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LKQ Corp. (LKQ)

Q3 2022 Earnings Call

CORPORATE PARTICIPANTS

Joseph P. Boutross
Vice President-Investor Relations

Dominick P. Zarcone
President, Chief Executive Officer & Director

Rick Galloway
Chief Financial Officer & Senior Vice President

Varun Laroyia
Chief Executive Officer & Managing Director-LKQ Europe

OTHER PARTICIPANTS

Daniel Imbro
Stephens, Inc.

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

Ali Faghri
Guggenheim Securities LLC

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

Scott L. Stember
MKM Partners LLC

Bret Jordan
Jefferies LLC

Gary Frank Prestopino
Barrington Research Associates, 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

Q3 HIGHLIGHTS

Management Team

- Last month, we announced a couple of important leadership changes, including Varun Laroyia moving from the CFO Chair to become the CEO of our European operations and Rick Galloway succeeding Varun
- Since that move happened with just a few weeks left in the quarter, after I provide some high-level comments, Varun and Rick will tag team on the financial details and the updated guidance for 2022

- I will then provide some closing comments before opening the call to your questions

Pandemic, Foreign Exchange Market and Transactional Exposure

- Once again, LKQ recorded strong operating results notwithstanding a very difficult macro environment
- The pandemic is still creating challenges, the labor market remains tight and the supply chain is less than optimal, so finally starting to show some signs of improvement
- The war continues in Europe and economies around the globe are showing signs of softness as many governments try to curb the runaway inflation created by the monetary stimulus utilized to support economies during the early days of the pandemic
- But the biggest current headwind is in the foreign exchange market, with the US dollar reaching levels we haven't seen in over 20 years
- While we can hedge much of our transactional exposure with about 46% of our revenue being sourced from our European segment, we cannot hedge the translation exposure

Exchange Rates and EPS

- To put things into perspective, the euro and pound sterling fell approximately 7% relative to the dollar during Q3 and have fallen about 15% since the start of 2022
- The volatility and exchange rates on a y-over-y basis had a material impact on our reported results during the quarter, reducing revenue by \$228mm and adjusted EPS by about \$0.07 per share during Q3
 - I believe when you focus on our local currency results, you will agree that our company is performing extremely well and we are quite pleased to achieve our EPS goals in light of the ongoing and challenging environment

Leadership Changes and Dividend

- The leadership changes announced in mid-September are moving forward in a seamless manner and clearly demonstrate the depth and breadth of our talent
- As discussed in each of the past three Investor Day events, talent management has been a key priority for LKQ and the benefits of that focus shine through at times like this
- Overall, it was a strong quarterly result and we continue to be optimistic about the future
- Our decision to increase the dividend reflects the confidence that we have in our business

Revenues

- Now, on to the quarter, revenue for Q3 2022 was \$3.1B, a decrease of about 5.9% as compared to \$3.3B in Q3 2021
- On a constant currency basis, third quarter revenue grew by about 1% to a little over \$3.3B.
- Parts and services organic revenue increased 4.8%, while the net impact of acquisitions and divestitures decreased revenue by 2.3% and the foreign exchange rates decreased revenue by 7.4% for a total parts and services revenue decrease of 5%
- Other revenue fell 17.4% due to changes in commodity prices relative to the same period in 2021
- And as a reminder, PGW was included in our third quarter 2021 results

Net Income, EPS and Prices

- Net income for the quarter was \$261mm as compared to \$284mm for the same period in 2021
- Diluted EPS for the quarter was \$0.95, compared to \$0.96 for the same period of 2021, a decrease of 1%

- On an adjusted basis, net income for the quarter was \$266mm as compared to \$300mm for the same period of 2021, a decrease of 11.4%
- Adjusted diluted EPS for the quarter was \$0.97 as compared to \$1.02 for the same period of 2021, a decrease of 4.9%
- Importantly, please note that FX volatility and lower metals prices collectively created \$0.16 per share headwind in Q3 2022 when compared to the 2021 results

North America

REVENUES, DIVESTITURES AND ORGANIC GROWTH

- Now, let's turn to the quarterly segment highlights
- In North America, organic revenue for parts and services of our North American segment increased 10.9% in the quarter on a y-over-y basis, which exceeded our expectations
- The impact of divestitures, primarily PGW, reduced revenue by 10.6% in the quarter
- This organic growth performance is outstanding when you consider that the industry data suggest that collision and liability-related auto claims were up only 2%
- Also, North America delivered these results in the midst of decrease in miles driven, which is largely due to the increase in fuel prices

Diagnostics Business

LOSS RATES TRENDING AND OFFICE OCCUPANCY

- According to the US Department of Transportation, miles driven decreased 3.3% in July and was up only [ph] 0.007% (00:07:51) in August
- That said, the long-term trends for North America continue to be very favorable
- Continued technician shortages will benefit our diagnostics business as shops look to outsource their diagnostic repairs
- Total loss rates trending down into the high-teens, parts per claim reaching over 12 parts per vehicle, a 20% increase from Q3 2018, and office occupancy hitting nearly a three-year high, which ultimately lead to more congestion in claims frequency

