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LKQ Corp. (LKQ)

Q1 2021 Earnings Call

CORPORATE PARTICIPANTS

Joseph P. Boutross
Vice President-Investor Relations

Dominick P. Zarcone
President, Chief Executive Officer & Director

Varun Laroyia
Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

Stephanie Benjamin
Truist Securities, Inc.

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

Scott L. Stember
C.L. King & Associates, Inc.

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

Gary Frank Prestopino
Barrington Research Associates, Inc.

Bret Jordan
Jefferies LLC

Daniel Imbro
Stephens, Inc.

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 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 then Varun will dive into the financial details, including our banner margin and FCF performance, as well as our improved 2021 outlook before I come back with a few closing remarks
- Wow, we've come a long way over the past 12 months
- A year ago at this time, the threat of the pandemic had become a tremendous and painful reality

- Immediately our teams got into action with a key focus on across the entire organization to right-size the cost structure and maximize cash flow

Cost Structure

- In order to adjust to this new paradigm our teams had to make some very difficult decisions to protect the long term health of our company, and in the past three quarters have proven that our ability to reset the cost structure of LKQ
- Our global leadership team firmly believed we would come out of the pandemic period stronger and a better organization and our performance this past quarter absolutely confirms that belief

Key Initiatives

- Let me restate our key initiatives, which continue to be central to our culture and our objectives
    - First, we will continue to integrate our businesses and simplify our operating model
    - Second, we will continue to focus on profitable revenue growth and sustainable margin expansion
    - Third, we will continue to drive high levels of cash flow, which in turn, will give us the flexibility to maintain a balanced capital allocation strategy
    - And finally, we will continue to invest in our future
- As you can see from our results, our segment teams executed on each of these initiatives in Q1

Operating Initiatives

- Alongside these operating initiatives, the continued build-out of a comprehensive ESG program is a key focus for the organization
- As promised during our last earnings call, on April 6 we released our Inaugural Corporate Sustainability Report
    - This report validates our long-term commitment to enhancing our ESG practices and will serve as a guidepost for the further embedding of ESG principles throughout our global operations

CSR Report

- Slide 16 of today's earnings deck provides a brief one page overview of the CSR report
- If you have not already done so, I would highly encourage you to visit our website and download a copy of the full CSR.
- Now on to the quarter
- Revenue for Q1 was $3.17B, an increase of 5.7% as compared to $3B in Q1 2020
- Parts and services organic revenue in Q1 2021 increased 0.6% on a reported basis and 2.2% on a per day basis
    - While the net impact of acquisitions and divestitures decreased revenue by 0.6% and foreign exchange rates increased revenue by 4.2%
- Total parts and services revenue increased 4.2% in the quarter

Organic Revenue Growth

- The organic revenue growth for the quarter reflects the annualization of the initial pandemic impact last March
- Through February, organic parts and services revenue was 4.4% lower on a per day basis

- In March, organic parts and services revenue grew by 15.7% on a per day basis, recognizing we were coming off a lower comparable period
- Other revenue grew 27% in Q1 2021, driven by higher scrap steel and precious metal prices
  - While consolidated revenue is still running below pre-COVID levels, net income for Q1 was $266mm as compared to $146mm last year, an increase of 83% y-over-y

Diluted EPS

- Diluted EPS for Q1 was $0.88, an increase of 83%
- On an adjusted basis, net income in Q1 was $286mm, a 62% increase y-over-y, while adjusted diluted EPS was $0.94, a 65% increase

EBITDA Margin

- Each of our segments achieved EBITDA margins, well ahead of our expectations due to excellent execution, a continued focus on our cost structure, and with respect to North America, tailwinds from scrap and precious metals pricing
- When taken collectively, these strong performances allowed LKQ to record record consolidated segment EBITDA margins of 14.2% in Q1
  - This was a 350 basis point increase relative to Q1 last year

Revenue Trends

- Let's turn to some of the quarterly segment highlights
- Slide 5 sets forth the monthly revenue trends for the quarter and as you can see, all segments were positive in March on a per-day basis
- Obviously, during the tail end of February and the entire month of March, we were working from an easier comp, but we also benefited as mobility began to gain ground in certain markets
  - Additionally, the penetration rate of the vaccine in the United States is encouraging and as these trends gain ground in other key markets, we should begin to see a loosening of the stay-at-home mandates, and we would expect a gradual improvement in vehicle miles traveled or VMT

