**LKQ Corp**

**"Parts is parts," except LKQ delivers next-day at up to 50% lower prices than new replacement parts.**



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**Analyst Note** 10/31/2014

Narrow-moat-rated LKQ, the recycled, refurbished, and alternative aftermarket parts supplier to the collision repair market, reported third-quarter diluted earnings per share before special items of $0.31, a penny shy of the Street consensus EPS of $0.32 but $0.06 ahead of last year's result. Consolidated organic (excluding acquisitions) revenue growth for parts and services was 8.9% while North American organic parts and services revenue increased 6.7%, in line with our long-term expectations for market penetration relative to aftermarket collision parts supplied by the original-equipment manufacturers. Relative to our $25 fair value estimate, with the stock currently trading in 3-star territory, we think investors would be paying a reasonable or fair price for the economic profitability and estimated future cash flows of LKQ.

Including acquisitions, LKQ reported revenue of $1.7 billion, reflecting total growth of 33% from last year's reported revenue of $1.3 billion. While North America revenue increased 9.5% on the acquisition of Keystone Specialty, Europe revenue jumped 34% owing to the expansion of Euro Car Parts in the United Kingdom and Sator in the Netherlands. EBITDA margin contracted 20 basis points to 11.1%, driven in part by the integration of Netherlands distributors into Sator, the lower-margin business of Keystone Specialty coming on line, and other, smaller acquisitions.

Management maintained 2014 targets for organic revenue growth and cash flow from operations at 8%-10% and $375 million, respectively. However, it lowered its guidance for adjusted net income to $405 million-$417 million from $405 million-$430 million. As a result, EPS guidance was lowered to $1.32-$1.36 from $1.32-$1.40. We were already estimating 2014 EPS at $1.35, so there was no impact to our model.

**Investment Thesis** 08/02/2013

LKQ should still enjoy organic revenue growth in the mid- to high-single digits in this minimally cyclical industry where it is the only player with a national presence and network. This network cannot be matched by a local parts yard, and new entrants would have to undergo substantial time and expense to obtain the necessary zoning, environmental, and auto-salvage permits. A not-in-my-backyard mentality among many politicians represents another significant barrier to startup competition.

LKQ has grown quickly since its 1998 inception through acquisitions and incremental market penetration. The company is the leading provider of recycled and aftermarket auto parts to collision-repair body-shops, as well as mechanical repair shops. The wholesale parts industry represents a $57 billion addressable market, including $16 billion in collision replacement parts and $41 billion in mechanical replacement parts.

Alternative parts generally cost 20%-50% less than new original-equipment manufacturer, or OEM, products. The recycled OEM product market (engines, transmissions, doors, and so on) is composed of more than 6,000 companies, and roughly 90% of those have less than $3 million of annual revenue. In contrast, LKQ annualized revenue is nearly $5.0 billion, with about one third coming from recycled and remanufactured OEM parts. An integrated IT system allows each facility to stock the right parts for customers. The result of this scale and integration is that LKQ is out of stock far less than the 50%-60% industry average.

Aftermarket and refurbished parts are new parts such as mirrors, fenders, and hoods that are manufactured by non-OEM firms, primarily from Taiwan, as well as refurbished wheels, bumper covers, and lights. Aftermarket and refurbished parts sales represent a little more than half of LKQ's total revenue. These items are gaining popularity with insurance companies, which typically have the final say as to how the body shop will repair a vehicle. Also, like the recycled parts business, aftermarket and refurbished part distributors are highly fragmented and LKQ has no real competition.

**Economic Moat** 08/02/2013

We have assigned LKQ a narrow moat rating because of its cost advantage and efficient scale derived from the company's unique, difficult-to-replicate, nationwide distribution network, as the firm now has about 500 facilities. The difficulty and time required to obtain zoning and dismantling permits and other environmental authorizations necessary to operate newly sited recycled-parts facilities represents a significant barrier to entry for any would-be competitor. This network allows the company to fill more of its orders than the industry average, since it can move parts around the network to meet demand. This mobility is something single-point recyclers cannot do unless they form an alliance, which would be difficult to organize. LKQ is seeking to replicate its light-vehicle recycling operation on the heavy-duty-truck side, but may have more formidable competition in refurbished-parts markets from established firms such as Meritor.

