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LKQ Corp. (LKQ)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Joseph P. Boutross
Vice President-Investor Relations

GAAP AND NON-GAAP FINANCIAL MEASURES

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

Dominick Paul Zarcone
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- This morning, I will provide some high level comments related to our performance in the quarter and then Rick will dive into the financial details and provide an overview of our updated guidance before I come back with a few closing remarks
- Q3 2023 represented some mixed results, which collectively fell short of our expectations
- Wholesale-North America continued to outperform, all while working on the integration of the Uni-Select acquisition

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    - However, we experienced some unusual transitory events that in aggregate affected the short-term performance of our European operations
- We also had continued pressure on commodities, which impacted Self Service, along with less-than-expected demand for our specialty products

Operational Excellence Strategy

- The LKQ culture is one that takes accountability for results and is humble enough to understand that this quarter's results fell short of both our expectations and the expectations of many of you on the call
- Make no mistake, the shift to our operational excellence strategy implemented in 2019 has not changed
- Structurally, our business model and financial outlook are sound and we continue to be very optimistic about the future of LKQ

Business Model

- One quarter does not define the resiliency of our business model, the uniqueness of our global enterprise, or the long-term opportunities that lie ahead for LKQ.
- The perpetual challenging macroeconomic conditions are not unique to LKQ and they will continue to persist, but the LKQ team will move forward
- On the positive side, we continue to experience strong organic revenue growth in our North American and European businesses, achieving same day growth of 5.8% and 6.2% respectively
- North America achieved excellent EBITDA margins, which were ahead of expectations, and our FCF was excellent, particularly in North America and Europe

Headwind

- On the downside, during the quarter, we faced a few unusual and transitory headwinds
- In late September, our Italian subsidiary, Rhiag, completed a negotiation with the Italian tax authorities on the remediation of a value-added tax violation that was committed by certain of our third-party suppliers dating back to 2017
- These suppliers are no longer in business, and thus, Rhiag agreed to remit the disputed amounts to the Italian Revenue Agency to remedy any damage caused by the VAT violations of the former suppliers
    - Additionally, our German operation was hit with periodic strikes at our large distribution center, which reduced our ability to fully replenish the branch network with inventory on a daily basis

European Organic Growth

- Negotiations with the works council are ongoing, but there have been additional strikes in October, which will affect our Q4 results
- It's important to note that resolving the matter is not fully in our control as the labor contract involves multiple employers in Southern Germany that must agree on terms through the employers' association
- These two items alone reduced our European organic growth by approximately 160BPS and reduced segment EBITDA margins by 110BPS.
    - While we are disappointed with these two transitory items, our long-term view of the growth and margin potential of our European business has not changed

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Self Service Segment

- Related to commodities, pricing pressure continued in Q3 with scrap and precious metal down sequentially 14% and 23%, respectively, decreasing both margins and EPS.
- For context, in Q3, catalytic converter prices fell below $100 for the first time since early 2019 vs Q3 last year, when they averaged $197
    - This difficult commodity environment, again, had a particularly negative impact on the profitability of our Self Service segment
- Rick will provide a deeper dive into the EPS and segment margin details in the quarter when he discusses our updated guidance
- The quarter included many other highlights worth noting

Uni-Select Acquisition

- The company generated robust FCF and we are on target to again reach $1B for 2023
- On August 1st, we announced the completion of the Uni-Select acquisition, a bespoke and highly synergistic opportunity that will add positive long-term shareholder value and further widen the competitive moat around our North American business
- Yesterday, we completed the sale of GSF Car Parts to Epiris, a private equity firm based in the UK
- The proceeds from the sale will be used for debt repayments
- And finally, our board has declared a 9% increase in our quarterly cash dividend from $0.275 to $0.30 per share of common stock
    - This increase reflects the board's ongoing confidence in our ability to continue to generate solid FCF and drive long-term value for our shareholders

Parts and Services Organic Revenue

- Now, on to Q3 2023 results and y-over-y comparisons
- Revenue for Q3 2023 was $3.6B, an increase of 15%
- Parts and services organic revenue increased 3% on a reported basis and 4.3% on a per day basis
- Diluted EPS was $0.77 as compared to $0.95 for the same period last year, a decrease of 18.9%, while adjusted diluted EPS was $0.86 compared to $0.97 for the same period of 2022, a decrease of 11.3%

North America

- Let's turn to some of the quarterly segment highlights
- As you'll note from slide 8, organic revenue for parts and services for North America increased 4.1% on a reported basis and 5.8% on a per day basis
- We continue to perform well in North America, especially when you consider that non-comprehensive related auto claims were down 4.3% y-over-y in Q3
- Similar to H1, the growth in North America was a combination of price and volume improvements with the organic growth in our aftermarket collision products predominantly being volume related
- These nice volume increases were driven by our disciplined procurement efforts that allowed us to achieve the proper levels of inventory and the ability to stabilize and maintain our industry-leading fulfillment rates of over 93%, which helped us grow the business

