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LKQ Corp. (LKQ)

Q4 2022 Earnings Call

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Joseph P. Boutross
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GAAP AND NON-GAAP FINANCIAL MEASURES

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

Dominick P. Zarcone
President, Chief Executive Officer & Director

BUSINESS HIGHLIGHTS

Opening Remarks

- This morning, I will provide some high-level comments related to our performance in the quarter and full year 2022, and then Rick will dive into the financial details and discuss our 2023 outlook before I come back with a few closing remarks
- This month, we are celebrating the 25th anniversary of our company's founding in February 1998
- What started with a few salvaged facilities in the US has grown to a Fortune 300 business with operations in 28 countries and over 45,000 employees, providing a wide array of aftermarket and recycled parts used to repair, maintain and accessorize vehicles

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Strategy

- Our operations are leaders in their respective markets and are well-positioned to continue their success in the future
- Getting to this point has been the result of the dedication of our past and present teams, and I want to express my sincere appreciation for all of these efforts
- I am excited to see what this team can deliver in the future as the LKQ team is never satisfied, never rest on its laurels, and is always pushing to be the best
- When LKQ was founded, ESG was not the hot topic that it is today
- But ESG has always been a vital part of our strategy
- To our recycling operations, we are enabling the circular economy in doing our part to reduce waste

ESG

- I am proud of our contributions to-date and I can assure you that our emphasis on sustainability will continue to be an integral part of our mission
- Our success in ESG is being recognized by external parties
- On December 5, 2022, MSCI upgraded LKQ to their highest ESG rating of AAA, placing LKQ in the top 5% of all companies that they rate globally
- And on January 31 of this year, LKQ was included in Sustainalytics' 2023 top-rated ESG companies list
- Q4 2022 closed the year where the resilience of our businesses shined through a myriad of uncontrollable headwinds ranging from economic softness, inflation, supply chain disruptions, labor shortages, energy cost spikes, and a war in Europe

Operating Perspective

- From an operating perspective, Q4 was a very strong set of results, and I could not be more proud of our team
- The continuation of exceptional organic revenue growth and strong margins in our North American Wholesale segment, when combined with solid organic revenue growth and the highest fourth quarter EBITDA margins in the history of our European segment offset the impact of the continued headwinds experienced in our Specialty and Self Service segments
- The January revenue trends are similar to the levels generated in Q4
  - While the operations were collectively right on target with the guidance that we provided back in October, the annual tax provision was higher than anticipated, which drove a full-year catch-up in Q4 and resulted in quarterly EPS at the low-end of the guidance range
- Rick will provide more detail on the tax provision in a few minutes

Q4 RESULTS

Revenue

- Now, on to the strong quarterly results
- Revenue for Q4 2022 was $3B, a decrease of 5.8%, as compared to $3.2B in Q4 2021, driven by FX translation and the divestiture of PGW.
- Parts and services organic revenue increased 4.5% on a reported basis and 5.9% on a per day basis
- The net impact of acquisitions and divestitures decreased revenue by 3.1%, and foreign exchange rates decreased revenue by 6.1%

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Parts and Services

- For total parts and services, revenue decrease of 4.8%
- Other revenue fell 20.1%, primarily due to weaker commodity prices relative to the same period in 2021
- Net income in Q4 was $193mm, as compared to $235mm for the same period in 2021
- Diluted EPS for Q4 was $0.72, as compared to $0.81 for the same period last year, a decrease of 11%
- During the quarter, we had an unfavorable $0.15 y-over-y impact related to the higher than anticipated tax rates
- The tax rate was also higher than anticipated during our third quarter call, which generated an unfavorable $0.05 effect on adjusted diluted EPS relative to our guidance

Adjusted Basis

- On an adjusted basis, net income in Q4 was $209mm, as compared to $254mm for the same period of 2021, a decrease of 17.5%
- Adjusted diluted EPS in Q4 was $0.78 as compared to $0.87 for the same period of last year, a decrease of 10.3%
- Net income for the full year of 2022 was $1.14B, as compared to $1.09B for the same period last year
- Diluted EPS for the full year of 2022 was $4.11 as compared to $3.66 for the same period of 2021, an increase of 12.3%

Sale of PGW

- Please note the 2022 results include the gain on sale of PGW
- On an adjusted basis, net income for the full year of 2022 was $1.1B, as compared to $1.2B for the same period of 2021, a decrease of 9.4%
- Adjusted diluted EPS for the full year was $3.85, as compared to $3.96 for the same period of last year, a decrease of 2.8%
- Adjusted earnings exclude the gain of the PGW sale, but includes the impact of the higher tax rate

Organic Revenue

- Now let's turn to some of the quarterly segment highlights
- As you will note from slide 12, organic revenue for parts and services in Q4 for our North American segment increased 10.3% on a reported basis and 12% on a per day basis compared to Q4 2021
- We continue to perform well in North America, especially when you consider that according to CCC, collision liability related auto claims were down 0.09% y-over-y in Q4