US Department of Energy

- According to the US Department of Energy, at the end of the second week of April, fuel consumption was 71% above the prior year and just 3% below that same week of 2019
- According to the Apple Mobility Index, the trend in driving trips in our European markets was down early in the year relative to the third and fourth quarter levels of 2020, but as we progressed through Q1, the index rebounded, and by the third week of April, the index had increased 33% from the first week of January
- So there are clearly some green shoots of momentum in VMT around the globe, albeit, we're still below pre-COVID levels

North America

- Turning to North America, from slide 6, you will note that organic revenue for parts and services for our North American segment declined 8.4% in the quarter on a reported basis and 7.0% on a per day basis
- While still down on a y-over-y basis, it is an improvement relative to Q4 of last year

- We continue to outpace the market in North America, especially when you consider that industry data suggests that collision and liability-related repairable auto claims declined approximately 14% in Q1 2021 compared to the prior period

Market Share Gains

- Relative to the competitive landscape, we are confident that we are gaining market share from small salvage and aftermarket operators that are typically capital constrained and facing lower inventory levels due to product availability and cost inflation
- Our strong balance sheet gives us the ability to continue to invest in our North American business, including inventory replenishment, and also in various technologies and programs to further enhance the efficiency of our operations and the service experience for our customers
- With capital constraints, many smaller competitors lack the flexibility to stay relevant and competitive

North American Operations

- During Q1 our North American operations benefited from the disruption to the OE component supply chain, which impacted the OE's ability to build major mechanical inventory
- This lack of major mechanical inventory for the OEs, combined with our robust levels of recycled and remanufactured engines and transmission products, provided the opportunity for our North American business to gain share in the quarter

Salvage Operations

- Our salvage operations have been extremely judicious in their procurement efforts and selling more parts from the vehicles we procure, enabling us to have stronger fulfillment rates than the industry average
- In North America during Q1 we continued our environmental stewardship efforts by processing 190,000 vehicles, resulting in among other things, the recycling of 900,000 gallons of fuel, 491,000 gallons of waste oil, 482,000 tires and 176,000 batteries
- During Q1 we also processed approximately 282,000 tons of scrap steel

European Segment

- Moving on to our European segment, organic revenue for parts and services in Q1 increased 30BPS
- As the largest pure play distributor of aftermarket automotive parts in Europe, this is a solid start to 2021, even in the face of continuing COVID lockdowns in several regions of Europe

REGIONAL OPERATIONS

- Our regional operations experienced varying revenue performance in the quarter with positive y-over-y performance in Germany, Benelux, and Eastern Europe, with some softness in the UK, and Italy continuing to drag on the overall performance of this segment
- Specific to the UK, in addition to our two-step distribution business of mechanical service parts, we operate a few other businesses, including our collision parts and coatings businesses, which registered materially lower growth than our two-step mechanical parts distribution business in Q1

REVENUE GROWTH

- Importantly, with our corporate wide focus on profitable revenue, we spent the past year rationalizing the footprint of our UK business, which eliminated over 40 unprofitable branches, resulting in a small negative impact on revenue, but a significant improvement in EBITDA margins
- Revenue growth from our ongoing mechanical service parts operations was positive in the quarter, while our data indicates the overall UK market was down on a y-over-y basis
- In total, we are delighted with the performance of our UK operations

FOURCE CENTRAL DISTRIBUTION CENTER PROJECT

- Other items of note in Europe includes the fact that we continue to add talent and expect the organizational design elements of the 1 LKQ Europe program will be largely completed by the end of Q2
- The Fource central distribution center project remains right on track
- Our ERP implementation at Rhiag, Italy also remains on track for a Q2 go-live, which will make it the first large platform company on our new European ERP system
- And we continued to expand our payables optimization initiatives, which includes the vendor financing program

ESG PROGRAMS

- Lastly on Europe, and consistent with our ESG programs, we recently launched an electric delivery vehicle trial for our UK and Republic of Ireland operations
- The pilot will run for about six months and will take into account the charging point infrastructure to identify branches with vans whose typical mileage is suited to the range and capability of an electric vehicle
- LKQ is also considering pilot projects with fuel-cell powered heavy trucks, once those vehicles and filling stations become available