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State Farm

- The strong volume was also attributable to State Farm expanding their usage of aftermarket headlights, taillights, and bumpers beginning earlier this year
- Further on State Farm, during our last call, I mentioned that State Farm launched another pilot program in California and Arizona for the use of a full range of aftermarket collision parts, including sheet metal products like fenders, hoods, and trunk lids, and other items like side mirrors and grills
- Today, I am pleased to share that on October 16th, State Farm announced that they are rolling out the use of these parts nationally to collision repair shops, which are part of their DRP program
- We expect the incremental left from this expansion at a full run rate will reflect $20mm to $30mm annual benefit in revenues once fully ramped up

UAW Strike

- With respect to the UAW strikes, we believe that a continuation of the strikes will create incremental demand for our aftermarket and to a lesser extent our recycled collision parts
- Because the strike started in late September, there was no impact on our third quarter results, but we are starting to see an incremental per day volume uptick across all product lines with some lines that have historically been sourced primarily from the OEs expanding at a faster rate
- Obviously, we don't know how long this demand benefit will last, so we have not adjusted guidance for the UAW strike
- North America EBITDA margins exceeded our expectations for the quarter, and we are on track to achieve the greater than 19% full year target we have previously discussed excluding the anticipated dilution of Uni-Select

European Segment

- Let's move to our European segment
- Europe's organic revenue for parts and services in the quarter increased 5.1% on a reported basis and 6.2% on a per day basis
    - While the market remains competitive, the business is performing well by increasing the organic growth rate in the quarter, mostly driven by volume

Organic Growth

- During Q3, we saw solid organic growth in all of our regions despite the impact of the strikes in Germany, with regional same day organic growth ranging from approximately 4.7% on the low end to 16.3% on the high end and a total same day growth rate of 6.2%
- Excluding the impact of the strike, the same day growth rate was just shy of 8%, which is outstanding
- The diversity of our European platform is also highlighted by the dispersion in EBITDA margins, with key lines of business and markets posting margins in the low-teens, while certain smaller markets delivering mid-single digit performance
    - While the labor situation will weigh on our margins in Q4, we remain confident in the long-term margin potential of our European operations

Specialty Segment

- Now, let's move on to our Specialty segment, which continues to face a soft demand environment

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- During Q3, Specialty reported a decrease in organic revenue of 6.1% on a reported basis and 4.6% on a per day basis, which, again, was below our expectations
- As in the past, there were major differences in the demand for various part types, with the RV OEM warranty products and truck and off-road products up 3% and 2%, respectively, during the quarter, while RV accessories and towing-related products were off double-digits on a y-over-y basis
- The RV portion of our Specialty business was impacted by the wholesale shipment and retail unit sales of RVs, which were down 45% and 17% YTD through August, respectively
    - Though still down, the Specialty revenue decline in Q3 was less significant than in H1
- Still, we don't see a natural near-term catalyst for demand to bounce back, and we anticipate tough comparisons into the start of 2024

Self Service Segment

- Now, on to the Self Service segment
- Organic revenue for parts and services for our Self Service segment increased 5.1% in Q3
- Self Service was, again, confronted by the decreasing metals pricing I mentioned earlier, particularly with respect to catalytic converters, which are linked to precious metal prices
- Operationally, the Self Service team also had challenges with their ability to source vehicles at the appropriate cost
- Simply put, car costs have not declined in lockstep with commodity prices, creating significant margin pressures and pushing Self Service into a loss position for Q3
- We have already taken action with our buying practices and have installed an operational leader to drive standardization and process improvements across our Self Service buying group
- The leadership team has also taken actions to reduce overhead costs, and the early returns have been positive
    - We expect this business to be marginally profitable in Q4

Uni-Select Acquisition

- As reported, we closed on the Uni-Select acquisition on August 1st
- The integration activities and synergies are on target and, in some cases, ahead of schedule
    - This past week, we completed the first wave of FinishMaster facility optimizations, with 10 locations being folded in to an existing LKQ aftermarket warehouse location and two other FinishMaster locations being merged
- From here, we will begin to see an acceleration of our footprint optimization
- Our sales force and operations teams, dedicated to the paint and related products market, have been fully aligned and we've built out a synergy tracking team with various tools and metrics to assure we hit the targets we established when we announced the transaction back in February

FinishMaster Business

- Now that we've owned the business for a few months, we see a slight shift in the FinishMaster business with MSOs representing a slightly larger share of activity
- As you know, the MSOs are some of our largest customers on the parts side of the business
- The Bumper to Bumper business in Canada is actively working with our European team to assess and take advantage of the procurement leverage that exists between their respective businesses
- We have completed two tuck-in acquisitions in Canada that Uni-Select had in the hopper, and we have another small transaction that we'll close shortly

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- We are excited about the growth opportunities in Canada, and believe we have a great team to execute the plan