AFTERMARKET VOLUMES AND SPOT MARKET PRICING

- During the quarter, we were encouraged by the upward trend in our aftermarket volumes
- During the quarter, we experienced some relief in the aftermarket supply chain relative to Q2, which translated into an increase in our full rates
- The biggest challenge exists on the domestic side of the supply chain, including the rail carriers and truckers, all of which are out of our control
- In talking with several third-party experts, they generally expect these domestic challenges will continue into H1 2023
 - The spot market pricing for containers used in ocean freight has softened measurably, and our team is laser-focused on active rate reductions from our contracted carriers

Self Service Segment

REVENUES, PRICES AND EBITDA

- Now on to our Self Service segment
- Organic revenue for parts and services for our Self Service segment increased 7.2% for Q3
- The softness in commodity prices resulted in a decline in other revenue of 24.8%
- The soft metal prices also had a significant impact on segment EBITDA margins on a y-over-y basis
 - This was anticipated given the lag effect that Varun touched on during our second quarter call

European Segment

REVENUES, ACQUISITIONS, ORGANIC GROWTH AND SALES

- Moving on to our European segment, organic revenue for parts and services in Q3 increased 4.8% on a reported basis and 5.8% on a per day basis
- Acquisitions [ph] 0.5 of 1% (00:10:02) growth in the quarter, while the exchange rates resulted in a 14.7% decline on a y-over-y basis
- I am quite pleased with the organic growth, albeit mostly driven by price in an environment facing high inflation, continued supply chain hurdles and an energy crisis in Europe
- All of our European regional platforms recorded strong local currency organic revenue gains, with some being in the low double digits
- The only decline on a y-over-y basis related to the sale of product to Russian-based jobbers, which, as previously mentioned, we completely stopped back in February when the war commenced

Specialty Segment

REVENUES, ORGANIC GROWTH AND ACQUISITIONS

- Now, let's move on to our Specialty segment
- Organic parts and services revenue for Specialty declined 9.1% in the quarter, a sequential improvement from Q2, but still down and below our expectations
- You may recall, this segment reported 14% organic growth in Q3 of last year, so on a two-year stack, the annual revenue growth is still positive
- The impact of acquisitions had a 6.6% positive impact on revenue growth in Specialty, while as a predominantly US business, the exchange rates had a negligible impact

NEW RV UNIT SALES & SEMA-RELATED PRODUCTS AND RV PARTS

- During the quarter, certain product groups such as towing that have some exposure to new unit volume again underperformed during the quarter as the new RV unit sales have decreased YTD by over 23% through August
- As a reminder, the majority of our RV parts are replacement parts that are not tied to new unit volume, but are largely related to the size of the RV part, which is still running at record levels
- Also, some of the softness that the SEMA-related products faced in the quarter was due to a y-over-y decrease in light truck and SUV vehicle sales in the United States, an important vehicle category for our specialty offerings
- Total US light vehicle sales were flat y-over-y

RV INDUSTRY ASSOCIATION AWARD

- Importantly, I would like to congratulate our Specialty team for receiving the RV Industry Association award as the 2022 Distributor of the Year
 - This is the second year in a row for this recognition, further validation that our people are truly our greatest asset

OUTLOOK

Revenues

- Let's move on to initial Q4 revenue trends
- Revenue for our North America Wholesale operations has gotten off to a solid start, largely driven by the improvement in aftermarket fill rates
- Though we don't anticipate we will continue to run at these very high levels, particularly as we lap the pricing movements initiated last year
- Our European segment is also witnessing a good start, with growth rates continuing at Q3 levels
- Specialty revenue is also trending similar to Q3 performance, and it will have easier comps in Q4 compared to the rest of this year

Corporate Development Perspective and Divestitures

- From a corporate development perspective, in the [audio gap] (00:13:18) quarter, we divested our Florida shredder
- As part of this transaction, we entered into a supply agreement to which our Florida self-service yards will sell or offer to sell its crushed vehicles to the new acquirer
- We also divested our equity interest in a small subsidiary of Stahlbruber
- Neither of these divestitures are material

ESG Efforts and Participation Rate

- Our employees sit at the center of our ESG efforts, and we are in the process of working through our second employee engagement survey
- We just completed surveying all of our North American employees and are in process in Europe
- We have a lot of data to analyze, but the North American team had a 93% participation rate
- Our independent advisor has mentioned this is extremely high for these types of activities and is generally indicative of a high level of engagement across the workforce
- I look forward to sharing more on this topic once the process is complete

Rick Galloway

Chief Financial Officer & Senior Vice President

FINANCIAL HIGHLIGHTS

Strategic Initiatives

- I'm honored to take on the position of CFO of LKQ, and I look forward to driving our financial and strategic initiatives to lead the company to even greater success

- As part of the North American leadership team, I was heavily involved in rolling out and executing the operational excellence initiatives that have spurred significant improvement in profitability and cash flows over the last few years

Profitable Revenue Growth

- Now as CFO, I will continue to drive the organization's focus on profitable revenue growth, delivering strong margins and FCF generation from this new vantage point
- Especially as we face the macroeconomic headwinds Nick mentioned, it will be critical to lean in on productivity and efficiency, and I look forward to partnering with the segment teams to continue to drive this forward

EPS and Operational Performance

- Turning now to the consolidated results, we reported diluted EPS of \$0.95 and adjusted diluted EPS of \$0.97, which was \$0.05 reduction relative to Q3 last year
- 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 effects of \$0.09 from volatility in metals prices and \$0.07 from foreign currency exchange effects caused by the stronger dollar