Specialty Segment

- Now let's move on to our Specialty segment, which absolutely knocked the cover off the ball during Q1 by reporting organic revenue growth of 30.9%
- This represents the highest quarterly organic revenue growth since we bought this business in 2014, with Q4 of last year being the second highest quarter

ONGOING DEMAND

- The primary factor driving this tremendous performance is the ongoing demand for RVs and RV parts
- The RV Industry Association's February 2021 survey of manufacturers determined that total RV shipments increased 30%, making it the best February RV unit shipment total on record
    - This is good for LKQ on a longer-term basis, as a larger RV park should lead to more RV part sales in the future

Specialty Performance

- Also driving the Specialty performance was the demand for light truck parts we offer, which, during Q1, increased 17% y-over-y, with strong demand for products installed on Jeeps and pickup trucks
- We believe that the third round of stimulus checks benefited our Specialty business in the quarter

- Across all of our segments, and like many others in vehicle part distribution, we are witnessing some supply-chain disruptions which have led to incremental cost in freight, labor and cost of goods sold
- Related to ocean freight, the container capacity constraints that we first experienced last fall continues to be a challenge

Supply Chain Team

- Our supply chain teams across the globe are in constant communication with our suppliers, working to procure the products we need to maintain and grow our market share in each of our segments
- Importantly, we have witnessed minimal impact to our fulfillment and customer service levels and believe the inventory challenges are subsiding

Inflationary Risk

- As it relates to inflationary risks, we remain cautious near-term but as we progress through the year, we are expecting a continuing pandemic recovery, which should benefit each of our operating segments
- Again, we expect to see continued inflation related to freight, labor and cost of goods sold
- That said, as witnessed throughout 2020 and in Q1 this year, we have a number of levers that we can pull to help offset these inflationary risks, including price

Corporate Development Perspective

- From a corporate development perspective, in Q1 we acquired a diagnostics business that provides various mobile diagnostic and programming services to professional collision and mechanical repair shops in Nebraska
- By year-end, this business will be fully integrated into our Elitek Vehicle Services brands
    - We have a couple of other diagnostic transactions in the pipeline

European Team

- Finally, I previously noted several senior level additions to the European team in the quarter, which will lead our efforts in the areas of strategy, sales, logistics and supply chain, product pricing, and e-commerce
- LKQ Europe is viewed by candidates as being a unique and extremely well-positioned enterprise with an exciting future and we've been able to attract great talent from across the European automotive industry and digital channels
- At the corporate level, during Q1, we brought on a new SVP of Human Resources to the executive team
- Genevieve brings a wealth of experience in managing a large hourly based workforce and she has on-point experience in building programs focused on employee engagement and diversity and inclusion, key elements of our ESG initiatives

Varun Laroyia
Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Pre-COVID Levels

- We entered 2021 with strong momentum coming off the two highest quarterly results in the company's history, the third and Q4 2020
- This morning I am pleased to report that we were able to build on that momentum in Q1 and take advantage of some tailwinds to produce yet another record quarter
- As we've said repeatedly over the last year, we can't control when revenue growth will return to pre-COVID levels
    - However, we are able to manage our costs and have focused on right-sizing the cost structure and emphasizing efficiencies so that we can generate operating leverage when revenue growth returns

Cost Reductions

- The permanent cost reductions that we enacted in 2020 continue to drive y-over-y profitability growth
- And encouragingly, we got an additional boost in Q1 as we were able to support the sequential revenue growth across all our segments without adding back costs at the same rate
- Our SG&A expenses as a percentage of revenue showed this operating leverage, dropping to 26.8% in the quarter or 320BPS better than Q1 of 2020

Gross Margin

- We were also able to improve our gross margin by being disciplined on pricing to ensure that our strong inventory availability and service level were recognized in the industry
- We believe that these operational strengths are sustainable going forward and will drive our results as the recovery picks up pace as expected in H2
- We saw this transpire in the month of March as rebounding economic activity generated healthy revenue growth, and cost controls limited the amount of incremental expenses, which resulted in the highest monthly profitability in the company's history

EBITDA and Adjusted Diluted EPS

- I mentioned the benefit of tailwinds in the quarter and commodity prices were most certainly significant
- As you can see on slide 20, scrap steel and precious metal prices, which have been mostly favorable over the last year, provided additional benefits in the quarter
- We estimate that scrap steel and precious metal prices added roughly $34mm in segment EBITDA, which will translate into about $0.08 in adjusted diluted EPS relative to the prior year
- We expect that commodities will be a net benefit in the short term, although likely at a lower level than Q1 as car costs continue to rise, owing to the commodity price changes and further moderate in H2