SUMMARY

- Overall, I am confident in our North America team managing the Uni-Select integration and that they will deliver the same strong results as they've had with their operational excellence efforts over the last three years
- Let me now turn the discussion over to Rick, who will run you through the details of the segment results and discuss our updated outlook for 2023

Rick Galloway

Chief Financial Officer & Senior Vice President

FINANCIAL HIGHLIGHTS

North America Segment

- As Nick mentioned, our third quarter results reflected a mix of positives and negatives, but, on balance, was below our expectations
- Our cash flow generation and our North America segment margins continue to be bright spots for us, and we will continue to build on these strengths
- The earnings pressure was attributable to a combination of unusual items, softness in precious metal prices and difficult market conditions impacting our Specialty and Self Service segments
    - While we expect challenges around economic conditions, commodity prices and exchange rates to impact Q4, we remain highly confident in the prospects of the overall business as the fundamental strengths that have driven the strong results since we implemented our operational excellence strategy in 2019 remain intact

Debt and Leverage Ratio

- I will now provide further details on the financials, starting with cash flows and the balance sheet
- As of June 30th, we had total debt of $4.0B, including the $1.4B bond offering from May, with a total leverage ratio of 2.3 times EBITDA.
- With the August 1st acquisition of Uni-Select, we drew down a CAD 700mm term loan and approximately $150mm on our revolving credit facility to complete the funding

Hedging

- By hedging the Canadian dollar exchange rate after announcing the transaction, we were able to save almost $50mm on the US dollar equivalent of the purchase price, which is a terrific outcome
- Factoring in the proceeds from the hedge settlement and the cash acquired, our net cash out for the Uni-Select acquisition dropped down from $2.1B to $2.0B.
- We committed to paying down debt post-acquisition to bring our total leverage ratio below 2.0 times, again, within 18 months, and we got to work on this pledge in August and September

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FCF

- During which, we paid down over $200mm of revolver debt with our FCF
- As of September 30th, our total leverage ratio was 2.3 times, so consistent with the June level, and we expect a reduction in the leverage ratio as of year-end
- The proceeds from the sale of GSF will be utilized to reduce our total debt, putting us in a better position to begin implementing a more balanced capital allocation strategy, which includes share repurchases
- Q3 debt repayments were possible because of our solid balance sheet and the generation of $344mm in FCF during the quarter
- Through September, FCF is $911mm and we are raising our full year guidance to approximately $1.0B in recognition of the strong performance YTD.

Tuck-In Acquisitions

- I am pleased with our ability to meet the FCF expectations despite the headwind from acquisition-related transaction, restructuring and financing costs of almost $50mm
- Also during the quarter, we invested $65mm on tuck-in acquisitions and we paid a dividend of $74mm in September
- As Nick mentioned, we raised our quarterly dividend to $0.30 per share, which speaks to our confidence in being able to generate robust FCFs through economic cycles
- Our effective borrowing rate rose to 5.5% for the quarter due to global market rate increases
    - We have $2.1B in variable rate debt, of which, $700mm has been fixed with interest rate swaps at 4.6% and 4.2% over the next 2 to 3 years, respectively

Segment Performance

- Moving to segment performance
- Starting on slide 10, North America reported a segment EBITDA margin of 17.0%, which includes the results of Uni-Select effective August 1st
- As we previously disclosed, Uni-Select operates at a lower margin than our legacy North America business because of the mix of product it sells
- Adding Uni-Select diluted the North America margins by 180BPS.
- Without Uni-Select, North America continued its strong performance with a Q3 margin of 18.8% and stayed on track to finish the year with a segment EBITDA margin in the low 19% range, consistent with what we disclosed last quarter
- North America gross margin decreased 60BPS in line with expectations with a decrease in salvage margins tied to car cost
- Overhead expenses were roughly flat y-over-y

ACQUISITION OF UNI-SELECT

- After the acquisition of Uni-Select, the North America team was able to work on integration and achieve a better understanding of the timing of our original assumptions
- With increased access to personnel and visibility of financial and operational data, we are updating our projections for 2023 for Uni-Select to be dilutive in the range of $0.04 to $0.06
- As Nick mentioned, we are focused on integration and are accelerating synergies related to FinishMaster branches to drive improvement relative to the estimated range and maximize the 2024 benefits

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    - We remain confident in our investment thesis of Uni-Select and we believe the transaction will be accretive in 2024
- Europe delivered segment EBITDA margin of 9.3%, down 200BPS from the prior period

Value-Added Tax Audit and Distribution Center

- There were a couple unusual items that had a negative effect of 110BPS on the results Nick mentioned
    - First, we booked a charge for value-added tax audit matter in Italy related to prior years for $11mm, which impacted the margin by 70BPS
        - We are comfortable that this VAT issue has been addressed and won't have a recurring effect
    - Second, the strikes at our primary distribution center in Germany had an estimated negative effect on segment EBITDA of 40BPS
- The remaining margin variance is attributable to gross margin compression, primarily in our Central and Eastern European regions related to customer price sensitivity with difficult macroeconomic conditions
- We are addressing this matter with specific category management actions to meet price point expectations in the region while helping to improve margins