Financial Crisis

- Looking back at our performance through the financial crisis from 2008 to 2010, our North American business grew organically at an average of 7.5%, which drove the alternative part usage rate, or APU rate, above its historical annual growth rates
- As we enter 2023 and face the reality of a global recession, our alternative parts offerings clearly become more attractive during these challenging economic periods
  - We are also encouraged by the trend in parts per repair, which reached an all-time high in 2022
- Important to note is that our sweet spot has expanded and today stands at model years, 4 to 15 years of age

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- All these items combined positions North America well for continued organic growth in 2023

Aftermarket Sales Volume

- The upward trend in our aftermarket sales volumes and the ongoing improvement in our flow rates continued in Q4, with flow rates reaching their highest percentage levels in 2022 and today stands at close to the pre-pandemic level of 93%
- Importantly, as the supply chain recovered and flow rates increased, the entire industry realized a 220 basis point improvement in the aftermarket percentage of APU taking share back from the OEs as we progress throughout the year

Inventory

- The supply chain has stabilized and our inventory is generally where we want it to be
- The main issue we are confronting today are continued delays at some of the rail heads due to congestion
- As many of you know, on December 7 of last year, State Farm announced that they are rolling out expanded non-OEM collision repair parts to use in most of the United States
- We are excited, State Farm is embracing the aftermarket value proposition that the industry offers, which will ultimately benefit the end consumer
  - We continue to actively analyze this opportunity and we are well-positioned to compete for our fair share of this opportunity and have both our inventory appropriately to do so

Salvage Inventory

- Our salvage inventory is also healthy, and we saw some relief on our cost per vehicle during the quarter
- The salvage business had solid organic growth, largely driven by price, but as we entered December we witnessed an upward trend in our salvage volumes
- Total loss rates increased a bit in Q4, which were largely seasonal, and as you can see, it had no impact on our organic growth
  - These slightly higher loss rates played a role in our ability to source the right level of inventory at auction at attractive prices
- As we have stated before, fluctuations in loss rates are largely net neutral events for LKQ.

European Segment

- Moving on to our European segment, Europe organic revenue growth of parts and services in the quarter increased 4.6% on a reported basis and 5.8% on a per day basis, which represents the best fourth quarter per day organic revenue growth since 2016
- I'd also like to highlight that Europe's segment EBITDA margin was the highest fourth quarter level since entering the European market in 2011
- On a full year basis, Europe's performance is another year of double-digit segment EBITDA margins, which is consistent with our 1 LKQ Europe initiatives and strategy
- Rick will cover more emerging details in his prepared remarks
- Throughout the quarter, our European team was laser focused on the cost structure, including rationalizing the head count to create a more nimble and agile team, and focusing our team on a narrow and actionable list of key projects

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  - These projects represent the highest return opportunities that the team can execute in the near-term, further cementing the long-term resiliency and market leadership of our European segment

Acquisition

- On February 1, LKQ Europe announced that it expanded its European salvage network with the acquisition of Dutch-based, Rhenoy Group
- Founded in 1991, Rhenoy is a leading supplier of remanufactured engines and recycled OEM car parts
- Rhenoy operates its salvage dismantling facility in the Netherlands and remanufacturing plants in both the Netherlands and Poland
- As you know, the roots of our company lie in the dismantling of salvage vehicles to recycle OEM parts
- As part of our European strategic plan, we intend to capitalize on that history and knowledge coupled with our remanufacturing capabilities to grow our salvage network across our European footprint

STAHLGRUBER TEAM

- And with this tuck-in acquisition, we take one small incremental step towards that objective
- I want to congratulate our Stahlgruber team on their 100th anniversary and commend them for building a resilient and market-leading business that continues to demonstrate an ability to adapt to the ever changing independent aftermarket, a century since the founding brothers, Otto and Willy Gruber, started the business
- Today, the Stahlgruber business continues its history of embracing change, which positions them well to capture further opportunity as the car park shifts towards EVs and other forms of mobility
  - We can't wait to see the next – what the next 100 years brings for Stahlgruber

Specialty Segment

- Now, let's move on to our Specialty segment
- During Q4, Specialty reported a decrease in organic revenue of 10.6%
- Throughout 2022, Specialty was up against tough 2021 comparisons in the midst of decreased demand for certain key RV parts and a slower-than-expected recovery in US light-vehicle sales
- Looking at the Specialty segment on a multiyear basis, since 2019, Specialty has generated approximately a 4% compound annual growth rate for organic revenue, outperforming the industry growth of SEMA and RV-related products
- A few Specialty operational highlights would include that Specialty continue to realize the full benefits of the SeaWide synergies, which exceeded our expectations in dollars and operational execution and Specialty won [ph] O'Reilly's 2022 Top Supply Line Award (00:16:26) for the third year in a row