Tailwind

- Even with the tailwinds related to commodity prices, the largest share of the y-over-y increase in adjusted diluted EPS related to pure operating performance
- I'll now turn to that operating performance with our segment highlights

North America

- Starting on Slide 10, North America produced its highest segment EBITDA margin in the company's history at 19.9%
- Q1 is the third consecutive quarter that we've been able to make this statement and is truly a testament to the resilience of the business and the management team's swift and decisive actions during the early days of the pandemic
- The segment continued to benefit from ongoing gross margin initiatives and the specific permanent cost reductions executed in 2020
    - Additionally, the commodity pricing benefits I mentioned are seen here, helping to drive the North America margins above our long-term expectation

Europe

- As seen on slide 11, Europe reported a 9.6% segment EBITDA margin which represented a 390 basis point improvement over last year
- We remain confident in our ability to deliver on the margin goal communicated last September at our Investor Day and reaffirmed in February following fourth quarter earnings
- Europe is benefiting from the revenue recovery and cost containment actions taken last year, with more anticipated on both fronts

Specialty Results

- Moving to slide 12, as Nick described, the Specialty results are truly outstanding
- We are super excited about the spectacular revenue growth, and we're really pleased with the way the segment team has delivered the growth without adding back significant operating costs or sacrificing gross margin
- The segment EBITDA margin of 13.4% is the highest Q1 result in the segment's history by approximately 150BPS and reflects the leverage benefit achieved in a period of rapid growth and the discipline to pursue profitable revenue growth
- We talked last year about the shift to an emphasis on operational excellence and our first quarter results provide further evidence of this mindset taking hold
- Each segment's disciplined execution of our strategic priorities has been excellent

Capital Structure

- We are also delivering meaningful savings from our focus on the capital structure
- Deploying FCF to debt pay-downs and share repurchases generated interest expense savings and an EPS benefit from a reduced share count
- We estimate that these two factors added $0.02 per share to our Q1 2021 results
    - Additionally, Mekonomen's solid performance and other investment income generated another $0.03 of y-over-y growth

Profitability

- Given the improved expectation for full-year profitability, we decreased our projected effective tax rate in our outlook from 28% to 26.5%
- The reduced rate relative to 30% rate used in Q1 of last year, contributed approximately $0.025 of the y-over-y EPS growth

Adjusted EPS

- So, to recap, our adjusted EPS of $0.94 is $0.37 increase over Q1 of 2020
- The commodity benefit along with the increases attributable to investments, the tax rate, our capital deployment and a slight tailwind from foreign exchange, produced approximately $0.16 of that improvement
- The remaining $0.21 comes from our operating performance, focusing on profitable revenue growth, enhancing gross margins and controlling our overheads
- And that should be the key takeaway when considering our Q1 profitability

Cash Flow and Liquidity

- Now on to cash flow and liquidity, Q1 was yet another successful quarter for cash flow generation
- As shown on slide 13, we delivered $523mm in operating cash flows as we continue to benefit from the trade working capital programs we've been driving since 2018, as benefits from payables more than offset the seasonal growth in receivables
- We expected inventory to be a larger outflow in Q1, though ongoing supplier delivery challenges exacerbated by ocean freight challenges have pushed the build to later in the year

Inventory Levels

- Despite the lower than anticipated inventory level, our teams with the support of our vendor partners, skillfully ensured that the right parts were in the right places and thereby minimized stock-out issues so that our class-leading fill rates were maintained

CapEx Cash Outlay

- CapEx cash outlays were $42mm, resulting in FCF of $481mm
- We used this cash to repay $83mm in debt and repurchase $57mm in LKQ stock
- We also built our cash balance mostly in Europe in advance of the early redemption on April 1, which was the earliest possible redemption date of our €0.75B Euro notes due in 2026
- We used a portion of the cash on hand to fund the redemption and drew the remaining amount on our revolving credit facility

Euro Bond

- The redemption replaces the Euro bond with a coupon of 3.625% with credit facility borrowings approximately 250BPS of lower cost
- Do note that we had already anticipated the redemption and the resulting interest savings in our original earnings outlook provided in February