Specialties EBITDA Margin and SG&A Expenses

- Moving to slide 12
- Specialties EBITDA margin of 8.6% declined 220BPS compared to the prior year
- Gross margin, which was down 300BPS y-over-y, is under pressure from increased price competition as the inventory availability continues to improve for our competitors, in addition to unfavorable product mix, as lower margin lines, such as auto and marine, have been less affected by revenue reductions
- SG&A expenses were favorable by 80BPS, mostly related to personnel and primarily coming from restructuring efforts in the last 12 months to align the cost structure with revenue trends
- As the y-over-y organic revenue decrease has narrowed each quarter in 2023 vs. the prior year, the same is occurring with segment EBITDA margin, and we expect the trend to continue in Q4 with the margin near last year's figure

Self Service Profitability

- As you can see on slide 13, Self Service profitability declined sequentially to a loss of 0.6% this quarter from 4.1% in Q2, and decreased relative to the 2.6% reported in Q3 2022
- Metals prices had a net negative effect on results of $7mm, with lower precious metal prices representing $17mm reduction in EBITDA and lag effects from sequential scrap steel price changes, driving $10mm improvement
- Other revenue decreased by 24.4% in total, contributing to a reduction in operational leverage of 590BPS.
    - While car costs typically move in tandem with changes in commodity prices, we continue to experience a stickiness in car costs, which is contributing to the margin compression

Adjusted Diluted EPS

- Now, for further details on the consolidated results
- As mentioned, adjusted diluted EPS of $0.86 was down $0.11 relative to Q3 last year

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- The primary negative factors were $0.04 from the impacts of metals prices, as shown on slide 27, $0.04 from the VAT charge in Italy, $0.04 in higher interest expense, resulting from rate increases, excluding Uni-Select costs, and $0.02 attributed to the effects of strikes in Germany

Operational Performance

- Our operational performance was a slight negative after excluding the items noted previously as solid gains in North America of $0.02 were offset by the decline in Specialty business of $0.03 per share
- We benefited by $0.02 due to the lower share count, resulting from our share repurchase in 2022 and foreign exchange translation contributed to $0.02 of higher earnings with the stronger euro and pound sterling
- On the tax rate, we applied an annual effective rate estimate of 27.0%, which is consistent with the rate in our prior guidance

2023 RESULTS

Organic Parts and Service Revenue

- I will conclude with our current thoughts on projected 2023 results
- Our guidance is based on current market conditions and recent trends and assumes scrap and precious metal prices hold near September levels
- On foreign exchange, our guidance includes balance of the year rates for the euro of $1.06 and the pound sterling at $1.23, in line with current rates

Organic Growth

- We expect reported organic parts and service revenue in the range of 4.75% to 5.75%
- Organic growth was 5.3% through September
- We decreased the range in recognition of the estimated revenue loss associated with the German strike activity, difficult macroeconomic conditions in parts of Europe, and the ongoing challenges at Specialty
- North America has potential upside in Q4 related to the State Farm rollout and the UAW strike, which could push the full year result above the midpoint of the range
    - We expect adjusted diluted EPS in the range of $3.68 to $3.82, which brings them both the high and low ends of the range from our previous estimate

Uni-Select Acquisition and VAT Charge

- The midpoint is now $3.75 per share, down from the prior figure of $4 provided last call
- The primary drivers of the decrease in the midpoint are as follows:
    - $0.06 from lost earnings related to the German strike activity
    - $0.05 of dilution from the Uni-Select acquisition that was not included in the prior guidance as we had not yet closed the transaction
    - $0.04 from the VAT charge in Italy; $0.04 from metal prices
    - $0.05 from operations primarily related to Self Service and Specialty
    - And $0.01 from foreign exchange rates

EPS and YTD FCF

- Slide 5 shows the full bridge of the EPS guidance change

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- We increased our FCF guidance to approximately $1.0B from $975mm with a 55% to 60% annual EBITDA conversion
- With our YTD FCF of $911mm, we are anticipating roughly $90mm in Q4, which would be our lowest quarterly amount this year
- Part of the sequential decrease is seasonal as we build inventory ahead of the busy winter season
- And we also have higher interest payments scheduled for Q4 this year as the semi-annual interest payment of the $1.4B Uni-Select bonds is due in December

Dominick Paul Zarcone

President, Chief Executive Officer & Director

Q3 HIGHLIGHTS

Global Team

- Before we open the call for questions, I want to reiterate what our global team has accomplished since starting the operational excellence journey back in 2019
- In 2022, North America adjusted EBITDA margins reached their highest full year level in the company's history at 18.7%
- Excluding the impact of Uni-Select, we are on track to beat that record again this year
- As a reminder, North America ended 2018 with segment EBITDA margins at 12.6%
- The 1 LKQ Europe program has generated tremendous results since introducing the plan in September 2019, and the segment is on track to consistently drive full year double-digit EBITDA margins
- Importantly, there is further runway for leveraging our scale and unparalleled distribution network
    - This is demonstrated by the strong organic revenue growth in the quarter and the first nine months of the current FY and the significant year-on-year increase in segment EBITDA of $40mm, after taking into account the two unusual items that cost the segment $19mm in aggregate
- We've generated FCF at or above $1B for three years in a row, and we are on target to make 2023 the fourth
- We've divested 16 businesses, representing over $625mm of revenue that did not fit our strategic objectives

