have their own strategy. In general, their prices have gone up a little bit, less than or generally less than overall inflation. And so whenever they take their prices up, that provides us an opportunity, not just us, the whole alternative parts industry as a whole, the ability to take pricing up a little bit as well.

I can't predict what they're going to do in the future. Ultimately, they're dealing with the same types of inflationary pressures as all the other businesses as it relates to input costs, whether that be materials, commodities, labor, all the rest, right. All I can say is we will try – we keep a very close eye as to how the OEs are pricing their product. We need to maintain a competitive stance. We think we're doing a good job of doing that in this current environment.

Daniel Imbro
Stephens, Inc.

Q

And then, Varun, maybe one on the European margin. I think we touched on demand a bit in the last question. But I think at the Analyst Day of our call you guys noted that further margin expansion was possible and above

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10% profit levels. Given the change in the last 30, 60 days, and FX rates, economic backdrop, inflation, I mean do you still think it's possible to see EBITDA margin expansion this year or next year for Europe as you look ahead?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

There's nothing, as you know, Q1 with the Ukraine-Russia conflict, there were some challenges associated with that. But the underlying business operates in a very resilient market. Folks have kind of talked about the fact that energy prices have been moving up with what's happening further out there. But we really haven't seen a significant drop off on a VMT basis, number one. And that really is the key driver for our European business.

So from that perspective, really happy with the way our European business continues to perform. Nick obviously gave some color on the broader platforms in terms of how they've been performing also. I think the key piece out here has been making sure that we have the inventory to satisfy the demand which we do. But overall, very happy with the way the margin trajectory of the European business continues and we feel comfortable and confident about double-digits on a full year basis.

With regards to 2023, we haven't given any guidance as of now. But needless to say, if you kind of go back to our commitment to the markets way back in September of 2019 when we launched the 1 LKQ Europe program, at that point of time, we said exiting 2021 we would be a sustainable double-digit margin business. We certainly delivered that in 2021. We're delivering that in 2022. There's no reason for us to start to backslide at this point of time. So while we haven't given any guidance, we do expect there to be further goodness from a margin and profitable growth perspective across our European segment.

Bret Jordan
Jefferies LLC

Q

On that last question, Varun, you said the VMT has remained pretty stable in Europe. Could you talk about the consumer demand trend, I guess, sort of the cadence in the quarter as obviously compounding volatility over there? Has it had any impact as we've progressed?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Actually, the back part of the quarter was much stronger than the first part of the quarter, Bret, which we were heartened to see. Again, you got to keep in mind, we're largely in what would be deemed a consumer non-discretionary business, right. We provide service parts that keep vehicles on the road. People need their cars for mobility to get to work, to conduct their daily life. And if the car can't operate, they're going to spend the money to put it back into operational mode.

And everyone knows in tough times, you can probably stretch out your oil change for a bit, right. You can stretch out some of the service items for a bit. But sooner or later, you need to repair your car. You need to keep it serviced. And that's what we love about our business, right. It's largely consumer non-discretionary. No business is totally recession proof, if you want to use that word. But we feel very comfortable with where we are. And again, our operating results in May and June were much better than they were in April. So we're optimistic.

Bret Jordan
Jefferies LLC

Q

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And then within Specialty, could you sort of carve out the performance differences between RV, which I think you called out as being pretty stable vs. the SEMA-related product just sort of within that total Specialty decline, could you give us a feeling on the pieces?

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

So the RV side of it, what I indicated was down less than the unit, the business as a whole, business as a whole was down 11.5%. RV was off less than that. And again, you really have to almost go product set by product set. So core RV products really are tied to – less to the RV SAAR, Bret, but more to the utilization of the RV and size of the park. We've done a lot of correlation analysis over the years on this, and what we've always seen is that RV revenue is tied a lot closer to campground spending than the RV SAAR, because a lot of what we saw are replacements and consumables, and that all relates to the utilization of those units.

If you go back to the financial crisis, right, the Great Recession, campground spending was flat. It stayed, hung right in there. And but there are some products like towing, which is a great example, which really crosses RV and Marine and some of the SEMA product. Towing was soft. And on the SEMA side, that's where probably a larger percent relative to RVs, a large [ph] portion (56:53) of the spend goes on [ph] for vehicles (56:56), right? People buy their new pickup truck, their new jeep, and they want to set it out. And pickup truck SAAR was off 12% in the quarter which is Q2 in a row that it was down, right. So that's where there was a little bit more pressure.

But again, some of it is a comp against almost an unrealistic comp of what we did in 2021. Like I said, the Specialty group including all parts of the Specialty group are doing better and they're clawing their way back to prior year volumes at least in the first few days of Q3. We probably won't get there for the quarter as a whole, but we're closing the gap. And from our perspective, that's what's important.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

A couple of questions here. First of all, Nick, you didn't cite the growth in collision claims in North America as a comparison to what you did in North America. Do you have that statistic handy?

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

So repairable claims in Q2, we're up about 6% compared to 2021 but still down 6% compared to 2019. So the industry is still down relative to pre-pandemic levels.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

On an absolute dollar basis, how much did FX positively impact SG&A?

Varun Laroyia
Chief Financial Officer & Executive Vice President
A

We haven't called that piece out. But I will tell you, from a North America perspective, clearly, there's little to none. But if you think about it, really, where does the FX exposure come through, it's from our European business. And so, if you think about where the European business total SG&A was around $420-odd-million, and if you then kind of go – you can back into that number, Gary, and this is the way you should think about it. Within the slide deck, we obviously have on slide number 27, we obviously have the FX rates out there also. But essentially, the euro has been the big kind of decline. So roughly, call it, about a kind of about 10% decline on there, so kind of run that

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piece of the $420mm, but that basically is what the – it kind of changes the benefit, but the translation benefit, if that's what you're referring to from a lower conversion rate, that's really where it would come through.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

It's important to keep in mind that the FX issues that we're dealing with are translation issues, i.e., just converting the foreign currency into US dollars. By and large, they are not transactional issues. But we do have some transaction exposure. Some of the purchasing of parts in Europe is dollar denominated, particularly things like oil-based products which are dollar denominated. But those are things what we know in advance we're going to be buying, and we can do some hedging of that. So total FX kind of exchange losses, if you will, from a transactional perspective in the quarter was less than $2mm. So it's all just translation of foreign currency results into US dollar results.

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