Self Service Segment

- Now on to our Self Service segment
- Organic revenue for parts and services for our Self Service segment increased 4.8% in Q4
- Self Service was again challenged by commodity pricing, as seen in the material decline of other revenue, which impacted our expectations for the quarter
- On the corporate development front, Q4 was fairly quiet
- While we did not complete any material transactions during the quarter, our corporate development team is actively assessing various opportunities that exist across our operating segments

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Synergistic Acquisition

- As the global economies continue to soften, that may lead to multiple compression, and we are well positioned to execute on synergistic acquisitions that fit our strategic objectives
- Outside of Q4 corporate development efforts, I am pleased to announce that this past January, we entered into a Memorandum of Understanding with Korea Zinc Company Limited, a world-class general non-ferrous metal smelting company
- Under the Memorandum of Understanding, we will work towards a potential large scale joint venture related to the recycling of lithium-ion EV batteries in the United States
  - This is, again, evidence that we will continue to strategically position the company to adapt to and seize the longer-term opportunities that exist in the ever-changing car park

ESG

- Turning to ESG, during Q4, we continued to build out our ESG program by focusing on our people efforts and various social initiatives
- Here are a few worth noting
- Every colleague employed by LKQ ELIT Ukraine for at least six months received a one-time hardship payment to support paying for energy and the general increase in the cost of living owing to the Russian invasion
- Our UK and German operations also implemented one-time hardship payments to support our employees in those markets given the state of the overall European economy
  - We initiated a voluntary daily pay benefit in the United States that allows our employees to access a portion of their earned pay on demand
- The company implemented this benefit with the financial wellness of our people in mind

LKQ Veterans Network

- And we launched our first employee inclusion group, the LKQ Veterans Network, a program that embraces our proud community of employee veterans and veteran allies who support and encourage each other through shared experiences, veteran recruitment, career development, outward engagement, professional growth, and retention
- In 2022, our North American salvage operations continued our leadership as the largest recycler of vehicles by processing over 753,000 vehicles, resulting in, among other things, the recycling of approximately 3.6mm gallons of fuel, 2.2mm gallons of waste oil, 2mm tires, 700,000 batteries, and approximately 955,000 tons of scrap metal
- The end result of these efforts resulted in nearly 13mm recycled and repurposed parts being sold into the collision and mechanical repair shop industry that otherwise would have ended up in landfills

Inflationary Environment

- Let's turn to the inflationary environment, again, a key item of interest for most listeners on this call
- As I discussed this time last year, we expected inflation to be a headwind throughout 2022, and that expectation became a harsh reality all year across each of our segments

EUROZONE

- Fortunately, we are beginning to see some moderation with inflation in the US and recently we witnessed the rate of inflation drop for the last three months in a row across the Eurozone

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- Eurozone inflation stood at approximately 8.5% in January, down from October, where it was almost 11%
- Despite this drop, many of our key operating markets continued to face high inflation rates, with certain countries running in the high single to low double-digits
- In the US, the labor markets continued to be strained and unpredictable in the midst of higher interest rates and mounting fears of a recession
- Daily we read about high profile layoffs, yet new claims for unemployment benefits remain at a historic low

Engagement Efforts

- As of late, wage inflation is beginning to slow and certain areas of our business are seeing reductions in turnover
- But these reductions are not material and we are far from out of the woods
- But it is validation that our retention and employee engagement programs are gaining traction
- Our engagement efforts aren't simply an HR mandate
- They are programs that stretch across all levels of the organization and are a key component of our culture

Global Engagement

- Our global engagement score of 74 is significantly above the average for companies of our size
- Studies have shown that employees who are engaged are 14% more productive and that companies with engaged employees are 23% more profitable than those with disengaged employees

Business Perspective

- So from a business perspective, positive employee engagement is critical
- But importantly, it's the right thing to do for our most important asset, our people
- Lastly, before I turn the discussion over to Rick, who will run through the details of the segment results and discuss our outlook for 2023, I am pleased to announce that on February 21, our board of directors approved a quarterly cash dividend of $0.275 per share of common stock, payable on March 30, 2023 to stockholders of record at the close of business on March 16, 2023

Rick Galloway
Chief Financial Officer & Senior Vice President

FINANCIAL HIGHLIGHTS

Operational Excellence Initiatives

- Before I go into details of Q4, I'd like to reflect on what LKQ accomplished in the last year
- We entered 2022 with a strong position based on the success of our operational excellence initiatives and solid balance sheet after reporting the highest profitability in the company's history in 2021
- We expected there to be headwinds in 2022 from the areas Nick mentioned
- As you can see on the bridge on slide 5, these headwinds did set us back, but the LKQ team drove operational improvements to produce roughly $0.40 of operating increases relative to 2021
    - We also sustained the positive momentum around cash flow generation with FCF of just over $1B in 2022 and a healthy conversion ratio of 60% of EBITDA.