Liquidity

- On slide 15, you can see the further progress we have made to strengthen our liquidity position
- Our net leverage ratio has decreased to 1.4 times from 1.9 at the end of 2020, owing to our strong profitability and cash flows in Q1
    - We believe that we are very well-positioned in our stated pursuit of an investment grade profile
- We're also pleased with the positive developments on this objective with both S&P and Moody's upgrading our credit rating in Q1

Revenue Trends

- I will close with our updated thoughts on 2021
- With the ongoing COVID uncertainties especially concerning revenue trends, we are providing an abbreviated outlook
- We are comfortable making the following statements, all of which assume that, one, additional mobility restrictions beyond what are currently in place are not re-implemented or exacerbated in our major markets; two, foreign exchange rates hold near recent levels; and finally, three, scrap and precious metal prices trend lower in H2

Parts and Services Revenue

- With that, on revenue, we reaffirm our belief that parts and services revenue will be higher on a full year basis in 2021 vs. 2020, with the most significant growth coming in Q2, albeit, off a low base
- We anticipate that the revenue recovery will continue in H2 as vaccines are distributed more broadly and mobility restrictions decrease
- But we do not currently expect to return to our 2019 annual revenue until 2022

North America

- As discussed previously, we'll have two fewer selling days in North America in 2021 with one already completed in Q1 and the second one in Q4, while Europe is flat with one fewer selling day in Q1 but made up in Q2 with the additional day
- The other piece I want to talk about was EPS
- And with a strong first quarter performance, projected revenue growth and the ongoing benefit of our margin and operating expense programs, we expect our 2021 adjusted diluted EPS will be significantly above the comparable figure for 2020

Adjusted Diluted EPS

- We are projecting an adjusted diluted EPS range of $3 to $3.20 with a midpoint of $3.10
- On a GAAP EPS basis, this would be $2.68 to $2.88
- The $0.35 or 13% increase at the midpoint reflects Q1 outperformance and upside in the projected results for the last nine months compared to our prior outlook
- We expect to achieve this upside while covering the effects of inflationary pressures being faced across the industry related to labor costs, ocean and domestic freight expenses, and higher input costs raising inventory prices

Cash Flow

- And finally on cash flow, we are indeed off to a terrific start on cash flow generation in Q1, which gives us the confidence to raise our minimum FCF expectation
- We now project that FCF for the full-year 2021 will be within the range of $850mm to $950mm, with a midpoint of $900mm
    - We expect inventory purchases to represent an outflow over the remainder of the year as we replenish our inventory levels to support the anticipated growth
- Essentially, it is just going to happen later in the year than we had previously anticipated
- Some of the investment in inventory will be offset by continued improvements in days payables, resulting from the European payables optimization program, which is producing benefit and tracking well in line

with the target we had set out in September of 2019 when we initially launched the 1 LKQ Europe Program

Dominick P. Zarcone
President, Chief Executive Officer & Director

CLOSING REMARKS

- As a company, we are always focused on financial performance, but we are equally focused on facing change head on and rapidly adapting in order to continuously deliver positive results for our stockholders, employees, and most importantly, our customers
- In Q1, our team of nearly 44,000 employees globally maintained that focus, which again allowed us to deliver positive results above expectations
    - I am very proud of our team and the outstanding results we posted in Q1 2021

QUESTION AND ANSWER SECTION

Stephanie Benjamin
Truist Securities, Inc.

Q

My first question is just on, as you've pointed out, both Nick and Varun, just the impact from this inflationary environment. I think you called out some levers that you can pull including pricing. I'd love to get an update on any pricing actions that may have been implemented in Q1 and just overall customer response, and as well as maybe hearing a little bit more on some of those other levels (sic) [levers] (33:18) that you can pull just given this environment. And then I just have a quick follow up.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Thanks, Stephanie. And the reality is we're operating in an unusual environment. And volumes in our North American and European businesses are okay. They're not great, but they're okay. And they're still constrained relative to 2019. But as Varun indicated, we've been very disciplined on the pricing front, and there's no need to give away product at discounted prices, particularly in those cases where we're the only supplier that may have the products. So we've been very disciplined in our pricing.

We have seen some creep in the cost of goods sold just because of the inflationary pressures at some of our suppliers, and we're doing our best to recover that and maintain gross margins. And we're comfortable with our approach. We have not seen significant pushback from our customers. The reality is we're not alone. I mean, the entire industry is facing the same set of conditions.

