LKQ Corporation (LKQ)

Company Description
LKQ Corporation is the largest provider of alternative collision replacement parts, including recycled parts and aftermarket parts. The company obtains and dismantles salvage vehicles (recycled parts) and sources aftermarket parts from Asia (generic parts) to supply the collision repair market with an alternative to more expensive original equipment parts. LKQ also remanufactures aluminum alloy wheels and refurbishes head and tail lamps and bumpers for this market. LKQ partners with insurers to drive demand for alternative parts, which often cost 20-40% less than comparable new original equipment parts. In 2011, LKQ acquired Euro Cart Parts, a leading commercial distributor of aftermarket parts based in the UK. Since 2011, LKQ has continued to expand its European footprint, making three subsequent acquisitions (Sator Beheer – 2013; Rhiag – 2016; Stahlgruber – 2018), which expanded the company's presence in continental Europe (Benelux region; Italy & Eastern Europe; Germany). Additionally, LKQ entered the Specialty part market in 2014, through the acquisition of Keystone Automotive and entered the automotive glass market in April 2016, through the acquisition of Pittsburgh Glass Works (PGW).

Revenue Profile

Revenue
- Sell recycled OE, generic, and remanufactured parts to collision repair shops
- Sell fluids and reclaimable parts (e.g., alternators) to remanufacturers
- Sell remaining vehicle "hulk" to scrap dealers
- Europe: sell primarily mechanical parts for the UK, Benelux, Italian, and Eastern European repair markets
- Specialty: sell specialty aftermarket parts (e.g., floor mats) to specialty retailers and equipment installers in North America

Revenue by Segment - 2019

- North America: 39%
- Europe: 49%
- Specialty: 12%

Source: Company data, Baird research
Quick Summary
LKQ beat expectations but noted stiff headwinds as driving activity slows during the global pandemic. As we anticipated, a massive decline in vehicle miles traveled (VMT) has caused demand for collision and mechanical auto parts to plummet, temporarily. Management announced aggressive measures to reduce costs and preserve profitability and positive cash flow. While we lowered our 2020 EPS forecast (steeper revenue loss), the pandemic may actually 1) hasten productivity improvements and 2) improve market competitiveness as the crisis fades.
Investment Thesis

Valuation. Our $30 target price represents 14-15x our NTM EPS estimate one year from now, slightly below the five-year average (15x) as investor contemplate the impact of COVID-19. Prior to the pandemic, we liked the potential for LKQ shares to be re-rated as the company generated stronger margins and free cash flow - near-term, those goals may be on hold as the company contends with the pandemic, but we expect LKQ to emerge in a stronger market position after the crisis passes. Shares of LKQ currently trade at 21x our NTM EPS estimate (which represents a period pandemic-depressed earnings).

LKQ is a leading distributor of automotive aftermarket parts, including collision, mechanical, and specialty parts. In North America, LKQ has established itself as the leading provider of recycled and generic collision parts, benefiting from a secular trend favoring alternative-to-OEM parts. In the U.S., alternative part utilization has reached 36%, driven by insurance company efforts to lower repair costs. In Europe, LKQ is creating a leading mechanical part business serving mechanical repair shops – and is executing a strategy to consolidate continental Europe with the recent acquisition of Rhiag. Additionally, LKQ has an opportunity to amplify growth by selling collision parts through the same mechanical distribution infrastructure. European alternative part utilization is under 10%, revealing an opportunity for LKQ to penetrate the market by forging partnerships with key European insurers. Finally, LKQ has established a new growth platform in specialty parts with the addition of Keystone Automotive. Investment highlights include:

- Secular trend favoring alternative collision parts (U.S. and globally) driven by insurance industry
- Superior part availability as LKQ builds one-stop-shop for repair shops
- Opportunity to become the NAPA of Europe and LKQ of Europe
- Evolving from three-step to two-step distribution model in parts of Europe

Risks & Caveats

LKQ distributes automotive parts for collision repairs, mechanical repairs, and aftermarket improvements, primarily in North America and Europe. Demand for these parts is sensitive to trends in accident frequency, vehicle populations, vehicle technology, insurance trends, regulatory considerations and other factors in each of the markets it serves. Key risk factors include:

- Accident frequency (collision avoidance technology, weather, miles driven)
- Vehicle population (age, warranty, part types)
- Regulatory factors affecting use of aftermarket parts
- Litigation (OEMs often sue to protect intellectual property)
- Alternative part utilization in the U.S. and globally (insurance relationships)
- The cost of inventory (salvage trends, scrap prices, transportation costs)
- The mix of revenue
- Competition including internet vendors
- OEM exposure (glass business)
- Organic growth trends (calculation includes same-store sales and new store openings)
- The availability of acquisitions to fuel consolidation strategy; integration and accounting complexity
Appendix – Important Disclosures and Analyst Certification

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1 Robert W. Baird & Co. Incorporated makes a market in the securities of LKQ.

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