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- Our work on FCF in recent years supported some noteworthy accomplishments in the last year

Investment Grade Ratings

- LKQ achieved investment grade ratings from all three major rating agencies, returned $284mm to shareholders through quarterly dividends and increased the quarterly amount by 10% in October
- Repurchased roughly 20mm shares of LKQ stock for just over $1B, which, combined with the carryover benefit from 2021 purchases, added $0.23 of EPS compared to 2021, and all while maintaining a net leverage ratio at less than 1.5 times EBITDA

Credit Facility

- In early January 2023, we replaced our prior credit facility, which included $3.15B revolver with a new unsecured facility, including $500mm term loan and $2.0B revolver
- Our confidence in the balance sheet and ability to generate robust cash flow factored into the decision to reduce the size of the facility, we were pleased to complete this new facility ahead of the prior facility becoming current and lock in funding over the next five years at a competitive rate structure
- Generating these successful outcomes despite challenging conditions is a credit to the entire LKQ team and I want to thank all of them for their contributions

SEGMENT PERFORMANCE

Wholesale North America

- Now, turning to Q4 results, starting with segment performance
- Going to slide 14, Wholesale North America continued its strong performance, posting a record fourth quarter segment EBITDA margin of 18.5%, a 330-basis-point improvement over last year
- We saw gross margin improvement of 150BPS driven by favorable mix and the sale of the lower margin PGW business as well as pricing and productivity initiatives
- Overhead expenses were favorable by 180BPS, primarily related to non-recurring expenses incurred in 2021
- Strong organic revenue growth aided by the rebound in aftermarket parts volume offset inflationary cost increases and benefited operating leverage

EBITDA MARGIN

- As mentioned in prior quarters, we believe there will likely be some moderation in segment EBITDA margin in upcoming quarters as the benefits of the 2022 price increases fall away with resultant EBITDA margin expected to be in the high-17%, low-18% range for 2023
- Europe also delivered its highest ever fourth quarter margin at 10.0%, up 110BPS from the prior-year period
- As seen on slide 15, gross margin improved by 10BPS as we worked to offset inflation with pricing and procurement initiatives

OVERHEAD EXPENSES

- Overhead expenses decreased by 70BPS with an emphasis on cost structure and improved leverage due to the 5.8% per day organic revenue growth

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- Inflation related to personnel, freight and fuel cost remains a critical concern across the European markets

Europe

- The team is actively addressing the pressures through productivity initiatives
- Europe produced a segment EBITDA margin of 10.2% for the full year, the second consecutive year of double-digit margins
- I want to commend the Europe team for achieving this result despite the onset of the war on the Ukraine and significant macroeconomic headwinds, and we are optimistic about incremental margin expansion of 20 to 30BPS in 2023

Specialty's EBITDA Margin

- Moving to slide 16, Specialty's EBITDA margin of 6.2% declined 130BPS compared to the prior year, coming from a decrease in overhead expense leverage, driven by an organic revenue decline of 9.1% per day as they anniversary a tough comp from the prior year when the business delivered a 6% organic revenue growth in Q4 on top of the 17% growth in Q4 2020
- Inflationary pressures also pushed overhead expenses as a percentage of revenue higher, including personnel, freight and fuel expenses
- The overhead expense increase were partially offset by lower incentive compensation and benefits from operating expense synergies largely generated from the SeaWide acquisition

Self Service Profitability

- As you can see on slide 17, Self Service profitability improved sequentially from the low point in Q3, but remained on the low-end of our historical range at 5.2% for Q4 and below our expectations
- Metals prices continued to have a negative effect on results, with the unfavorable lag effect and reduced operating leverage caused by the lower metals revenue dollars
- When we broke out Self Service as a separate segment in Q1 2022, we highlighted that this business would have cycles, mostly driven by commodity price volatility
    - We are working through a down cycle now and the team is focused on buying the right quantity of cars at the best price to drive margin dollars higher
- With the uncontrollable commodity dynamic in this business, we will emphasize generating margin dollars and FCF rather than targeting a specific margin percentage

Q4 RESULTS

Diluted EPS

- Now, on to the consolidated results
- We reported diluted EPS of $0.72 and adjusted diluted EPS of $0.78, which was $0.09 reduction relative to Q4 last year
- As previously mentioned, our operational performance showed y-over-y improvement and was in line with our expectations
- However, this solid operational performance was more than offset by unfavorable y-over-y effects of $0.04 from volatility in metals prices and $0.03 from the foreign currency exchange effects caused by the stronger dollar

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- Additionally, we had a negative effect of $0.03 from higher interest rates as benchmark rates were markedly higher in Q4 2022

FY Effective Rate

- As Nick mentioned, taxes were the most significant unfavorable variance for the quarter, reflecting $0.15 y-over-y impact and $0.05 negative variance relative to the guidance provided back in October
- As a reminder, in Q4 last year, we recognized almost $0.10 in tax provision benefits from discrete items and a reduction in our full-year effective rate
- We experienced the opposite effect in Q4 2022 as we recorded a negative provision effect of approximately $0.05 from increasing our full-year effective rate and unfavorable discrete items