On the Specialty side, the growth there was largely due to volumes just going through the roof, which was terrific. And again, our Specialty team is paying particular attention to be really disciplined on the pricing front.

Stephanie Benjamin
Truist Securities, Inc.

Q

Got it. Thank you. And then just as a follow-up, specifically on the salvage side of the business, you called out benefiting from the ability to procure OEM parts and remanufactured parts just given the OEM shortage. Have you seen any inflation in the quarter or inability to procure some of those parts at auction just given collision [ph] actions (35:18) are down or higher demand from maybe other buyers? Would love just to hear how you've been able to procure those salvage parts.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. So we're really proud of our remanufacturing operations. They've done a terrific job over the last several quarters, not just in Q1. The salvage markets are tight. And the prices we're paying for the cars are higher today than they were a year ago or even two years ago.

And part of it reflects the fact that the number of cars just going through the auctions are down just given the overall level of driving and overall level of accidents and total losses. But again, we're working hard to make sure that we keep our margins at really healthy levels. And the fact that we've got a great team on the remanufacturing side that's able to produce product that the customers are needing, has really helped.

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

Q

Okay. Great, perfect. I guess just at high level maybe we could talk a little bit about the trends that you've seen to date on the driving side in the US and Europe. And then just kind of thoughts on how that plays out and the impact it could have in the rest of 2021.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Sure. I'll take that. It's been an interesting year, a year ago at this time, April through June, vehicle miles traveled were down significantly in the United States and in Europe. The US hit a low point really in the second, third week of April 2020 being down better part of 55% or so.

If you look at really from kind of mid to late June through the November timeframe, VMT in the United States was down in and around anywhere from 9% to 12% kind of week-in, week-out. The last part of 2020, it was down about 15%, really from through Thanksgiving into the end of the year. And then more recently though, it's picked up. In the last few weeks VMT in the US is down say, 5%. And I'm talking about passenger cars. Truck miles has actually been positive really since last summer. But almost all our revenue relates to passenger vehicles and that's what we focus on.

As I mentioned in some of my prepared remarks, the European activity and mobility again, in Q1 started off really slow. It did rebound, and here in April, we're still below 2019 levels, but only down kind of low – we believe low single digits from a VMT perspective in Europe.

But there are some variations country-by-country. So when you look – the question, behind your question I believe, is when do we get back to 2019 kind of revenue levels and VMT levels, right? And we think in the United States, it's going to take us a bit longer. We think it's going to take until 2022 to get back to 2019 levels.

In Europe, which is a little bit closer from a starting point perspective, we can see getting back to 2019 levels in the third or Q4 this year. It all depends on how the vaccine gets rolled out and whether people truly get back on the road. And then the Specialty business has been running above 2019 levels for several quarters now and so that's a little bit different.

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

Q

Okay. I guess as a follow-up. Just to be clear, that's kind of what's built into the current – the updated guidance that you gave. And then, second would be what part of the commodity metals upside is built into or the expectations built into the revised guidance that you gave? Thank you.

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Hey, Brian. It's Varun out here. So, yes, as part of my prepared comments, I did mention the fact that, as of now, we do see some moderation on the metals pricing, both scrap and precious metals in H2. And so, that is the piece that has been built into the outlook at this point of time. We've talked previously also commodity prices are incredibly volatile. We're certainly benefiting from the upswing at this point of time with the sequential rise.

But, again, make no mistake, there are others in the industry also that are faced with a similar set of commodity price increases. The question really is we believe our salvage teams, self-service and full service are by far, the best in the industry and essentially are doing an incredible job in operationally taking advantage of the upswing out there. Clearly, we are keeping a lookout on when these moderate. But as of now, the outlook contemplates a H2 moderation.

Scott L. Stember
C.L. King & Associates, Inc.

Q

I'm just trying to break out March a little bit better. I think you've partially answered my question with commentary about reaching 2019 levels again. But in March, we saw some nice increases, Specialty up 61%. Can you maybe go through the three businesses and just how much of it is easy comps, if you were to flesh everything out, did you see inherent improvements in March sequentially month-over-month from the January-February timeline into March? Thanks.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Sure. The reality is March was a good month for us. Specialty was off the charts. We're not going to begin to imply we're going to be able to continue to grow at 60% y-over-y every month for the rest of the year. The growth rate is going to come down, but the absolute dollars should be strong.