Another of LKQ's advantages relates to the insurance industry. Indirectly, automotive insurers are also LKQ customers because they pay for approximately 85% of all collision repair bills in the United States. The company's primary customers (body shops and mechanical repair shops) look for parts on a daily basis to fill the specific needs for the repairs that are currently in their vehicle bays. These customers will order from a single source if that source can consistently deliver all the repair products required to complete all the shop's repair jobs within a reasonable amount of time and at a reasonable price. Since LKQ maintains a substantial amount of inventory across several facilities, all the repair products needed can usually be delivered within 24 hours and at prices that can be up to 50% less than new OEM replacement parts. Insurance companies, seeking to reduce the amount of money paid out in claims and in fees for rental vehicles used during repairs, look for the least expensive, quickest alternative to supply repair shops. As a result, LKQ, being the only nationwide provider, is usually designated as a preferred supplier by automotive insurance companies.

Due to the company's size and nationwide presence, LKQ also has an advantage in the procurement of salvage vehicles, the company's primary source of recycled and refurbished replacement parts. LKQ obtains most of these vehicles from salvage vehicle auctions. The company has developed software technology that compiles information on recycled parts, for example, current inventory, historical demand, current demand, and estimated value. Armed with handheld computing devices, LKQ's buyers can go to salvage auctions and find vehicles containing high demand, recyclable parts. Once located, the buyers can input the vehicle and its salvageable parts and get an estimated maximum bid, reducing the likelihood that LKQ will wind up with obsolete inventory while bolstering profitability.

It behooves LKQ to maintain good relations with insurance companies and vice versa. While the firm is indirectly paid by automotive insurance companies through the collision repair shops with which they do business, LKQ is the automotive insurance industry's largest buyer of salvage vehicles, creating a modest network effect, adding to LKQ's economic moat. Typically, when auto insurers reimburse a policyholder for a "totaled" vehicle, the insurers try to offset the claim payout by selling the wrecks at salvage auctions. LKQ in turn, buys the wrecks and salvages the good parts, selling them to the repair shops that are reimbursed by the automotive insurance companies.

[**Valuation**](http://quicktake.morningstar.com/StockNet/StockValuation.aspx?Country=USA&Symbol=LKQ&culture=en-US) 09/01/2014

Our fair value estimate is $25 per share, reflecting the acquisition of Keystone Automotive. We estimated incremental revenue of roughly $588 million and $59 million in EBITDA for 2014 plus $122 million (including 5% organic revenue growth) and $12 million in incremental revenue and EBITDA in 2015. We also increased interest expense by roughly $9 million on the draw-down of its revolver by the total amount of the $450 million purchase price. Additionally, our fair value estimate reflects annualized revenue growth from market penetration and acquisitions of more than 13%, and a weighted average cost of capital of 8.1%, more commensurate with narrow-moat, medium-uncertainty-rated growth companies but not other auto-parts companies. We are also forecasting that EBITDA margin will average around 11.6%, down just slightly from our previous 11.7% average assumption on the lower margin from the Keystone acquisition. We also assume capital expenditures averaging just over 2.0% of revenue per year over our five-year forecast. Even though we think LKQ has a great business model, the company will need to focus on generating organic growth as fewer large acquisition targets remain. To reflect the lower rate of growth, we assume a 14% ROIC and our long-run free cash-flow growth assumption is 10%, even though since 2003 the company has historically grown its free cash flow by an annualized rate of 34%. However, our fair value estimate is also offset by $553.3 million, the net present value amount derived from our assumption of the company's future cash outlays for acquisitions during the next five years, including two payments of $85 million in 2013 and 2014 each--performance-based awards from the Euro Car Parts acquisition.