Repurchase Plan

- We've achieved investment-grade ratings from each of Standard & Poor's, Moody's, and Fitch
- We've repurchased $2.4B of stock since initiating our first repurchase plan in October of 2018
- We've distributed $578mm in quarterly dividends to our shareholders, and we've achieved a AAA ESG rating from MSCI and built out a team to drive our global sustainability effort forward with targeted objectives
- So yes, we are very LKQ-proud

SUMMARY

- As we move forward towards the end of 2023, let me restate the key strategic pillars which remain central to our culture and objectives
    - First, we will continue to integrate our businesses and simplify our operating model

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  - Second, we will continue to focus on profitable revenue growth and sustainable margin expansion
  - Third, we will continue to drive high levels of cash flow, which, in turn, give us the flexibility to maintain a balanced capital allocation strategy
  - And lastly, we will continue to invest in our future
- As always, I want to thank the over 49,000 people who work for LKQ for all they do to advance our business each day and for driving our mission and our LKQ DELIVERS values forward regardless of the challenges
- Without a doubt, our people are LKQ's biggest asset

QUESTION AND ANSWER SECTION

Bret Jordan
Jefferies LLC

Q

Could you give us a little more color, I guess, on the UK asset sale, maybe some – either quantified or maybe EBITDA multiple you got for that sale?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Sure, Bret. Great question, anticipated. The definitive sale agreement includes a provision wherein we are not allowed to disclose any of the terms of the transaction. What I will tell you is that we ran a full and complete auction process that started out with dozens and dozens of potential buyers. We closed the transaction at the highest value that came out of the auction process. We have fully anticipated that the multiple that we would receive for GSF would be materially less than the multiple that we paid for the other businesses and we built that into all the original analysis, and that exactly proved to be the case.

All things considered, we're happy to get the transaction behind us. As Rick indicated, we're going to use the proceeds to repay debt. And the other thing I would say is the multiple reflected the current M&A environment and the impact of higher interest rates, particularly for leveraged transactions. We sold this to a PE shop over in the UK. But, again, it was generally in line with what our going in expectations were, maybe a little bit on the skinny side, but not materially different.

Bret Jordan
Jefferies LLC

Q

Okay. And then a follow-up, I guess. The Canadian business, could you maybe talk about where you see working capital trending there? I mean, obviously, it should be a source of cash. Can you talk about maybe what their working capital investment is and how you might lever that?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. Thanks, Bret, for the question. I'll take that one. So one of the things that we're pretty excited about is the ability that the CAG Group or Bumper to Bumper Group has with the vendor financing program. We got about $65mm in the vendor financing program as one of the components to drive performance. It was underutilized and something that we think we can grow fairly significantly. The overall trade working capital that we inherited from the transaction, roughly, call it, $200mm that we think we can continue to enhance and benefit within the payables, similar to what we're doing over in Europe.

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

Q

Hey, Nick. Good morning. So in the guidance walk, you pegged the Uni-Select impact at $0.05 headwind. I think, Rick, you said, $0.04 to $0.06. I believe that last quarter that was $0.04 headwind projection. I know that's a small move, but it's in the wrong direction. I'm just wondering if you uncovered something that wasn't as good as you hoped, or is that just a function of rounding?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Craig, I'll take that one. When we were analyzing and negotiating the transaction some 9 to 10 months ago, we were working off of the Uni-Select annual budget for 2023. We had to make some estimates on our side as it relates to the quarterly phasing of how their business was going to unfold. We're now sitting here in October, and we recognize that our estimates, as it relates to the seasonality and the phasing of their business, were off a bit with kind of more their activity hitting earlier in the year than we anticipated and a little bit less late in the year.

In response, we're working hard to realize the synergies sooner rather than later, as Rick indicated. From our perspective, nothing really changes in a material manner related to the long-term economics of the transaction. And what I'd also highlight for you, as Rick mentioned, is between the benefits of the FX hedge on the original purchase, some of the higher-than-expected cash on the balance sheet at closing, the transaction value actually declined by about $100mm, which helps offset some of that earnings difference from a return perspective, not necessarily from an EPS perspective.

Rick Galloway
Chief Financial Officer & Senior Vice President

A

And maybe I'll just add just a little bit more to that. You talked about the synergy piece. Craig, it's important to understand, on the synergy piece, we've accelerated some stuff. We've talked about how we closed 10 facilities within the FinishMaster business. As far as the overall synergies, we're – roughly, 20% of our synergies have already been achieved on a run rate basis as of today.