The comparison for Europe and North America, obviously, we're happy that it's up on a y-over-y basis, but it's somewhat off easy comps. But the March levels were better than the February and January levels. Again, not back to 2019 levels, but they were better sequentially. And that's what gives us a little bit of confidence going forward that we will slowly creep back to those 2019 levels a little bit faster in Europe, a little bit slower in the US, but we're headed in the right direction.

Scott L. Stember
C.L. King & Associates, Inc.

Q

Okay, just last question on supply chain. I think you touched on some of this already, but a couple of quarters ago, Specialty was meaningfully impacted. It appears that you've been able to work through that. Just could you just talk about some of the countermeasures that you have in place, which are helping you get through this?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Well, we have a lot of orders out there for inventory. We have product that's coming into our receiving bay and headed out of our shipping bays almost in the same day. We've got product that's not even touching the shelves, because the velocity of the business and the demand is just so significant.

We're doing the best we can. We're working hand-in-hand with our vendor partners. The reality is the industry as a whole, the vendors are running hard to keep pace. And we're working very closely with our vendor partners to make sure that we can get the product we need when we need it.

We anticipated and not just in Specialty, but in all of our businesses, that we would have added more to our inventory levels in Q1. But the supply constraints are what they are. And we think we'll get back to slightly higher inventory levels by – in H2.

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

Q

It sounds like your – good morning. It sounds like your competitive advantage, especially as it relates to inventory availability has really strengthened during the pandemic. And I'm wondering to what extent you think that is sustainable. What does the competitive landscape look like? Do you think you've seen any of those competitors exit permanently?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

I wouldn't say that we've seen a rash of competitors exit, Craig. But as most people know, ocean freight is a significant consideration for all industries. Anybody importing product, particularly from the Far East, the lack of containers, the backlog at the ports, I mean, it all creates a bit of a bottleneck. The difference is we're not importing a few dozen or a few hundred containers a year. In North America, we import over 16,000 containers a year.

And so we use that position to our advantage. The orders to the vendors are big orders. We are a very important customer. And I think we get – we've got great relationships with our vendor partners, and they're working hard to help us be successful. And if you're a smaller business, you don't have that same flexibility to have power with the vendors and/or with the shipping lines. And we use our size and scale to our advantage.

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

Q

Thank you. And then sort of related, but the other impact of the pandemic, really you forced yourselves to look at your operating performance and make some tough decisions unfortunately, in terms of head count. As you look to add staff to meet the new resurging demand, to what extent do you need to add back staff and can you get by with a leaner footprint going forward?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Well, we clearly leaned out the organization globally as we went through the depths of the pandemic, right. And my marching orders to all of my operating heads out in the field is we need to keep that leanness going forward. Yes, we will need to bring back people and add people as revenue improves. But we're not going to bring the people back until the revenue is up and we know it's sustainable. And the goal is – this is the new cost structure, Craig. This is how we're going to operate the business going forward.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

I've got a question here that may be a little bit different than what you were expecting in terms of questions for the call on the quarter's numbers. But can you give us an idea of on the mechanical side for EVs, what kind of parts demand you're seeing initially? I just want to get to that because obviously we're going to start seeing more EVs come into the car park, so.

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Very little demand for electric vehicle parts. Almost – I won't say none, but almost none. And you have to keep in mind our sweet spots, Gary, is the aftermarket products from a collision perspective and the salvage parts from a collision perspective, sweet spot being kind of vehicles 3 to 10 years old.

On the mechanical parts, the sweet spot is even older, generally, kind of in that 4 to 5, to kind of 15 years. And so there is a pretty big lag between kind of when the cars come off the showroom floor and when there's a real demand for the types of parts that we and others in the industry sell. So, you're not going to see an impact of EV-related parts for quite some time.

Bret Jordan
Jefferies LLC

Q

A pretty good sequential improvement in the payables ratio. How high do you think you can get accounts payable as a percentage of inventory without getting to investment grade?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

So as of now in Q1 as I mentioned in my prepared comments, Bret, we certainly saw the payables continue to deliver – the overall payables program deliver. It again, was not only the European payables program, our North America team also did an outstanding job.

But really it was a case of not being able to get the inventory build to take place. So in Q1, while the number for the conversion is above 100% in terms of FCF to EBITDA, as I mentioned previously also, that is not a sustainable number. Our conversion factor on an annual is the 55% to 60%. But again, really happy with how the payables program is going across the board but clearly, the largest opportunity being over in Europe. As of now, Q1 with the lack of the inventory build, it's basically timing. And from Q2 onwards, we expect that inventory build to take place to get us back into that 55% to 60% conversion ratio.

