



Home	Companies	Funds	ETFs	Markets	Articles & Videos	Portfolio	Help & Education	Newsletters	Enter a Ticker or Name
------	-----------	-------	------	---------	-------------------	-----------	------------------	-------------	------------------------

## LKQ Corp LKQ |

PDF Report

Quote Chart **Stock Analysis** Performance Key Ratios Financials Valuation Insiders Shareholders Transcripts Filings Bonds Options

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

### LKQ Expands Offerings While Consolidating European Operations



by  
 Scott Pope  
 Equity Analyst

**Analyst Note** 07/25/2019

Despite numerous unfavorable factors in the second quarter, narrow-moat LKQ was able to deliver adjusted EPS of \$0.65, which slightly exceeded consensus of \$0.64. Macroeconomic headwinds in Europe coincided with optimization efforts in the region, which led to a 90-basis point year over-year drop in segment EBITDA margin to 7.7%. Compounding matters was a 2.6% decline in repairable auto claims in North America. The

collective effects of these mostly exogenous factors led management to revise 2019 GAAP and adjusted EPS downward by \$0.17 and \$0.06, respectively. We believe these impediments are temporary and feel significant synergies will ultimately be realized across LKQ's disparate operations. Initiatives such as its European catalog consolidation will help close the 650-basis point gap between North American and European EBITDA margins. As our long-term view has not changed after LKQ's second-quarter release, we are maintaining our fair value estimate of \$38.00.

Consistent with news from companies in our heavy equipment sector, weakness in Europe related to Brexit and a malaise in Italy constrained LKQ's sales in the region. This led to an organic 4.3% year-over-year decline in segment revenue as customers chose to forestall auto repairs. We believe the inevitable can only be delayed so long before more expensive outlays are incurred. Additionally, LKQ may modestly benefit during weak economic conditions as owners delay new car purchases and automobile fleets age. That said, we were disappointed that management failed to provide concrete information on progress of its European transformation efforts. Instead, they will provide an update to the investment community in September after a third-party consulting firm has reviewed its operations.

Despite a strong North American economy, LKQ's revenues were muted in the region during the second quarter. Organic growth declined by 0.4% year over year as milder weather led to a reduction in collision claims.

#### Business Strategy and Outlook 03/01/2019

LKQ is a leading alternative automobile parts distributor with operations in North America and Europe. The range of products it distributes includes new aftermarket parts and remanufactured and recycled parts, typically at a discount of up to 50% over OEM parts. Its ability to source new products from low-cost overseas manufacturers and to obtain parts through salvaging more than 300,000 automobiles annually gives LKQ unparalleled scale of operations. In addition, it has combined extensive distribution networks in North America and Europe with local delivery and strong customer relationships. These elements allow LKQ to offer its repair shop customers significantly higher fulfillment rates than its competitors.

Beginning in 1998 as a roll-up of auto salvage companies in the fragmented North American market, LKQ quickly grew its operations through more than 260 acquisitions and by increasing its market penetration. It now sells a broad spectrum

#### Morningstar's Take LKQ

Analyst		
<b>Price</b> 08-07-2019	<b>Fair Value Estimate</b>	<b>Uncertainty</b>
25.57 USD	38 USD	Medium
<b>Consider Buy</b>	<b>Consider Sell</b>	<b>Economic Moat</b>
26.6 USD	51.3 USD	Narrow
<b>Stewardship Rating</b>		
Standard		

#### Bulls Say

- LKQ has demonstrated its ability to grow its business through a successful acquisition strategy without experiencing significant earnings volatility.
- Its difficult-to-replicate distribution network combined with its sophisticated procurement activities has enabled LKQ to provide its customers with the highest fulfillment rates and best prices, which will lead to ongoing market share gains.
- It has developed symbiotic relationships with auto insurance companies as both the largest supplier of alternative collision parts to repair shops and the biggest buyer of salvage vehicles.

#### Bears Say

- OEM collision parts manufacturers are becoming more aggressive with their discounting strategies that have slowed growth of alternative parts purchases by repair shops.
- Laws intended to protect consumers from potentially inferior non-OEM collision repair parts vary by state and could become less favorable for alternative parts suppliers in the future.
- The challenges LKQ faces in consolidating its European operations are very different from those it experienced during its North American roll-up activities. Integration costs are likely to weigh on margins for many years.

#### Competitors LKQ

More...

Name	Price	% Chg	TTM Sales \$ mil
<b>LKQ Corp</b>	<b>\$25.57</b>	<b>0.08</b>	<b>12,474</b>
Denso Corp ADR	\$21.09	-0.05	50,561
Denso Corp	\$44.61	3.99	50,561
Continental AG ADR	\$13.54	0.52	49,705
Continental AG	\$132.71	-5.88	49,705
Aptiv PLC	\$83.52	0.38	14,323

of vehicle parts, including specialty items, in North America and Europe. Along the way, it has amassed over 75 LKQ Pick Your Part salvage yards that acquire over 500,000 vehicles per year and are open to public.