PGW Business, Interest Rates and Tax Rate

- Additionally, we had negative effects of \$0.06 in total from: one, divesting the PGW business in Q2; two, higher interest rates; and three, a 20 basis point increase in the effective tax rate to 25.5%
- We mitigated about \$0.07 of the decline with the lower share count resulting from our share repurchase program

Wholesale North America Segment

EBITDA MARGINS, GROSS MARGINS AND EXPENSES

- Shifting to segment performance, much of the operational improvement in the quarter came from the Wholesale North America segment
- Going to slide 10, the segment EBITDA margin of 19.4% is a record for Q3
- We saw strong gross margin improvement of 190BPS, with a little over half from pricing and productivity initiatives and the remainder from the mix with the sale of the low margin PGW business
- Overhead expenses were favorable by 20BPS, primarily related to non-recurring expenses from Q3 2021
- We are very pleased with the way Wholesale is performing
- Now while we believe Wholesale will continue to generate strong margins, there will likely be moderation in the upcoming quarters as we move towards the long-term expectation we presented at Investor Day earlier this year

Self Service

- On Q2 call in July, we noted that Self Service would face difficult conditions in Q3
- And as expected, Self Service had a tough quarter with roughly breakeven segment EBITDA and a 2.6% margin

- With scrap metals prices falling, we experienced a negative lag effect as we turned cars purchased in Q2 when metals prices were higher at lower scrap prices
- We added a slide to the presentation to depict this effect

Scrap Metals Price

PRICES, COSTS AND GROSS MARGINS

- Looking at slide 29, you can see the delta between the average scrap metals price in Q2 of \$279, which influenced the amount we paid for the cars purchased and the current quarter average of \$198, which drove the amount we received when scrapping Q2 cars we purchased
- We wanted to provide this depiction to help provide more clarity on the lag effect
- But caution, there isn't a perfect correlation between scrap steel prices and car costs, as other market conditions will impact the purchase price of the cars
- The reduction in prices, along with lower volume processed in Q3, produced the decrease in gross margin and the negative leverage effect on overhead costs
- We expect improved sequential profitability in Q4 as we cycled through most of the higher cost Q2 purchases by the end of September

Varun Laroyia

Chief Executive Officer & Managing Director-LKQ Europe

HIGHLIGHTS

EBITDA Margins, Gross Margins and Other Expenses

- Appreciate that introduction and the overview of North America Wholesale and Self Service segments performance
- Let's move to slide 11 of the earning deck
- Europe delivered an 11.3% EBITDA margin for the quarter, down 20BPS from the prior-year period
- Gross margin improved by 10BPS, as we worked to offset inflation with procurement initiatives and pricing
- Overhead and other expenses increased by 30BPS, with inflation weighing primarily on personnel, freight, and fuel costs
- The segment's solid third quarter performance reinforces our expectation that we will deliver a double-digit margin for the full year, despite the macroeconomic headwinds around general inflation, energy costs, and the Russia-Ukraine conflict

Frontline Businesses

- While I have been in my new role as CEO of the European segment for a little over a month, I have gotten an opportunity to get an on-the-ground view of our operations and the management team, and I am even more impressed by the strength of our frontline businesses
- And despite the darkening macroeconomic clouds, with judicious and decisive prioritization, I am confident that we can achieve our long-term operational and financial target

EBITDA Margins, Revenues, Inflationary Pressures and Expenses

- Moving on to slide 12, Specialty's EBITDA margin of 10.8% declined 30BPS compared to the prior year coming from a decrease in overhead expense leverage driven by an organic revenue decline of 9.1% as they anniversary a tough comp from the prior year when the business delivered a nearly 14% organic revenue growth rate in Q3
- Inflationary pressures also pushed overhead expenses as a percentage of revenue higher, including personnel, freight, and fuel expenses
- The overhead expense increases were partially offset by a 70 basis point benefit from lower incentive compensation and 80BPS of benefits from operating expense synergies largely generated from the SeaWide acquisition of a year ago

Cash Flows and Balance Sheet Items

- Shifting to cash flows and the balance sheet
- We produced a healthy \$224mm in FCF during the quarter, bringing the YTD total to \$862mm
- We have made good progress in rebuilding our inventory levels in Wholesale North America and in Europe
- As shown on slide 32, we increased our inventory values in these segments, though please note that the dollar increase doesn't directly equate to a quantity change given the higher input costs, using North America aftermarket as an example with higher per unit costs, i.e. inventory balance in dollar terms is close to Q4 of 2019, while the total available quantity on-hand is down approximately 20%

Inventory, Cash Conversion Ratio and FCF

- We still have some work to do to optimize inventory at-hand, especially going into the busier winter season, so we expect further fine-tuning of inventory levels over the balance of the year
- Through September, the cash conversion ratio is 64% conversion of EBITDA to FCF just above our target range of 55% to 60%
- There continues to be timing elements that will reverse over the course of the year, for example, Q3 inventory build will result in higher outflows for payables in Q4
- And we are confident in our ability to generate sustainable FCF in line with our expectations

Net Debt, Net Leverage Ratio, Capital Structure and Credit Facility

- As of September 30, we had net debt of \$2.2B with a net leverage ratio of 1.3 times EBITDA, which is comfortably inside our target range of being below 2 times
- Our effective borrowing rate rose to 3% for the quarter and with the effect of rate hikes in the US and Europe
- We have \$1.6B in variable rate debt, so a 100 basis point rise in interest rates would increase annual interest expense by approximately \$16mm
- As you can imagine, we are evaluating our fixed vs. floating rate mix as part of a larger review of our capital structure and credit facility, which matures in approximately 15 months
- And we expect to complete this assessment shortly