With regards to what the long-term hypothesis is or what the long-term plan is with regards to payables as a percentage of inventory, we clearly know for our European business, there are some North American comps that we are targeting. It certainly takes time, but really happy with the progress that team is making.

Bret Jordan
Jefferies LLC

Q

Okay. And a question on UK mechanical, I think you'd called out a spread between your mechanical business and the collision business. I think one of your peers had called out the UK is particularly strong. Are you seeing any market share shifts on the mechanical side of that market or is your regional softness more tied to the product mix?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Look, Bret. It's tied to product mix, as I indicated. I mean, the collision and coatings activities in our UK operations were down double digits. And the environment there is not too different from the collision environment here in the United States. Fewer miles traveled, less collisions, all the rest, right. Our core continuing operations on the mechanical parts side was up in Q1. The market was down. We took some share and that's our goal, is to continue to take share.

Most importantly though in our UK business, we're highly focused on the profitability and the cash flow of the business, because it's not how much you take in, it's how much you keep, right? And our focus is to keep as much of that revenue in the form of profits and cash flow and we're happy with the growth of our business.

Bret Jordan
Jefferies LLC

Q

And you said you'd rationalize the footprint in the UK, is that done now? Is your store base pretty static?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Yeah. All done.

Daniel Imbro
Stephens, Inc.

Q

Nick, I wanted to start on the diagnostics piece. Could you talk a little bit more about Greenlight and maybe what they bring to the table? And then taking a step back, you mentioned in your prepared remarks there were some more diagnostics deals in the pipeline. Can you expand on what you're looking for in these targets? Is it just scale? Is it new capabilities, kind of how that fits into the North American outlook?

Dominick P. Zarcone
President, Chief Executive Officer & Director

A

Thanks, Daniel. The acquisition was similar to the other small acquisitions we've made in the diagnostics space. Again, this is very much of a local business, not unlike the rest of our North American operations where you're really selling into local markets. We're going to continue to do acquisitions that give us geographic coverage across the United States because you can't service body shops and/or mechanical shops in California with a diagnostics team that is in Texas or Colorado. It just doesn't work. And so we are going to continue to build out the footprint from a diagnostics perspective.

All of our activities thus far are what we would call mobile related, where we actually have feet on the ground, people inside our customers' shops doing the calibration work and/or the diagnostic work. We're going to continue to build that out. And we're looking for other ways, quite frankly, to service our body shop and mechanical shop customers perhaps using technology.

Daniel Imbro
Stephens, Inc.

Q

Really helpful. And then, Varun, just one on the balance sheet, obviously, leverage is down to 1.4 times, and you mentioned you reduced further on April 1 with the Euro bonds. Can you talk about the uses of free cash from here? Obviously, inventory will build, but you're still guiding to call it $900mm of free cash. Do you think about the primary use of that being buyback now that leverage is comfortable or how are you planning on deploying that capital?

Varun Laroyia
Chief Financial Officer & Executive Vice President

A

Yeah. So, a great question and thank you for raising it, Daniel. Yes, the first priority has been and remains to reinvest into our business. Apart from CapEx, which we are very comfortable with and what we've called out for quite some time in the 2% to 2.25% of revenue, that remains stable.

In addition to that, as Nick mentioned a few minutes ago, our ability to do high-synergy transactions, small tuck-ins, building up critical capabilities remains the primary use in terms of priority of the free cash. As you rightly pointed out, leverage is well within our target corridor. We don't expect to see further deleveraging taking place from a debt perspective.

And arguably, as profitability grows, that de-levering will take place in any case. So not really looking to pay down further debt, which obviously as you can make out, doesn't leave too many avenues left for the FCF. With share repurchases, which obviously, we resumed the program in Q4 last year, would end up being the primary deployment for that capital that we are building up.

Dominick P. Zarcone
President, Chief Executive Officer & Director

CLOSING REMARKS

- And we look forward to providing another update in late July when we report our second quarter results
- Again, in summary, we are thrilled with our first quarter
- I thank all of the 44,000 people of LKQ for working so hard to bring such terrific results to bear
- And we are very optimistic about the future of LKQ.