Share Count

- The effective rate increase primarily related to shifts in the geographic distribution of income
- We mitigated about $0.07 of the decline with our lower share count resulting from our share repurchase program
- During Q4, we incurred $11mm in restructuring expenses, the majority of which relate to a new program we kicked off late in the year
    - We initiated the 2022 Global Restructuring Program in recognition of the ongoing macroeconomic concerns heading into 2023

Projected Cost Savings

- All of the segments have submitted plans to improve operational efficiencies by streamlining functions, closing underperforming locations, and halting nonessential projects
- The total cost of the 2022 program are estimated to be in the range of $30mm to $40mm to be incurred over the next few years
- Projected cost savings of $20mm related to the program are included in our 2023 guidance, and we expect annual run rate benefits of approximately $30mm by 2025
- Shifting to cash flows and the balance sheet, we produced $166mm in FCF during the quarter, bringing the YTD total to $1.028B

North America and Europe

- The third consecutive year we have exceeded $1B
- With the supply chain issues abating, we made good progress in rebuilding our inventory levels in wholesale North America and Europe
- As shown on slide 35, we increased our inventory values in these segments, though note that the dollar increase doesn't directly equate to a quantity change given the higher input costs
    - We are comfortable with our current inventory holdings and are pleased with improvements in aftermarket fill rates
- We will continue to evaluate our inventory holdings and may increase our balances in 2023, but not to the extent seen in 2022

Supply Chain Finance Program

- The Supply Chain Finance Program contributed to an increase in days payable outstanding in Europe in 2022

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- With the signing of the new credit facility, certain restrictions around the program were eliminated and we view further program expansion to be an opportunity in the next few years
- For the year, the cash conversion is 60% conversion of EBITDA to FCF, in line with our [indiscernible] (00:32:29) range of 55% to 60%

CapEx

- We finished at the high end of the range and our guidance partially due to the lower than projected CapExs
- For the year, CapExs were 1.7% of revenue, which is below our targeted 2.0% to 2.25% range
  - We have experienced delays in receiving capital assets such as trucks as a result of supply chain delays
- As a result, some of our 2022 orders will be delivered in 2023 and reflected in CapExs in the 2023 financials
- As of December 31, we had total debt of $2.7B, with a total leverage ratio of 1.5 times EBITDA, which is comfortably inside our target range of below 2 times

Leverage Statistics

- Please note that going forward I will reference total leverage statistics rather than net leverage, as the new credit facility changed the metric to total leverage
- Our effective borrowing rate rose to 4% for the quarter due to the market rate hikes in the US and Europe
- We have $1.8B in variable rate debt, so 100-basis point rise in interest rates would increase annual interest expense by $18mm
- In Q4, we repurchased 3mm shares for $152mm and paid a quarterly dividend totaling $74mm

Market Condition

- I will conclude our thoughts on projected 2023 results as shown on slide 6 through 8
- Our guidance is based on current market conditions and recent trends and assumes that scrap and precious metals prices hold near December prices, and the Ukraine/Russia conflict continues without further escalation or major additional impact on the European economy and miles driven
- On foreign exchange, our guidance includes recent European rates with balance of the year rates for the euro of $1.08, and the pound sterling at $1.22
  - We expect organic parts and service revenue growth of between 6% and 8%

STATE FARM WRITING CLAIM

- Please note that we have one fewer selling day in 2023 and have included associated with the expansion of aftermarket parts, volume resulting from State Farm writing claims on CAPA certified parts in three product lines, headlights, taillights and bumper covers
- We are projecting full year adjusted diluted EPS in the range of $3.90 to $4.20 with a midpoint of $4.05
  - This is an increase of $0.20 or 5% at the midpoint relative to the 2022 actual figure

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GUIDANCE

Operating Performance

- Looking at slide 7 in the presentation, you can see how we get from the 2022 actual EPS to our 2023 guidance
- Operating performance is expected to generate growth of $0.24 relative to the 2022 results, mostly related to wholesale North America from volume growth and Europe due to margin improvement
- We do expect a continuation of challenging conditions for Specialty from softening demand for RV related products and self-service related to commodity prices and input cost inflation

Share Count

- Share count benefits are projected to add $0.10 to the full year 2023 EPS over and above the share count benefit associated with the deployment of our PGW proceeds
- Note that there are no share repurchases assumed for 2023 in this figure
    - This amount reflects the carryover benefit from 2022 purchases
- So we're expecting very solid improvement on the operations side in 2023, which will drive y-over-y growth despite some nonoperational challenges
- The exchange rate benefit is nominal and is offset by softening in metals prices