Currency and Contracts

- Most of our transactions are conducted in the home entity's functional currency, for example, buying inventory for our US locations in US dollars or European entities borrowing funds in local currency to create a natural operating hedge
- As a result, our currency exposure is weighted to translation of foreign currency denominated results into US dollars rather than transaction gains and losses
- Where we have transaction exposures, we hedge through forward contracts
- We are comfortable with our current approach to managing foreign exchange risk, though we are monitoring market conditions to determine if a change in strategy is required

FCF, Dividends and Share Repurchasing

- With our strong FCF and the proceeds from the PGW Glass sale earlier this year, we have been able to return a significant amount of capital to our shareholders in 2022
- We repurchased over 17mm shares for \$891mm through September, including almost 7mm shares for \$343mm in Q3
- Additionally, we paid quarterly dividends totaling \$210mm YTD.
- We had approximately \$260mm available on the previous board share repurchase authorization as of September 30
- And we have remained active in the market in October with a further \$119mm purchased through last Friday
- Earlier this week, our board authorized \$1B increase to our share repurchase program for a total authorization of \$3.5B and extended the term through October of 2025
- We are pleased to have this program expansion to be able to continue to use share repurchases as part of our balanced capital allocation strategy
- As our earnings release of this morning indicated, the board also approved a quarterly cash dividend of \$0.275 per share, which will be paid on December 1 to stockholders of record as of November 17
 - This reflects a 10% increase in the quarterly dividend

Global Finance Organization, Profitability and FCF

- Before I turn the call back to Rick, I would like to take a moment to thank LKQ's leadership team, our global finance organization, and all our dedicated employees across the organization
- It has truly been a great privilege to serve as your CFO over these last five years
- Over that time, the company has achieved tremendous things with significant growth and profitability and FCF, building a rock solid fortress-like balance sheet and generating robust shareholder returns
- I truly appreciate everyone's efforts to reach this point and I feel honored to have been a part of the team during this pivotal period
- Now, we need to leverage our strengths to become even more successful
- I leave the finance organization in Rick's capable hands and I look forward to working with him in my new role

Rick Galloway

Chief Financial Officer & Senior Vice President

Q3 RESULTS

Foreign Exchange, Organic Parts and Service Growth

- I'm also looking forward to working with you in this new capacity
- I will conclude with our updated thoughts on projected 2022 results shown on slide 6
- Our guidance is based on current conditions and recent trends and assumes that scrap and precious metals prices hold near September 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 the balance of the year rates for the euro of \$0.97 and the pound sterling at \$1.11 vs. \$1.02 and \$1.20 in the previous guidance, effectively a 5% and 7.5% decline
- We narrowed the organic parts and service growth range to 4.75% to 5.75%, with the midpoint up slightly from our YTD growth at 5.1%
- Please note that we have one fewer selling day in Q4 this year

EPS

- We are projecting full-year adjusted diluted EPS in the range of \$3.85 to \$3.95 with a midpoint of \$3.90
- We have narrowed the range as we are three quarters through the year and lowered the midpoint of our prior guidance by \$0.05
- To understand why we reduced the midpoint, please refer to slide 7 in the presentation, which bridges our prior and current guidance figures

Operating Performance

CAPITAL ALLOCATION AND PRICES

- Operating performance remains solid and represents upside of \$0.02 relative to our prior guidance
- The frontline businesses continue their resilience in difficult conditions
- Capital allocation is also a benefit of \$0.03 relative to our prior guidance, primarily related to higher repurchase volume
- Note that we are including share repurchases through the week ended October 21 in our guidance
 - That's the good news, generally tied to the areas under our control
- Then, there are the negatives, which are primarily external factors
- Declining metals prices are projected to have a negative \$0.04 effect
- Headwinds from the weakening FX rates, mentioned earlier, contribute \$0.03 reduction relative to prior guidance and unless the trend reverses, will be a negative factor in 2023
- Taxes and interest drive another \$0.03 negative effect including the rate changes previously noted
- FX rates and metals prices can move significantly over time
 - We may have further upside or downside if the actual figures play out differently than we assume in our guidance

FCF, Cash Flows and EBITDA

- We expect to deliver approximately \$1B of FCF for the year, achieving FCF conversion in line with our expectations for the business

- Translation of foreign currency denominated cash flows will have a negative effect given the lower euro and pound sterling rates used in our latest estimates
- But we are still anticipating 55% to 60% EBITDA conversion to FCF adjusted for the PGW gain

Dominick P. Zarcone

President, Chief Executive Officer & Director

HIGHLIGHTS

- Let me restate our key initiatives, which are central to our culture and our objectives: first, to integrate our businesses and simplify our operating model; second, to focus on profitable revenue growth and sustainable margin expansion; third, to drive high levels of cash flow, which in turn give us the flexibility to maintain our balanced capital allocation strategy; and fourth, as always, to continue to invest in our future

Operating Environment

- As you can see from our results, we are committed to driving these metrics forward regardless of the operating environment
- Our teams across all of our segments are executing on their operational targets, and they have done a tremendous job during these unpredictable and unique times
- With respect to the items we can't control, such as FX rates, the supply chain, and labor market constraints, we don't have a crystal ball, but it appears we will be confronting these uncontrollable items as we enter 2023
- That said, I am confident our operational excellence efforts can navigate and effectively manage almost any challenge

CLOSING REMARKS

- Why? Simply stated, we have the best teams in each of our segments and industry, and their track record over the last three years speaks for itself
- And for that, I offer a tremendous thank you to our team members across the globe that make it happen each and every day
- They define what it means to be LKQ proud

QUESTION AND ANSWER SECTION

Daniel Imbro

Stephens, Inc.