**Risk** 08/02/2013

Like all acquisitive companies, LKQ faces the risk of overpaying for an acquisition and then taking a loss in the disposition or a fair value impairment charge in a subsequent period. LKQ also could have operational problems integrating acquisitions that could negate any synergies. Another risk comes from the Anti-Car Theft Act passed in 1992, which requires all parts recyclers to catalog vehicle identification numbers for most parts they recycle. In January 2009, the Justice Department authorized implementation of an electronic system but has yet to issue final rules. If LKQ were ever forced to comply with this regulation, it could represent a significant expense, causing operational inefficiency as each individual, recycled part is painstakingly identified and cataloged.

**Management** 08/02/2013

We like that the chairman and CEO roles are separated and that directors and officers own more than 7% of the company, which properly aligns their interests with outside shareholders'. We do not like that management's bonus is based on earnings per share because this is a metric with a near-term focus, and is more susceptible to accounting interpretation. This risk is magnified in a company that does extensive acquisition accounting.

Robert Wagman became president and CEO on Jan. 1. Wagman has been with LKQ since 1998 and has more than 20 years of experience in the auto-parts sector. The former CEO Joe Holsten, who remains vice chairman and serves as a consultant to LKQ, was CEO from 1998 to 2011, so we are not concerned about the timing of the change in leadership. We like that the company clearly spelled out the succession plan in advance, giving Wagman plenty of time to adjust to the CEO role.

**Overview**
**Profile:**

LKQ is the largest nationwide provider of aftermarket, recycled, and refurbished collision and mechanical replacement products for cars and trucks. Indicative of the fragmented nature of the industry, and despite being the industry's 800-pound gorilla, LKQ holds only a 30% share in the aftermarket and refurbished markets and a 20% share in the recycled OEM parts market. Repair shops and insurance companies (which fund 85% of U.S. collision repairs) want to use alternative parts that are up to 50% below the cost of new OEM replacement parts.

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**Morningstar's Take**

LKQ **Analyst**

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| --- | --- | --- |
| **Price**01-20-2015 | **Fair Value Estimate** | **Uncertainty** |
| 25.65 USD | 25 USD | Medium |
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| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 17.5 USD | 33.75 USD | Narrow |
|  |
| **Stewardship Rating** |
| Standard |
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| **Bulls Say** |
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| • | LKQ has a symbiotic relationship with auto insurers--it is the largest buyer of insurance company auctioned salvage cars in the US and it is the largest provider of collision-repair body-shop recycled and aftermarket parts. |
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| • | State Farm left the aftermarket after losing a 1999 lawsuit relating to not using OEM parts for collision repairs. Management is convinced that State Farm will re-enter the aftermarket business soon, which would boost top-line growth. |
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| • | LKQ has established itself as a successful acquirer and integrator of recycled, alternative, and aftermarket parts distributors. |
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| **Bears Say** |
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| • | If the Justice Department ever forces LKQ to comply with the Anti-Car Theft Act, it will burden the company with a distraction and higher expense to keep more detailed records on most of its recycled parts inventory. |
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| • | The market has paid a premium for LKQ's earnings in the past, which means bad news may cause the share price to tumble, as is typical with growth companies. |
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| • | Over the long term, the firm could be threatened by local recycling companies forming alliances that could help them to match LKQ in price or product offering. |
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**[Competitors](http://library.morningstar.com/stock/industry-peer?t=XNAS:LKQ)**

[LKQ](http://library.morningstar.com/stock/industry-peer?t=XNAS:LKQ)

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| Name | Price | % Chg |   | TTM Sales $ mil |
|  |
| **LKQ Corp** | **$25.65** | **0.08** |  | **6,373** |
| [Denso Corp ADR](http://library.morningstar.com/stock/quote?t=0P000008BA) | $22.82 | 0.48 |  | 4,179,048  |
| [Denso Corp](http://library.morningstar.com/stock/quote?t=0P0000BNYY) | $44.67 | -1.93 |  | 4,179,048  |
| [Johnson Controls Inc](http://library.morningstar.com/stock/quote?t=0P0000032T) | $45.24 | -0.33 |  | 42,828  |
| [Continental AG ADR](http://library.morningstar.com/stock/quote?t=0P0000087W) | $44.26 | -0.10 |  | 33,995  |
| [Continental AG](http://library.morningstar.com/stock/quote?t=0P0000AVIS) | $222.00 | 12.00 |  | 33,995  |