PGW Divestiture and Tax Rate

- The PGW divestiture creates $0.02 headwind, reflecting the net reduction caused by lost profits, partly offset by the share count benefit generated from the redeployment of proceeds into share repurchases
- Interest is projected to be a significant cost increase with our weighted average borrowing rate on variable rate debt having already risen from close to 1% in 2022 to about 4% by yearend
- We anticipate an additional $0.13 in interest expense in 2023 on a y-over-y basis due to higher average market rates
    - We have included an effective tax rate of 26.3% in the 2023 guidance, roughly in line with the final 2022 rate
- We expect to deliver approximately $975mm of FCF for the year, achieving 55% EBITDA conversion to FCF despite a few key headwinds

Profitability and Trade Working Capital

- As seen on slide 8, we expect to produce incremental cash flows relative to 2022 from operations, including increased profitability and trade working capital improvements to counteract the following uses of cash
    - First, as mentioned previously, we underspent on CapExs in 2022, including equipment delays and expect to see an increase of approximately $78mm relative to the prior year
    - Second, the higher interest rates will require increased cash payments for interest expense, which were currently projected at roughly $50mm
    - Third and final, we anticipate increased tax payments of $60mm due to profitability increases and the timing of payments

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Dominick P. Zarcone
President, Chief Executive Officer & Director

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Q4 HIGHLIGHTS

Strategy and Business Model

- In closing, 2022 was another banner year for our company, and again validated the strength of our strategy, our business model, and most importantly, our people
- Let me restate our key strategic pillars, which continue to be central to our culture and objectives as we've entered the New Year
  - First, we will continue to integrate our businesses and simplify our operating model
  - Second, we will continue to focus on profitable revenue growth and sustainable margin expansion
  - Third, we will continue to drive high levels of cash flow, which in turn gives us the flexibility to maintain a balanced capital allocation strategy
  - And fourth, we will continue to invest in our future

SUMMARY

- With these pillars in place, coupled with our industry-leading teams, we are well positioned to both face the challenges the New Year presents and to continue to deliver positive y-over-y operating results for our shareholders
- As always, I want to thank the over 45,000 people who work at LKQ for all they do to advance our business each day and for driving our mission forward regardless of the challenges
- Time and time again, our teams have shown that these challenges are opportunities for growth, both for themselves and for the overall organization

QUESTION AND ANSWER SECTION

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

Q

I wanted to ask about your recycling business in Europe after you've acquired Rhenoy. I mean, I know it's not large in the scheme of things, but perhaps you could just update us on the recycling footprint you have today in Europe and whether the time is right to maybe make a bigger push to build something like your North American auto recycling business now in Europe.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. Good morning, Craig, and thanks for the question. So for many years, we've had an operation in Scandinavia, in Sweden, we call it ATRACCO. It's been operating quite well for quite some time. It's not a huge business, but it is a nicely profitable business. And we started in Scandinavia, and particularly Sweden, because that recycling market looks the most like the US market, when you think about how the insurance companies participate in the industry and the utilization of recycled parts. And so that was our beachhead, if you will. And it's proven to be a very nice investment.

Obviously, Rhenoy is our maiden voyage onto the continent, and we anticipate that there will be incremental opportunities to expand the footprint.

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The recycling business in Europe is, generally speaking, is different than in the US. It is largely driven by the commodities as opposed to parts sales, and as you know, as a distributor of parts, we're more focused on the parts side than the commodities side. And so, it's going to take some time for the European market to shift. There are some regulatory changes going on in Europe as it relates to the circular economy and utilization of green parts. We think this is going to be a good time to slowly kind of build up our presence.

We've got a boatload of intellectual capital here in the US. We think it's going to be a good time to extend that to the other side of the Atlantic. But it's going to be a slow process, Craig, you should not expect any major shifts over the next year or two or three. But we think we're incredibly well positioned to expand our footprint on the recycling side in Europe. And it's all a matter of finding the right businesses to acquire, the right management teams, the right values, the right environmental practices, but we're optimistic that there will be more tuck-ins like Rhenoy as time unfolds.

Scott L. Stember
ROTH MKM Partners

Q

Can you talk about State Farm, what you're seeing, early experiences, how fast it's ramping up? And then also, are you hearing anything about State Farm potentially expanding past the two or three SKUs that they're currently using right now?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. So, State Farm made their announcement just in December. It's not like going over to the wall and flipping the switch, right? You have a couple decades of history of repair shops being kind of driven into their – had that State Farm, did not use aftermarket parts. And so, it's going to be a slow transition.

Our volumes of those three-part types on State Farm claims is moving up, and so we think that it's on track for that to hit the overall opportunity for 2023. I think we quantified that in our last call. It has been under $100mm.

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Correct.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

We've had one month, right, January under our belt. If you kind of extrapolate that out, we think that they're going to continue to push their new policy throughout the marketplace, but it's going to take a little bit of time to get up to kind of full speed.

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

Q

Got it. And then as just a follow-up...

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

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There is no indication at this point in time, but again, we're not – but, what, 45 days after the announcement that they're going to extend the program to new product types, that's certainly our hope. We think that is the logical thing to do, but we thought that was the logical thing to do for the last 20 years.