Q

I want to start on something you said around kind of North American margins. I think the comment you made, would you expect them to moderate going forward maybe Q4 into next year? Can you just provide more detail on what the drivers of that outlook is? Is it a change in underlying core margins due to maybe wage or other cost pressure or kind of what was driving that comment around moderation going forward?

Rick Galloway

Chief Financial Officer & Senior Vice President

A

The margins we had in Q3, obviously, very favorable record that we had. And so, very pleased with what the team's done. One of the things that we've seen over the last, you know call it, 12 months or so is the competitive market and the ability of us to be able to pass-through some pricing and do it pretty effectively early on. So there's a couple of things that are happening.

One of the things that we'll see is the increase in our overall product cost inflation that we would expect and going back to what we've seen and what we told you guys in Q2 is, the long-term view for us is probably somewhere in the low to mid-17s is where we would expect that to be. With the inflationary increases that we keep seeing, the ability to pass on that cost to our customers will be a little more challenged as we come into 2023. I would think that it would be a slow move, a little bit slower move to those numbers that we've said on the long-term piece, though, so I don't know if you want to add anything on that [indiscernible] (00:32:21).

Michael E. Hoffman

Stifel, Nicolaus & Co., Inc.

Q

So I do have two. So this one's a little out of left field, it's geopolitical. So I'm curious about your views on, looking forward, it appears the EU energy crisis has peaked a bit. We're at full capacity on natural gas supplies. Maybe there's a little relief. So I'm curious about that. And then the other part of that same question. The China leadership – not changes but continuity. What's the plan B if China decides it's going to embargo shipping out of Taiwan? And what's plan B related to that? And then I have a question about 2023 after that.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

As you know and as everyone knows, the entire aftermarket collision parts industry moved to Taiwan decades ago. There are no material production capacity outside of Taiwan. It just doesn't exist. There are no plants sitting in Mexico or Vietnam or India sitting idle, waiting for the Taiwanese machine to get shut down, right? It doesn't exist. Now, we pay very close attention, obviously, to geopolitical events, and we're not overly concerned about the scenario that you laid out, where China would effectively shut down the Taiwanese economy, because they wouldn't pick out auto parts specifically. And the reality is, if they were to shut down the economy and shut down kind of shipments out of Taiwan, auto parts is the least of everyone's concern.

65% of all semiconductor production and 90% of all advanced chip production comes out of Taiwan. So if China were to embargo export shipments, you would not be able to buy iPhones or new cars or medical equipment or anything that has a chip in it. And we think that the Chinese leadership is – they're very smart. They certainly don't want to cook the golden goose that Taiwan represents in form of a really strong economy. Our sense, and in

talking with outside advisors, is it'd be more likely that China would move kind of to a Hong Kong model first, where they would seek to have significant influence over the territory, but not just shut – totally just shut down their economy.

Michael E. Hoffman

Stifel, Nicolaus & Co., Inc.

Q

And then, the second follow-up question, I realize you're still on budget process for 2023, but there are some knowns sitting here today. You know where your interest rates move to taxes, FX, freight. Of those pieces of the waterfall, what is the net, +/- of those relative to the new midpoint? And then clearly, you have a positive view about their structural growth still, so I'm just trying to understand the known headwinds.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

So on the 2023 outlook, you are absolutely correct. We're in the middle of our budget process, and we have yet to see any submissions from the field. We don't have a consolidated view at this time. What I can tell you, however, is that nothing has changed materially from what we presented back at the Analyst Day and the Investor Day this past June 1 in Nashville. So on the revenue front, we will likely shake out at a consolidated per day growth rate similar to 2023 or similar to 2022. But we'd probably get there with a slightly different mix. As indicated in my prepared comments, we do not anticipate that the recent double-digit organic growth in North America Wholesale business will be sustainable. It's just – it's too high.

Europe should post up similar organic growth next year as what we're doing this year, which is in the mid-single digits. We do anticipate that Specialty will return to positive revenue growth, likely in the low to mid-single digits. And Self Service, assuming scrap prices stay where they are, can sustain low to mid-single-digit growth as well for their parts and services business. All that obviously is based on what we talked about in Nashville, and that is market growth being in the low-single digits, a bit of share gain, which we always are trying to achieve each and every year in each of our businesses, and some boost from inflation.

As Rick indicated, 2023 will have one pure selling day than 2022, which [ph] clips you for (00:37:52) a few basis points of growth, 40BPS to be exact. And so hopefully that gives you a sense of local currency revenue trends. But the strong dollars that we've had this year, that's going to carry over assuming rates stay about where they are next year. And so, Michael, when you and everyone else on the call are building your models, you should probably bake in kind of the exchange rates over the last few weeks, which is about \$0.97 for the euro and \$1.11 for the sterling, because at those levels, just to put it in perspective, that's like \$450mm headwind from a US dollar perspective after taking into account the translation impact of the currencies.