LKQ's addressable market for wholesale parts purchased by mechanical and collision repair shops is \$106 billion in North America and \$168 billion in Europe. Currently, LKQ supplies approximately 4.3% and 3.1% of aftermarket parts in the North American and European markets, respectively. Repair shops are often time-pressed, as the lack of a single part can halt the repair process. Such customers can be impatient, demanding strong customer service capabilities that minimize their downtime. This characteristic favors LKQ, which can provide inventory from different sources and shift it across geographic areas as needed.

Insurance companies have played an important role in LKQ's growth story. As they seek to minimize both costs and downtime of their policyholders' automobiles, they have steered collision repair shops toward LKQ. As LKQ has grown, its relationships with insurers has strengthened as it has become the largest purchaser of their salvage vehicles.

#### **Economic Moat** 03/01/2019

LKQ's narrow moat is rooted in its ability to maintain a cost advantage, which is realized through its extensive distribution networks in North America and Europe along with its unique procurement abilities. In total, LKQ maintains over 1,500 locations. From the customer's standpoint, the principal benefits of LKQ's business model include high fulfillment rates, which are 95% compared with approximately 65% for the best competitors, and LKQ's ability to provide a savings of 20% to 50% on OEM part prices. For the past 10 years, it has generated returns on invested capital, including goodwill, averaging 9.3% compared with a weighted average cost of capital of 7.9%. While we forecast average ROICs for the next five years of only 8.7% because of large acquisitions in Europe, we expect LKQ's ROIC to reach 9.3% by 2023 as it refines its operations outside of North America.

The logistics advantage provided by the sophistication of LKQ's distribution and depth of catalog manifests itself in rapid turnaround time where parts can be delivered in less than 24 hours. In North America, its distribution system employs tractor-trailers to ship parts across states, if necessary, and local drivers who are familiar with local repair shops. In certain U.K. operations, parts can be transported via a third-party motorcycle fleet for exceptionally rapid delivery. Providing a mix of new aftermarket, recycled, remanufactured, and specialty products across a region allows LKQ to shift inventory between warehouse locations to maximize fulfillment rates and minimize delivery times. In some cases, these parts can include difficult-to-stock items, such as a complete car door.

While LKQ offers e-commerce, its call centers receive over 1 million calls per week. Often these inquiries are from individual repair shop customers who are time-pressed to complete a job that may be stalled by lack of a single part. Many of these repair shop owners are older--in their 50s and 60s--and impatient, desiring to speak to a representative immediately instead of using an e-commerce alternative. This nuance would make it difficult for an online-centric alternative to capture significant market share in the near term. It is a tremendous benefit for repair shop owners to have the ability to contact a large, single distributor with a deep catalog instead of juggling myriad smaller suppliers. This enables larger entities with strong customer service capabilities, such as LKQ, to capture greater market share over time.

Having a large network and customer base enabled LKQ to embark on big data and predictive modeling initiatives. In some regions, it is using data analytics to drive weather-related stocking and sales. It is also using data science to provide a better understanding of price elasticity and customer purchasing behavior. The greater volume of data it collects through improvement of these systems, along with its underlying growth, enhances the value of this information, enabling LKQ to improve further its cost advantage and margins.

The large scale of LKQ's procurement of salvage vehicles further bolsters its moat.

Approximately 4 million cars become available for LKQ to bid on annually. Only 8% of these can be absorbed by LKQ. Because much of the bidding for these vehicles has transitioned to an online format, many of LKQ's bidders are using photos and vehicle specifications compared against the company's current and anticipated parts needs provided by internally developed technology integrated into its salvage ERP system. This software provides bidding guidance, including an estimated maximum bid and hints for areas requiring closer evaluation, such as impact damage to the engine compartment. By establishing an operations center in Bangalore, India, LKQ was able to offshore a significant portion of its online bidding activity, allowing it to further reduce costs.

Environmental matters related to LKQ's auto salvage yards and self-service locations further enhance the moat. In many cases, these facilities can be difficult to create on greenfield spaces due to requisite government permits and local opposition. The separation of hazardous materials, recycling of fluids, cleanup of accidental spills, and companywide environmental risk avoidance requires expertise based on institutional knowledge gained over decades. On the flip side, the establishment of a larger, more sophisticated entity may present a bigger target for litigation and government fines than the small and medium-size businesses acquired. Yet, we believe the professionalism and legal acumen maintained under a larger corporate structure outweigh the risks.

As it has grown in scale and scope, LKQ has strengthened its relationships with automobile insurance carriers in North America, as these entities pay for most collision repairs in the region. While insurance carriers are not the direct customers of LKQ, as the auto repair shops purchase the parts, LKQ provides insurance companies a range of free services, such as the review of repair estimates, direct quotations to adjusters, and participation in aftermarket quality-assurance programs. As a result of its significant growth, LKQ has become the largest acquirer of total loss vehicles sold by insurance carriers, further solidifying the company's relationships with these entities.