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

Q

Got it. Well, we're clearly in a better spot than we were 10 years ago, so.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Absolutely.

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

Q

And just if I could just slip one last question in Europe, I don't know if you gave granular detail by market, but what are you seeing the countercyclical benefits of the aftermarket or the mechanical parts aftermarket starting to kick in? Maybe just give us a little color there.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. So, as Rick and I both indicated, organic growth in Europe in Q4 was a little bit over 5% on a per day basis, on a same day basis, which was terrific. Every single one of our markets was up nicely and either in and around that mid single-digit range with the exception of one business, which is we call it components business on a y-over-y basis.

That was still negative because that's the business that used to sell into Russia. And if you recall, we shut every single element of that down the day that Putin rolled tanks over the border. And so, on a y-over-y basis that volume is just gone. But all the geographic platforms showed really good organic growth in Q4.

Bret Jordan
Jefferies LLC

Q

You called out strength in alternative parts utilization in North America. Is that a tailwind from OE certification programs? Are what they're doing in collision on the OE side driving prices up to the point where it forces more alternative parts utilization or what do you see as the tailwind in that mix?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Well, we believe that in Q4, the biggest part of that tailwind is that the aftermarket, including ourselves, is by far the largest player. We actually had inventory to sell. As you recall, we had supply chain challenges coming out of 2021 into 2022, and our fulfillment rates because of that were down.

I mean, historically we've been in this the mid 90% range. And as we indicated in prior quarters, we were down into the low to mid-80s, right. The fact that we actually have the inventory need to be responsive to customer demand is the primary reason the whole aftermarket industry was able to grab over 2 percentage points of share back from the OEs.

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And we think – and we're very proud of that. Obviously, we're the largest player in the aftermarket parts space. We're charging hard to take share not just from the OEs but from our smaller competitors as well.

Bret Jordan
Jefferies LLC

Q

Okay. Great. And then on the recycling of batteries in North America, the partnership you talked about, could you give us a little more detail? Sort of, is that something that use your – this existing infrastructure? And obviously, not a lot of batteries in the vehicle park yet, but where do you see that being a contributor?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. This is not a play for 2023 or even 2025 for us. This is 10 to 15-year play, right? And what ultimately we believe is it's pretty well documented that there's not enough lithium being mined to produce all these batteries that can go on the EVs that folks are anticipating going to be on the road. And so, recycling the key elements out of existing EV batteries is going to become critical.

We don't have the technology to do that. We recycle parts, but we don't know how to recycle chemical elements, right? But that's where Korea Zinc comes in. I mean, they are truly a world-class organization when it comes to reclaiming and recycling all sorts of various nonferrous metals.

And we believe that the combination of their ability and process technology on the one hand with our ability to source cores and batteries on the other hand is a – it could be a great partnership. Now, it's a memorandum of understanding, right? It's not a joint venture yet. The goal is over the next couple of years to figure out and work together to develop a plan that could be profitable for both companies. But...

Bret Jordan
Jefferies LLC

Q

Okay, great.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

But, it's moving us into the next generation of mobility. And we're very excited about it. And we think Korea Zinc will be a terrific partner for us.

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

Q

Just on the first one on the guidance, when you think about the $975mm in cash flow, I mean, it sounds like that's kind of the minimum. And if you were to try to back up into an EBITDA number using the conversion of the 55% to 60%, that kind of puts you at $1.77B, kind of just under 13% margins. Is that kind of the right way to think of the low-end of EBITDA?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. So, the way we're looking at it – thanks for the question. The way we're looking at it is, 55% is the minimum of where we're sort of guiding on the conversion piece of it. So as we're driving into this thing, the mix between

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what happened y-over-y in the earnings, with the interest payments, the tax payments coming down and the CapExs, I think we've got a gap, call it, 50-+/-.

We kind of gear right in that range. That's where I would kind of look on the FCF piece. And then backing into that we've guided 55% to 60%. And we think that's a pretty reasonable approach where we hit the 60% in the prior year, 2022. Bringing that down a little bit with the CapEx expenditures in 2023 is how we end up getting to that $975mm.

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

Okay. But just think, I mean, again, just kind of backing it into – trying to guess at the EBITDA, I mean, as that gets to the 60%, you would expect the EBITDA costs would be higher as well. Is that a fair way to look at it?

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

Absolutely.

Rick Galloway A
Chief Financial Officer & Senior Vice President

Yeah. That's a fair way. Yep.

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

Okay. And then on the follow-up question. When you think about the CapEx, the additional spend that kind of moved from 2022 and 2023. I mean, if you kind of even that out over the two years, you kind of were at $1B based on your guidance.

Rick Galloway A
Chief Financial Officer & Senior Vice President

That's exactly...

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

You would be at about $1B in guidance. So...

Rick Galloway A
Chief Financial Officer & Senior Vice President

Yeah. That's exactly [indiscernible] (00:51:58).