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

Q

And as a follow-up to that, Rick, I thought a lot of those synergies were tied to leases, which it took maybe three years before their expiration. So how are you able to accelerate what are essentially contractual agreements?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. They weren't all tied to that. There's a fair amount on the FinishMaster side that go throughout the period. So, if there's something that is a little bit tighter, a little bit closer, that's the area that we were able to identify and see a pull in that opportunity and close those facilities at an earlier time.

Scott L. Stember
ROTH MKM

Q

Can you talk about in Europe and Germany, you mentioned that it sounds like there was some progress in negotiations, I guess, later in the quarter. Are we trending in the right direction? Just trying to get a sense of how long this could potentially last and how far into 2024?

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Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Are you talking about the strike in Germany?

Scott L. Stember
ROTH MKM

Q

Yes. Yeah, yeah. Sorry about that. Yes, the strike in Germany.

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Yeah. So, look, employees, there are certain employees at our big distribution center in Sulzbach-Rosenberg, which fulfills all of our branches in Germany, a number of those folks belong to a union or a works council as they're called over on the other side of the pond. We don't have advance warning as to when they decide to call a strike. It's very episodic. The issue is, we're down head count. Not all the members go on strike, but probably we lose about 40% of our workforce when they are out in strike. And that creates significant issues in trying to move product into and out of the distribution center. But we need to replenish our branches on a daily basis. Because if the product is not out in the branch the next morning, it can't be sold. And some of the key bottlenecks are actually on the inbound movement of goods, as you can imagine, with less people to bring all that product in, the vendor delivery trucks get stacked up out in the drive, etcetera, etcetera, right.

We have a phenomenal team at STAHLGRUBER that's doing everything possible to mitigate the issues. We are in flight in bringing a second DC online up in Bielefeld, which is in the northern part of Germany. But that's not going to come online in time to help with these strikes. The branch and corporate personnel in Bavaria, we pull some of those folks into the distribution center to help with staffing. We're still down even after that from an overall head count perspective. And, obviously, those employees are not as productive because they're doing new things. We're trying to push more inventory out into the branches on non-strike days, but there are limits as to how much the branches can hold from a practical perspective. And we have to make educated guesses as to what product each particular branch may need in the future, which is not the same as fulfilling orders based on actual sales to prior night.

As I indicated, the employees have been on strike for several days here in October, and we anticipate that's going to continue. The biggest part of it is it's not like in the US where, say, Ford, GM, and Chrysler are all negotiating separately with the UAW. Here, there's a group of employers, including STAHLGRUBER, that are all part of the same works council. And we need to get to a settlement as a group. We cannot do a one-offsettlement with the union. We're hopeful we can bring this to a close yet this year. Like many unions around the globe, they've got really big expectations. And there's a difference both in the amount of wage increases and the term of the contract. We obviously want to lock in a longer-term, so we're not here next year talking about the same kinds of things. So the impacts of the strike are continuing into Q4, and we anticipate that they will continue at least through November.

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Scott, maybe just to throw a couple of numbers to that. In Q2, we saw about $0.02 per share. In our guidance, we essentially double that for Q4. So we're optimistic that it'll close out in 2023 and not have an impact on 2024. But as of right now in our guidance, we have a total of $0.06, $0.02 in Q3 and then $0.04 in Q4.

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Scott L. Stember
ROTH MKM

Q

Okay. Got it. And then just a quick last question on the Bumper to Bumper business. I don't know if you've mentioned this before, can you just give us an indication of how the organic sales growth has been running just some of the industry dynamics up in Canada on the mechanical repair side?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Yeah. The Bumper to Bumper is pretty much right on track, right on plan. So we are really pleased with that business and with the team. As I mentioned, we've got a couple of small tuck-in acquisitions that we've already completed and another one that will happen in Q4. So we anticipate nice growth up in Canada.

Rick Galloway
Chief Financial Officer & Senior Vice President

A

To throw a number at it, Scott, high single-digits is the way you should kind of think about that business right now.

Scott L. Stember
ROTH MKM

Q

Organically?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. Organically, yeah.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Rick, could you maybe go into some of the issues. I mean, you mentioned pricing, but what exactly is going on for the 140 basis point decline in gross margin in Europe that you cited? You talked about something pricing in Eastern Europe that was having some issues and can you maybe go on a little more detail on that?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. So, if you think about what's going on over there with the recessionary environment and the activities going on, there is a little bit of price sensitivity. So what I was talking about in my prepared remarks is some price sensitivity in Europe. That is – think of the good, better, best product offerings that we offer. The customers are moving from the best to the better, better to the good, and we're seeing that come down. What we have seen and what we think the opportunity is, is in our overall category management Think of things like private labeling, right. So private labeling, we have businesses not in Central and Eastern Europe that are getting in, call it, 35%, north of 35% on private labeling. And we also have businesses in Central and Eastern Europe that are at single-digits, mid to high single-digits in that private labeling branding.