#### **Fair Value and Profit Drivers** 04/26/2019

Our \$38 fair value estimate is principally driven by our assumptions of alternative parts adoption trends and LKQ's ability to consolidate its operations in Europe. Given the company's mix of less aggressive acquisition activities and modest organic revenue growth, we forecast a five-year average annual revenue growth of approximately 5%. Our midcycle organic revenue growth estimates in 2023 are 2.7% in North America and 2.6% in Europe. Based on CCC Information Services data, alternative auto-parts usage in collision repairs in North America increased to 37% in 2013, where it has appeared to have plateaued, from approximately 23% in 2000. Our recent research suggests that OEMs have been fighting the erosion of their market share with price-matching programs. LKQ's auto-parts sales in Europe are mostly for mechanical repairs, which leaves open the possibility of growth of collision parts sales in the region. We believe the improvement in and consolidation of its catalogs should increase its parts availability and expand customer choice, which should lead to organic revenue growth. We believe LKQ has significant opportunity to improve the profitability of its European operations through consolidation of many redundant functions. At the same time, it can increase its buying power through the recent growth of its operations, as it has become the largest procurer of aftermarket auto parts in the region. Unfortunately, LKQ does not report operating margin by segment; however, it does provide EBITDA margin information by segment, including "other" revenue, which includes scrap sales that are not part of European operations. In this apples-to-oranges comparison, European EBITDA margin in 2018 was approximately 8.1% versus 12.7% in North America. We assume that management will be moderately successful with its European consolidation, lifting margins for that segment that will elevate the company's historically low operating margin of 8.0% in 2018 to 10.5% in 2023.

#### **Risk and Uncertainty** 03/01/2019

LKQ's acquisition model is inherently risky. Individual deals can incur unique costs, present delays, and distract management from running existing businesses. LKQ has been fortunate in that it has not suffered from major deal hiccups of which we are aware. Future deals are expected but are likely to be smaller and less risky than the \$1.4 billion acquisition of Stahlgruber in 2018 or the \$1.1 billion acquisition of Rhiag in 2015.

The most pressing issue now is LKQ's integration and streamlining of its operations in Europe, where it is now the largest distributor of aftermarket automotive parts. After the acquisition of Stahlgruber, LKQ has 10 parts catalogs in Europe that it is trying to consolidate into one or two. The consolidation is a very complicated process, as the catalogs are very detailed and incorporate 3D images of the parts along with installation instructions. Further complicating matters is the constant influx of new parts that must be added to the underlying databases. LKQ has a history of managing disparate operations in North America, but European efforts present new problems because there are 13 languages and 10 currencies in LKQ Europe. As Europe is now the largest revenue-generating segment while also generating the lowest EBITDA margin, we will be looking carefully for evidence of the synergies in future quarters.

#### **Stewardship** 04/26/2019

We assign LKQ a standard stewardship rating. At the helm of the firm is Dominick Zarcone, who became CEO of LKQ in 2017 and was previously CFO of the company in the prior two years. He has a long history as an investment banker at Robert W. Baird and Kidder, Peabody & Co. We view this experience very favorably, as LKQ has an extraordinary deal flow due to the very nature of its roll-up strategy. Joseph Holsten, who now serves as chairman, was recruited to be CEO of LKQ when it was founded in 1998 and held the role until 2011, when he became co-CEO with Robert Wagman. Holsten subsequently retired in 2012. We like that the CEO role is separate from that of the chairman, who conveniently provides the board with unparalleled knowledge of the business.

Assisting Zarcone is Varun Loroyia, who joined LKQ in 2017 as CFO. He previously held executive positions at CBRE, Johnson Controls, Gateway, and GE. His international experience, including his early career at KPMG in London, is particularly valuable as LKQ expands its business in Europe and, more specifically, beefs up operations in the U.K.

LKQ's profitability has fluctuated modestly throughout its existence, and the company experienced its last annual loss in 2002. Its ability to maintain profitability throughout economic cycles and concurrently grow the business gives us reasonable confidence that management is allocating capital wisely. Because LKQ's acquisitive nature is known to other industry participants, it receives a large volume of inbound deal offers. LKQ rejects most of these inquiries, as it exercises discipline about insuring fit and maintaining margins. This could explain why the range of its operating margins over the past decade has been rather narrow, reaching a high of 12.1% in 2010 and a low of 8.0% in 2018.

#### **Overview**

##### **Profile:**

Chicago, -based LKQ is a leading global distributor of vehicle parts. Initially formed in 1998 as a consolidator of auto salvage operations in the United States, it has since greatly expanded its scope to include distribution of new mechanical and collision parts, specialty auto equipment, and remanufactured and recycled parts in both Europe and North America. It still maintains its auto salvage business and owns over 75 LKQ pick-your-part junkyards. Separate from the self-service business, LKQ purchases over 300,000 salvage automobiles annually that are used to extract parts for resale. Globally, LKQ maintains approximately 1,500 facilities.

S&P 500 index data: S&P 500 Copyright @ 2019

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. @ Copyright 2019 Morningstar, Inc.

**Contact us.** Please read our User's Agreement and Troubleshooting documents.  
©2019 Morningstar, Inc. All rights reserved.