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

So, what – can you give a little – okay, great. Can you give a little color just kind of on what drove that and then maybe kind of what's the right way to think about CapEx on a longer term basis?

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Rick Galloway
Chief Financial Officer & Senior Vice President

A

Yeah. So we look at 2% of revenue, 2% to 2.25% of revenue is usually the kind of guide that we've given. We have 1.75%, I think it was 1.77%, something like that in 2022. As things pushed out, primarily trucks, equipment pushed out with the supply chain issues. And then when you think y-over-y, right in that 2% range, that we've been kind of guiding to. So, there may be ebbs and flows back and forth between different years, but that 2% to 2.25% is the right way to look at it.

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

Q

Okay. Perfect. And then just last one. Is there any risk on the inventory build that's Specialty, if cars – kind of that that market, that demand remains soft? Is that something we should be watching?

Rick Galloway
Chief Financial Officer & Senior Vice President

A

No, I don't think so. So, we have a traditional build throughout the year and we ended up decreasing that a little bit and then driving that down to the end of the year to end up virtually flat y-over-y on overall inventories. And it's something that we're watching very closely with the demand. And so, nothing to be concerned about in that area.

Daniel Imbro
Stephens, Inc.

Q

Nick. I want to start on the European side. I think at the end of your prepared remarks, you talked about Europe having some specific projects they're working on. Can you provide some more color just around what those are? Is that just the growth into collision parts? Are there other cost project that Varun and the team are working on? Any kind of quantification as we think about potential margin impacts from those initiatives?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

The answer, Daniel, not to be snide, but the answer is, yes, right? We've got a number of different projects over in Europe. Rick mentioned restructuring, the 2022 restructuring plan .That hits all of these segments, including the European segment.

Folks should think about restructuring at LKQ is part of our continuous improvement plan that every year we're looking to find ways to optimize our business and to get access cost or better throughput and efficiency from each of our operations. And so, yes, there are some restructuring plans over in Europe just like North America and Specialty.

We're looking at programs to continue to drive organic revenue growth, particularly volume growth. And Varun and team are focused on some key programs there. They pulled in head count a little bit, particularly at the kind of the – at the head office levels, not just in Zug, but across the operating platforms as well, just to make sure that our administrative costs are aligned with the realities of 2023 and the economic climate.

So, it's a number of different initiatives Daniel, none of which we're going to put a pinpoint as to what it means from a euro or a dollar perspective. But it's all with the goal of continuing to drive organic revenue growth and better margins.

And as I think Rick indicated in his prepared comments, we're anticipating that the margins in Europe...

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Rick Galloway
Chief Financial Officer & Senior Vice President

A

20BPS to 30BPS.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

...will go up by 20BPS to 30BPS in 2023, and that's been included in the guidance that Rick set out.

Daniel Imbro
Stephens, Inc.

Q

Great. That's helpful color. And then I wanted to just circle back on the potential of battery remanufacturing JV. If you take a step back and just think about how State Farm handled the aftermarket after one accident 20 years ago, I mean, have you guys talked to the insurance companies? Do you think that they're actually going to reinsure remanufactured EV batteries or if there's one accident, does that become a category that insurance companies just won't touch because of liability, I'm just trying to think through what the actual end market...

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. Okay.

Daniel Imbro
Stephens, Inc.

Q

...could be there? And can insurance companies actually do that?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. So, Daniel, you need to separate the collision business from the mechanical repair business. And the EV batteries, what we're doing right now with Bumblebee and Green Bean, the two companies that we bought over the last year or so that remanufacture batteries, that has nothing to do with the collision business. That just has to do with the failure of the batteries and the life batteries to extend the life of the vehicle. Okay.

The Memorandum of Understanding on recycling with Korea Zinc, again, has nothing to do with remanufacturing. That is truly a recycling to get to the core elements that are inside that EV. And so, you need to keep them – there's a big difference between remanufacturing and recycling.

Recycling, there's not a battery left to go back into another vehicle, right? Remanufacturing is where we truly look at the battery, we replace certain cells. That is not an insurance-driven product. If you have a nine-year-old EV and your battery is failing, you're not going to get reimbursed a nickel from your insurance company to go replace that battery. That's going to be an out-of-pocket expense.

Daniel Imbro
Stephens, Inc.

Q

Got it. So this is more on the – it's on the mineral extraction or kind of recycling side...

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Dominick P. Zarcone
President, Chief Executive Officer & Director

A

[indiscernible] (00:57:48).

Daniel Imbro
Stephens, Inc.

Q

...the potential...

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah.

Dominick P. Zarcone

President, Chief Executive Officer & Director

CLOSING REMARKS

- We know it's a busy reporting period, and we appreciate you spending the hour with LKQ
- Again, I couldn't be more proud of our team and the results that we've posted up not only in Q4 2022 but the full year as a whole
  - We're looking forward to being back on line with you in about, I don't know, 60 days or so in late April when we announce our first quarter results.

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