As those customers move down to a different product offering, that's where we think we're going to be able to really drive overall profitability to move them over to a different product offering that actually helped us out. So it's just that consumer price sensitivity. The really good news, Gary, that I would tell you is our products are non-discretionary, as we've been saying. Volume is really solid. That continues to be the case both in Central and Eastern Europe. The team is doing a fantastic job as far as delivery performance and all of that. It's just that a

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little bit of sensitivity on that recessionary environment that is squeezing the margins a bit that we think we're going to be able to rectify here in the next couple of quarters.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Okay. Thank you. And then vs. the EPS bridge that you put in Q2 to Q3, it looks like, operationally, you were looking for $0.05 positive in Q2. It's now slipped to $0.05 negative with Q3 guidance. Is that all Specialty that is making that shift?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

It's primarily actually Self Serve (sic) [Self Service]. So Nick talked about some of the changes that we're making within Self Serve (sic) [Self Service]. It's Self Serve (sic) [Self Service] and Specialty that makes up that $0.05, Gary, but it's overweighted on the Self Serve (sic) [Self Service] side. So think of the car costs that need to come down. What Nick did and the team did is put some new leadership, and he talked about it in his prepared remarks, to drive down that overall procurement and enhance the overall margins.

The good news is, is that early in the quarter, we actually saw negative performance, negative EBITDA. That flipped to a decent-sized, profitable September as we're going into Q4. So we're seeing the trends in the right direction. But it's still that squeeze between the car cost and what the commodities have done. So think overweighted on Self Serve (sic) [Self Service] vs. what's going on in Specialty. Specialty when I talked about – if you think about Specialty in Q4, we've tightened up the margins. What we've done is we've tightened up both the revenue side and the margin side as we've gone through the year when you think y-over-y. And we think Q4, we believe Q4 will be pretty much on par on a margin basis vs. what Q4 was last year.

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

Q

Just on the first one back to Specialty there. Can you maybe break it down? How much of this is macro driven, higher interest costs in buying cars vs. just tough compares from what was a stronger 2022?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

Yeah. It's a little bit of both, Brian, to tell you the truth. As you know, our North American and European businesses largely sell non-discretionary parts that are used to repair vehicles, while Specialty primarily sells parts to accessorize the vehicles. As such, Specialty is going to be more directly impacted by the broader macroeconomic environment, things related to economic growth, interest rates, consumer balance sheets, and the like. The sale of light trucks, jeeps, and SUVs has been reasonably okay, while the sale of new RV units has been very depressed, as you know.

So with that, it should be no surprise that the sale of RV accessories and related products like hitches and other towing equipment have been much softer than the traditional SEMA product. We believe that retail sales of RV units is probably a better leading indicator for the potential demand for our RV accessories and wholesale shipments from the OEs to the dealers because the unsold units to the sitting on a dealer lot doesn't do anything to generate demand for types of parts that we sell. And so, with interest rates going higher and the financial health of the consumers eroding, that's why I said we don't see a near-term catalyst for a quick rebound in the RV marketplace. Now, as we get into next year, we obviously have an easier set of comps because 2023 has been

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very soft. And so, we wouldn't anticipate the same kind of negative growth in 2024 compared to what we have here in 2023.

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

On the FCF side, working capital is YTD kind of 150-plus-million in benefit. When you look at that $25mm increase in the FCF outlook for the full year, can we go back to that and just – and what kind of – is that just working capital, all of that benefit? Or is there some other pieces within there that's driving that slightly higher FCF outlook?

Dominick Paul Zarcone
President, Chief Executive Officer & Director
A

Yeah. No, it's a great question. I mean, you look at the FCF, you think y-over-y, when you combine three items, interest, CapEx and Uni-Select transaction costs, $250mm come down off of last year's number, where we were at roughly $1B, making all of that up and delivering a fantastic result. It's a little bit higher than $150mm, if you think about the trade working capital. It's more like $180mm as we go into Q3. It's things like our vendor financing program that the European team does.

The operational excellence initiatives span way beyond just the P&L side. They go to the balance sheet side as well. The team's doing a fantastic job driving the performance. They're up 12% vs. year-end, up about $35mm on the vendor financing program, up 10% in payables. And so, driving that over and over again is something that we see as a continuous improvement. So I would tell you, the performance is good, really solid performance y-over-y, and that trade working capital really is the catalyst behind driving that performance.

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

Okay. And if I can maybe slip one last one in. How much debt do you expect to repay in Q4?

Rick Galloway
Chief Financial Officer & Senior Vice President
A

To repay?

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

Yeah. How much debt paydown?

Rick Galloway
Chief Financial Officer & Senior Vice President
A

We should have roughly, what, about 150-ish, about $150mm debt paid down in Q4.

Bret Jordan
Jefferies LLC
Q

Second round here. You gave us the auto claims number y-over-y. Could you give us the total loss rate for Q3?