Now in terms of margins, as we just indicated in answering Daniel's questions, long term, we believe that our North American Wholesale business can sustain margins in that low to mid-17% range. We don't expect to go from where we are today down to 17% next year. We think it's going to be a more gradual decline. In Europe, we are absolutely committed to achieving consistent double-digit EBITDA margins. The 1 LKQ Europe Program is still underway. We would expect to see some minor margin improvements with Specialty, particularly if we can get some modest revenue growth. And the Self Service margins, assuming no significant changes in scrap prices, should get back to kind of mid-teens.

On FCF, again, 55% to 60% of EBITDA, we believe, is the right target. Interest costs will be higher, due to the impact of the higher rates on our floating rate line of credit balances. As Varun indicated, that was about \$1.6B as of September 30. At current interest rates, that would be about \$28mm headwind, which is about \$0.07 per share. Now, obviously, EPS will benefit from the 17mm shares that we've repurchased thus far in 2022. So, we've got a

lot of work ahead of us on the budgeting front, but hopefully that gives you enough to get into the right zip code when building your models for next year.

Ali Faghri

Guggenheim Securities LLC

Q

So my question is on used car pricing. Obviously, we're seeing used car prices come down real-time right now. Maybe you could remind us what the impact is of lower used car prices on your business.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

Simply lower used car prices generally translate into lower cost of the vehicles, of the total lost vehicles at the salvage auctions. Because there's, you know, as prices come down, the competition at the auctions includes we builders. And if used car prices come down, what they can pay for their feedstock, if you will, that total lost vehicle has to come down as well if they're going to maintain their margins. And so, it's not a dollar for dollar reduction, if you will. But we would expect that as used car prices settle down a little bit, that the price that we have to pay for the cars at auction will also come in a bit.

Craig R. Kennison

Robert W. Baird & Co., Inc.

Q

And congratulations to the whole team. Varun, I wanted to start with you and ask about your priorities for Europe and maybe frame them in the context of the LKQ 1 (sic) [1 LKQ] (00:42:09) strategy. Where do you see an opportunity to double down on some of these initiatives and where might you dial back your priorities in order to focus on what you see as the highest priority?

Varun Laroyia

Chief Executive Officer & Managing Director-LKQ Europe

A

Super excited both Rick and myself, but I think it's really yet another testament to the work that we as a management team have done from a talent development perspective that, you know, all the dominos that kind of went through were all fulfilled internal, with internal talent.

With regards to the European business, now that I'd been on the ground for a little over a month at this point of time, I kid you not, I am so excited about the opportunities we have out there, both internal and external. And I kind of frame it up from a market perspective in any case. If you think about the limited new car inventory, think about elevated used car prices, think about the aging car park, these are all supportive of a healthy demand in the aftermarket, so that's just kind of framing the piece. And despite the fact that VMT is under pressure, given the energy prices over in Europe, listen, people are still doing hybrid working.

So, as you think about the go forward run rate with regards to more people coming from, say, a day into the office a week to two days, moving now towards companies trying to push for three days a week and then from there on, VMT will recover and hopefully at some point of time once the geopolitical crises also tend to calm down a little bit, more specifically, the Ukraine-Russia conflict that's ongoing, I am bullish about the future. So [indiscernible] (00:43:48) just in terms of framing that entire piece.

With regards to my specific priorities, very simple, the one – first one is, we grow the business and we will grow the business faster than the market. Organic growth will be the key focus, though we always have the opportunity to look into highly accretive and selective acquisitions. So, number one, grow the business. The second one is be decisive about prioritization and then just flawlessly execute. We have so much opportunity across Europe that

arguably on the flip side of it is, we have too much opportunity. And so, really the key piece that I have shared with my management team is making the fundamentals, building the fundamentals, which essentially as a distribution business is the right part at the right place and at the right price. And then, we will deliver flawlessly, right?

We are here to promote affordable mobility and that really is what we do. There is no one else that has the kind of distribution footprint, the scale, the ability to invest through cycles. Our advanced logistics distribution centers like in Tamworth, in Berkel, in Sulzbach-Rosenberg, coupled with an aging car park, super excited. And this is before I get into some of the internal programs such as back office and private label. Those continue to remain opportunities for us. So, number one, grow the business faster than the market. Second, be decisive about prioritization and flawlessly execute. And the final one is developing talent. We have a tremendous management team out there. Super, super – I've got to put them up against absolutely anybody. But again, our ability to develop talent further as we continue to execute on the various opportunities out there.

To your question about the 1 LKQ Europe Program, if you can actually pull out the presentation that Nick and myself had presented on the 10th of September of 2019, there were four fundamental building blocks. One was procurement. The second one was private label. A third was revenue optimization. And then, the fourth one was essentially the ERP. Those are the key priorities and that is really where we are doubling down. I feel super excited about where we are, but clearly there is more work to be done. And just making sure that we don't get distracted by the various, I'd say, peripheral opportunities and really double down on what we had committed to doing. So, that really is where we are. And as I said, yes, the macroeconomic clouds are darkening, but in terms of our ability to execute through those, given the sectoral tailwinds, very, very excited.

Scott L. Stember

MKM Partners LLC

Q

And I echo my compliments as well to everybody in management.

