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ANALYST CORNER
An Introduction to LKQ Corporation
by Jon Baker, CFA

LKQ Corporation is comprised of three businesses, the smallest of which (a specialty distributor of recreational vehicle and truck accessories) we can set aside for this brief introduction. The original, and still largest, business is the leading distributor of aftermarket vehicle collision parts in the U.S. and Canada. The newer business is the largest European distributor of replacement automotive mechanical parts. Both businesses were cobbled together via acquisition: North America over the past two decades and Europe beginning in 2011. The consolidation, or "rolling-up," of the North American business created great value for owners. The long sought after European value creation remains the banana in the monkey trap for shareholders and management alike, but we believe there will be progress here over the coming years.

North America

The North American segment had its beginnings in the 1998 combination of several wholesale parts recycling businesses. Subsequently, some 270 acquisitions were made, many of which added geographic footprint that, over the years, resulted in a uniquely continent-wide physical network for both the collection and distribution of alternative car parts. Some of these acquisitions also added more content to push through that physical network, the most transformative acquisition being the Keystone aftermarket business in 2007.

All else equal, relatively scaled physical networks with unique content should provide better service (response times and fill-rates) to customers and over time take market share. Market share begets procurement advantage, resulting in improved margin and return and the ability to continually invest to extend the network, thereby enhancing service and earning more market share. Management spent decades allocating to both acquisitions and organic investment far in excess of the cash flow thrown off by the business. The short fall was funded by both debt and periodic share issuance. In the ten years preceding the initial European purchase, this leveraged investment increased LKQ's sales per share in excess of 20% per year. Operating margins doubled in this span, ratcheting up operating income per share 30% annually. By 2011, LKQ found itself with a uniquely scaled North American business, at a very reasonable level of financial leverage (under 1.5x), but with a size-induced inability to put its cash flow back to work in the way it had since inception.

And Thus, Europe

The first thing to note about the acquired European business is that there is virtually no overlap with LKQ's legacy North American operations—both distribute car parts, and that's about as far as the similarities go. They operate in different parts of the world, distributing different kinds of car parts to different types of repair shops with different ultimate payers. Importantly, the approach to integration differed between North America and Europe too. North American acquisitions were integrated along the way, with each additional business improving the whole to which it was added. For the first several years, the European acquisitions were neither integrated nor in a position to press a relative scale advantage in a way that made the whole any greater than the sum of its parts. This is how one's long run of high acquisition-driven returns comes to an end.

That's not to say that Euro Car Parts ("ECP") and its acquired European brethren aren't good businesses that can't begin to play in concert. ECP boasted after-tax returns on capital of 40%-50% around the time it was acquired and has since grown top line at a high-teens organic clip. Like North America's, LKQ's European acquisitions are physical network businesses. A denser branch network alone can allow for faster delivery times relative to competitors, and time is of the essence for a car repair garage that needs both to turn its bays and be responsive to consumers. If you add a scale buying advantage to the mix, along with a management team that perpetually invests to enhance these density and scale advantages, physical network businesses such as LKQ Europe can be formidable competitors. LKQ has acquired the largest players in various countries, and the combination is now the largest parts wholesaler in Europe.

At Long Last

The most recent, and largest, acquisition—the $1.8 billion purchase of Germany's Stahlgruber in May of 2018—has finally (nearly seven years into this process) created a heft with which to press payment terms with parts suppliers. Over time, this should result in both a margin tailwind and a reduced need for working capital. This newfound scale has also made available pockets of operating efficiency; some accessible in the very near term and some, such as the unification of dozens of enterprise resource planning systems, that may take a few to several years to garner.

EBITDA (Earnings before interest, tax, depreciation and amortization) margins in Europe will likely be below 8% in 2019. While AutoZone and O'Reilly have meaningfully different business mixes from LKQ's, they both earn EBITDA margins in excess of 20%. On a recent call to discuss the coming European integration, LKQ management shared a goal of normalized margins in excess of 10% by 2021, with continued upward progression thereafter. In our analysis, we model margins below management's guidance, we assume the company aggressively takes financial leverage lower and we still pencil returns from our purchase price in the low to mid-teens over the next several years. And, helpfully, both the U.S. and European businesses have demonstrated countercyclical tendencies in the past. We expect similar behavior if and when the world tilts the wrong way in the future.

Green Shoots

While European growth has been encouraging over the years, the data we have suggests that capital discipline has been lacking. For instance, ECP's working capital has ballooned, and the ratio of gross income to that supporting capital has been quartered since LKQ took the helm. Returns on the capital committed to Europe, in sum, have been mediocre. A change in approach has become increasingly necessary, and we have begun to see some steps in a positive direction.

Since early 2017, external hires have replaced long-time employees in positions such as CEO, CFO and CEO of the European segment. Last year, long-term compensation was shifted in favor of incenting organic growth and returns on invested capital. The long-awaited European integration has begun. Management has kicked off the process of extending payables with European parts suppliers, a practice AutoZone has enjoyed in the U.S. for decades. Near- to medium-term large acquisitions in Europe have been disclaimed. We have seen non-core businesses put up for sale. Finally, last year the company executed the first share repurchase in its history. In our view, all of these changes are individually encouraging, and, in sum, likely help surface the European value that has long evaded LKQ's grasp.

Jon Baker, CFA, joined Weitz Investments in 1997. Prior to joining the firm, he audited equity funds (including the Weitz Funds) as a certified public accountant at McGladrey & Pullen. Jon has a bachelor's in accounting and computer applications from the University of Notre Dame. Jon has been a CFA® charterholder since 2001.