Dominick Paul Zarcone
President, Chief Executive Officer & Director
A

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Yeah. Total losses, at least according to our best sources that we have here, Bret, was approximately 20.6% in Q3 of 2023, which was up a bit from both 2022 and 2021. So total losses were up a bit. That, in part, is why we think repairable claims was down 4.6%, right, because you had a few more total losses. As we've always said, we're agnostic to the total loss rate because, in reality, the more cars are rolled through the auctions, creates more buying opportunities for our salvage operations at reasonable prices. The key, we believe, is what's powering the overall demand for products. And while repairable claims maybe down a little bit, APU is going north.

And APU is going north, in part, because the average number of parts required to repair a vehicle hit an all-time high of 15.7 parts in Q3. Obviously, the industry is fully recovering from aftermarket parts availability. As we said, our fulfillment rates were back to over 93%, which is pretty close to our target. And then, you've got things like the benefit of the State Farm program, which will take a little bit of share away from the OEs as well. So our sense is that our same day organic of 5.8%, outstripped, what we believe would be the net impact of all the other headwinds and tailwinds, giving us confidence that we're continuing to take share.

Bret Jordan
Jefferies LLC

Q

Okay. Then, one quick question. In prepared remarks, you talked about FinishMaster having a slightly higher MSO mix. Could you give us more color on that? Is pricing on FinishMaster products lower on average than your traditional paint business?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

There's no doubt that the way that the accounting works and the way the contracts are, that the margin on the MSO business is less than the margins on a non-MSO because it's basically a service quotient, a service fee, if you will, even though we have to record the full value of the product that is sold. And as I mentioned in my comments, MSO volumes were a little bit higher as a percentage of the total than they've been in the past. And quite frankly, that happens every time one of the MSOs buys an independent shop, right, it switches to volumes. All in all, we're happy with where we stand with the paint business.

Daniel Imbro
Stephens, Inc.

Q

Nick, I wanted to talk about North American organic growth. Obviously, you're not guiding. But if we look, we are seeing more disinflation. Growth is slowing in North America. I mean that's offset by State Farm. But can we do the 2% to 3% kind of long-term organic growth in North America during this period of maybe disinflation and price competition?

Dominick Paul Zarcone
President, Chief Executive Officer & Director

A

We believe, absolutely. The reality is, we posted up 5.8% on a same day basis in Q3. Again, as I just mentioned in answering Bret's question, that's coming from better APU. It's coming from taking share from some of the smaller competitors. Our guess is that North America will probably have some similar growth in Q4 as in Q3. On the one hand, obviously, the comps get harder, right, because last – Q4 of last year, we were starting to get back to our fulfillment rates into the low-90% range in Q4, wherein earlier in the 2022, we're still down – well down in the 80s. So the comps were easier at the beginning of the year than they are going to be here at the end of the year.

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And on the other hand, though, we've got the benefits associated with State Farm and some of the benefits related to the UAW strike. And there's no doubt that the UAW strike helps our North American business. On a long-term basis, we absolutely are confident in all the expectations we've set, including those back in our Analyst Day in 2022 and where we think a couple percentage points of growth, excluding inflation, is absolutely within our capability.

Daniel Imbro
Stephens, Inc.

Q

Right. That's helpful. And then, maybe just a follow-up. Rick, so you mentioned in your script that buybacks are part of the capital deployment. But it does feel like you guys have done more M&A, whether it's the small ones in Canada. You just bought Uni-Select. Can you maybe talk about like what just the strategic rationale is, that buying at this point in the cycle? Do you typically get better prices if we do enter a downturn and just, I guess, how you plan on spending the $1B of free cash? You have $150mm of debt paid down in Q4 but what do you plan to do with the rest of it?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. Good question, Daniel. Thanks for it. As you start thinking about the overall capital allocation strategy, that hasn't changed. So, if you think about on an ongoing basis $1B, we have $300mm roughly for dividend. We obviously raised the dividend 9% based off of what the board has approved and the solid cash performance that we have. Then we earmarked about, call it, $200mm annually for tuck-in acquisitions, and then the remainder about $500mm to do kind of what we want with it, right, whether we do share repurchases, whether we do some debt paydown.

What we've said is we'd be overweighted. Until we get below 2 times, we'll be overweighted on that remaining $500mm on debt paydown. So that's going to continue. But we constantly are looking at our opportunities, whether there is an opportunity on the share price. If there's some timing that offers us, we'll continually look at that. But what we're committed to is within 18 months, we'll get down below that 2 times. And so that's something that's weighing in back of our minds. So that's the way you should think about that capital allocation.

Dominick Paul Zarcone
President, Chief Executive Officer & Director

CLOSING REMARKS

- We know this is a busy reporting period, and we certainly appreciate spending some of your time here with LKQ
- We obviously look forward to chatting with you again in February, late February of 2024 when we're going to announce our fourth quarter results full year 2023 results
- And obviously, we'll set the guidance for next year with all of you.

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