Scott L. Stember

MKM Partners LLC

Q

You guys talked about Europe, seeing some areas that are growing in low doubles. Could you just maybe parse out which areas in Europe did better? And with regards to, I guess, what you're seeing right now, are you seeing any signs that the countercyclical benefits of mechanical aftermarket are starting to kick in?

Varun Laroyia

Chief Executive Officer & Managing Director-LKQ Europe

A

Actually, let me answer your question. Listen, in terms of the elevated gas prices, those are something that – that's something that we're certainly tracking. We don't get regular VMT data like we get in the United States, but there are other metrics, other KPIs that essentially kind of give you the same result, whether it be congestion indices, whether it be fuel consumption, diesel, petrol things along those lines. So that is something that I am keenly watching along with my team.

And, yes, there are certain pressures from that perspective, but having said that, pricing, the higher input costs that's coming through is being priced through across the entire market, right? And that's kind of moving into, call it, mid to high-single digits, and that is coming through. You can see that through the gross margin side of things also. So with regards to, is there any deferral taking place at this point of time, we really haven't seen any deferral other than the fact that service mechanicals, you need to, if you're driving and even if you're not driving, once a

year, you need to get your oil and oil filter changed, for example. So from that perspective, the countercyclical nature of what we do over in Europe is actually very, very resilient and that really is what we are excited about.

Pricing is ticking through at this point of time and I know given how we operate our businesses, service reliability, having access to inventory, having a pristine balance sheet that supports us, my sense is there will be more stress in the broader market but the larger ones will continue to power their way through, because we've seen some fairly rational behavior taking place across the market.

I think on a go-forward basis, something to watch out for is inflation, okay, and that certainly, while it's kind of gone through the COGS side of it and that has stuck, my sense is that certainly we will be coming through on the labor side. I think based on CPI number that we're seeing out of the various European markets, that certainly is a key focus area for my team and myself and really driving the productivity side of things where again, we have a tremendous opportunity as you know with the three advanced logistics distribution centers that we've already set up essentially to future-proof our business. But again, lots more to do out there. And again, it won't be plain sailing for everybody, but really, this is when market leaders, thoughtful leadership teams, really rise to the top.

Scott L. Stember

MKM Partners LLC

Q

And just one follow-up. Any update on State Farm?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

The answer is, yes and no. So as you recall, Scott, last – during the summer, State Farm initiated a 12-week pilot program in the State of Texas and Oklahoma where they decided to start using aftermarket headlights, tail lights and bumpers. Well [indiscernible] (00:50:24) come to an end. That said, State Farm has continued to keep the program alive in the State of Texas and in the State of Oklahoma. And it's active today. We're assuming that State Farm is reviewing all the data from their pilot. And certainly while there can be no assurances of any change, we take the fact that the program is still on place and ongoing a month or so after it was supposed to come to a close, we take that as a positive indication.

Look, there's nothing more that we would prefer than for State Farm to expand the program, both from a geographic perspective, I mean, taking the national would be awesome. And from a product perspective, that being all aftermarket parts as opposed to just headlights, tail lights and bumpers. We have a continuous dialogue with all the major insurance companies. We're in constant communication. And obviously, if State Farm decides to broaden their aftermarket utilization, we will be sure to let everybody know. So officially, there's no news. But unofficially, they're keeping the pilot going, which we take as a positive as opposed to a negative.

Bret Jordan

Jefferies LLC

Q

Now that you've been in Europe for a month, and I guess we were talking about the 1 LKQ plan, how do you handicap that ERP consolidation and maybe if you could talk about sort of over what period of time. It seems like such a complicated mix of supply chain systems over there. Having lived with it – that is – is that a big an opportunity as you thought initially?

Varun Laroyia

Chief Executive Officer & Managing Director-LKQ Europe

A

I think, in terms of just to kind of remind everyone from a broader perspective, you're essentially talking about the, you know, one of the key underpinnings of the 1 LKQ Europe Program was to essentially integrate certain backend processes of the business. So maintaining the front-end entrepreneurial local nature of our business and making sure we have best-in-class customer intimacy and also the last mile of delivery, no change to any of that. But in terms of, you know, one of the key enablers in unlocking the overall cost to serve is from a back office perspective. Nick and I have talked about this ad nauseam with regards to where we get up here [ph] boils (00:53:08) down from where payroll runs from, that, frankly, one really doesn't care about as much as long as it is done efficiently and effectively.

But really, it's the case of having the ERP system out there, which unlocks all of these [ph] pieces (00:53:23). Nothing has changed on that front. And if you go back to thinking about how we built up the European business, largely both through private equity companies, and that has, I think, as all of us know, typically have a very limited time horizon with regards to certain investments. So in terms of making the investment on the ERP, no change at all. In fact, that's an area that I'm working with my management team to double down and get it done even quicker, because the pools of opportunity that it opens up are still very, very attractive. So no change on that front, and really making sure that the entire organization has got its shoulder behind it, rather than it being a technology project. So some do difference out there in the first few weeks, but overall, no change on that front in terms of where we're going.

Bret Jordan

Jefferies LLC

Q

And then a question on Specialty, when you think about the RV business vs. the SEMA type categories, could you sort of talk about relative cyclicity? And I think you'd expected sort of positive low-single-digit growth in 2023. What would be the impact of a recession, maybe as you look at the SEMA side of that business?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

What we have seen is our revenue on the RV side is not tied necessarily to RV SAAR new unit sales, as much as it's tied to campground utilization. And so, unlike there are a couple of product lines that I indicated, things like towing, there is a direct correlation to new unit sales, because the first time RV buyers usually need to get hitches and related towing gear installed on their vehicle. But again, most of the RV revenue comes from kind of consumables and things that need to be replaced. And that's directly related to the overall size of the RV park, as well as the campground utilization, which is currently running at record levels.

And so, there's going to be a little bit of a yin and a yang if a recession really does hit. What we also know is that during recessionary times, folks kind of reallocate their vacation dollars and would tend to shy away from getting on a plane and flying to Disney World and look for more cost-effective ways to vacation with their families [ph] and camping (00:56:07) cost-effective way of doing that.

On the SEMA side of the business, there are a number of products tied to new vehicle sales, particularly pickup trucks, jeeps, and other SUVs. The enthusiast marketplace tends to hold pretty steady through the recessionary environments. And so, at the end of the day, Bret, it depends on how deep and how long the recession goes. And we can't predict that. We feel good about our market position as being the leader in that market. And we will continue to work hard to drive profitable revenue growth whenever we can.

Gary Frank Prestopino

Barrington Research Associates, Inc.

Q

Quick question on the recycled side, I mean, we could be looking at an unprecedented decline in used car prices for the next year or two. How does that impact what you're buying at auction? And then I guess the other question I would have there is, do you see – do the prices of the parts, as the cars come down on the recycled side, do they come down concurrently with the decline in car prices?

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

The reality is, as prices come down, as I indicated, the cost of what we have to pay at auction tends to come down as well. Again, it's not dollar for dollar, but there is a correlation there. The reality is, that doesn't make us buy more vehicles or not. We buy the vehicles that we need to have the inventory that we believe is required to fulfill customer demand, okay?

We don't bid on every car that comes to the auction, and we bid on the vehicles based on the parts demand that we see and the need to have the inventory. And so that's not going to change. We're going to stay very focused on utilizing our models, our AI, and like to buy the vehicles that we need to drive the best margin. Just buying a total loss vehicle because it's for sale, if those [indiscernible] (00:58:51) going to sit on the warehouse shelf for the next year or two, there's no utility to us doing that.

And so we focus on buying what we need. And if the car prices come down, that is great. We do not adjust [indiscernible] (00:59:07) of the parts based on the cost of the car, because again, we price relative to where the OEs have their prices, we need to maintain that value proposition for the insurance companies to continue to have them push the utilization of alternative parts. And so our ability to price up is, in some parts, based on what the OEs are doing. But just because the price comes down doesn't mean we automatically lower the price of the parts that we sell. But, Rick, anything else?

Rick Galloway

Chief Financial Officer & Senior Vice President

A

I think it was spot on.

Gary Frank Prestopino

Barrington Research Associates, Inc.

Q

And then lastly, Varun, you mentioned something about – or somebody did, what's the impact of a 100 basis point increase in interest rates on your interest expense?

Varun Laroyia

Chief Executive Officer & Managing Director-LKQ Europe

A

I'm the one who mentioned that, Gary. Essentially, at the end of September, we had about \$1.6B of variable rate debt on the revolver. So, every 100BPS will essentially be \$16mm of higher interest expense. That was a simple math. So, total debt was about \$2.4B. We had cash on hand of about \$270mm, so net debt of \$2.2B. But as you know, we've got two Eurobonds, \$0.5B and [ph] \$250mm (01:00:27). So, really, the only change on that, really, would be on the variable rate debt.

Michael E. Hoffman

Stifel, Nicolaus & Co., Inc.

Q

For letting me do the follow-up. When do we see – well, maybe you answered it by saying, there'd be a gradual decline back to normal margins in the US, the benefit of freight coming through on the inventory, is a margin plus.

Rick Galloway

Chief Financial Officer & Senior Vice President

A

So appreciate the question. So we've been seeing a – obviously the spike that we saw earlier in the year, late last year, earlier this year, and so you'd start seeing the relative decline over Q4 going into Q1 as it sort of normalizes with a lot of offsetting items, right. So there's the other inflationary increases that we're keeping a keen eye on along with product cost increases that are somewhat flowing through that inventory level as well. So the other thing to keep in mind is that, as the spot market was rapidly going up due to our size and scale, we were able to get a lot of contracted rates and so, some of the increase that we saw would have been mitigated against competition.

Dominick P. Zarcone

President, Chief Executive Officer & Director

A

So another way of thinking about that, Michael, is as the spot pricing escalated from what was \$2,500 for a 40-foot container back in 2019 to as high as \$20,000 in parts of 2021 and early 2022. Because so much of our volume came on contracted rates, we were hurt less than our smaller competitors when the spot markets soared and we're going to benefit less as spot market comes back in. That will all roll through our inventory and then ultimately into the cost of goods sold.

Dominick P. Zarcone

President, Chief Executive Officer & Director

CLOSING REMARKS

- Well, obviously, as always, we really thank you for your time and attention
- We understand there's a lot of things going on today and in the markets
- We certainly look forward to providing another update in late February of 2023 when we report our fourth quarter and full year 2022 results
- And at that point in time, we'll establish obviously our full year 2023 guidance
- So again, we appreciate your time and attention as always and thanks for your interest in LKQ

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