LKQ CORP
Form 10-Q
November 03, 2006

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2006

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from to

Commission File Number 000-50404

LKQ CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	**36-4215970**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
120 NORTH LASALLE STREET, SUITE 3300, CHICAGO, IL	**60602**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(312) 621-1950**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

At October 30, 2006, the registrant had issued and outstanding an aggregate of 53,298,013 shares of Common Stock.

PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

LKQ CORPORATION AND SUBSIDIARIES
Unaudited Consolidated Balance Sheets
(In thousands, except share and per share data)

	September 30, 2006	December 31, 2005
Assets		
Current Assets:		
Cash and equivalents	$ 6,356	$ 3,173
Restricted cash		450
Receivables, net	45,769	39,500
Inventory	126,895	103,655
Deferred income taxes	2,102	2,122
Prepaid income taxes	3,315	
Prepaid expenses	2,542	2,437
Total Current Assets	186,979	151,337
Property and Equipment, net	118,305	97,218
Intangibles		
Goodwill	242,779	181,792
Other intangibles, net	73	88
Deferred Income Taxes		2,146
Other Assets	7,035	6,845
Total Assets	$ 555,171	$ 439,426
Liabilities and Stockholders Equity		
Current Liabilities:		
Accounts payable	$ 17,507	$ 15,496
Escrow liability	50	2,611
Accrued expenses		
Accrued payroll-related liabilities	9,927	10,115
Accrued procurement liability	1,924	2,537
Other accrued expenses	16,550	11,062
Income taxes payable		819
Deferred revenue	3,855	3,440
Current portion of long-term obligations	4,423	1,481
Total Current Liabilities	54,236	47,561
Long-Term Obligations, Excluding Current Portion	104,808	45,996
Deferred Income Tax Liability	991	
Other Noncurrent Liabilities	6,477	4,032
Redeemable Common Stock, $0.01 par value, 100,000 shares issued	617	617
Commitments and Contingencies		
Stockholders Equity:		
Common stock, $0.01 par value, 500,000,000 shares authorized, 53,120,093 and 51,414,314 shares issued at September 30, 2006 and December 31, 2005, respectively.	531	514

Additional paid-in capital	320,057	307,304
Warrants		80
Retained earnings	66,232	32,027
Accumulated other comprehensive income	1,222	1,295
Total Stockholders Equity	388,042	341,220
Total Liabilities and Stockholders Equity	$ 555,171	$ 439,426

See notes to unaudited condensed consolidated financial statements.

LKQ CORPORATION AND SUBSIDIARIES
Unaudited Consolidated Statements of Operations
(In thousands, except per share data)

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Revenue	$ 197,659	$ 133,640	$ 584,835	$ 403,470
Cost of goods sold	108,222	70,696	318,872	213,398
Gross margin	89,437	62,944	265,963	190,072
Facility and warehouse expenses	22,445	15,240	63,025	44,196
Distribution expenses	20,387	15,724	60,121	45,217
Selling, general and administrative expenses	25,604	18,455	75,245	54,899
Depreciation and amortization	3,136	2,060	8,764	6,089
Operating income	17,865	11,465	58,808	39,671
Other (income) expense:				
Interest expense	1,867	734	4,212	2,041
Interest income	(38)	(30)	(93)	(88)
Other income	(238)	(361)	(1,172)	(601)
Total other expense	1,591	343	2,947	1,352
Income before provision for income taxes	16,274	11,122	55,861	38,319
Provision for income taxes	5,816	4,519	21,656	15,688
Net income	$ 10,458	$ 6,603	$ 34,205	$ 22,631
Net income per share:				
Basic	$ 0.20	$ 0.16	$ 0.65	$ 0.54
Diluted	$ 0.19	$ 0.14	$ 0.61	$ 0.48
Weighted average common shares outstanding:				
Basic	53,098	42,489	52,658	41,825
Diluted	55,910	47,677	55,722	46,960

See notes to unaudited condensed consolidated financial statements.

LKQ CORPORATION AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Cash Flows
(In thousands)

	Nine Months Ended September 30, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 34,205	$ 22,631
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,915	6,089
Share-based compensation expense	1,521	
Deferred income taxes	3,184	1,198
Excess tax benefit from share-based payment arrangements	(5,696)	
(Gain) loss on sale of property and equipment	13	(161)
Gain on sale of investment securities	(719)	(335)
Other adjustments		42
Changes in operating assets and liabilities, net of effects from purchase transactions:		
Receivables	(887)	66
Inventory	(11,929)	(461)
Prepaid income taxes / income taxes payable	1,562	2,705
Other operating assets and liabilities	655	3,477
Net cash provided by operating activities	30,824	35,251
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(24,394)	(11,111)
Proceeds from sale of property and equipment	162	877
Proceeds from sale of investment securities	849	
Expenditures for intangible assets		(3)
Repayment of escrow	(2,561)	
Proceeds from conversion of escrow		2,561
Decrease in restricted cash in escrow	450	132
Cash used in acquisitions	(68,071)	(37,278)
Net cash used in investing activities	(93,565)	(44,822)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the sale of common stock and warrant exercises	5,474	7,387
Excess tax benefit from share-based payment arrangements	5,696	
Debt issuance costs		(302)
Net borrowings of long-term debt	54,754	4,712
Net cash provided by financing activities	65,924	11,797
Net increase in cash and equivalents	3,183	2,226
Cash and equivalents, beginning of period	3,173	1,612
Cash and equivalents, end of period	$ 6,356	$ 3,838
Supplemental disclosure of cash flow information:		
Notes issued in connection with business acquisitions	$ 7,000	$ 430
Notes assumed in connection with business acquisitions		203
Cash paid for income taxes, net of refunds	16,877	11,904
Cash paid for interest	2,617	2,067

See notes to unaudited condensed consolidated financial statements.

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LKQ CORPORATION AND SUBSIDIARIES

Unaudited Consolidated Statements of Stockholders Equity and Other Comprehensive Income

(In thousands)

	Common Stock Shares Issued	Amount	Additional Paid-In Capital	Warrants	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders Equity
BALANCE, December 31, 2005	51,414	$ 514	$ 307,304	$ 80	$ 32,027	$ 1,295	$ 341,220
Net income					34,205		34,205
Unrealized loss on investment in equity securities, net of tax						(48)	(48)
Foreign currency translation						(25)	(25)
Total comprehensive income							34,132
Stock issued as director compensation	3		54				54
Stock-based compensation expense			1,467				1,467
Exercise of stockholder guarantor warrants	785	8	857	(80)			785
Exercise of stock options, including related tax benefits of $5,696	918	9	10,375				10,384
BALANCE, September 30, 2006	53,120	$ 531	$ 320,057	$	$ 66,232	$ 1,222	$ 388,042

See notes to unaudited condensed consolidated financial statements.

LKQ Corporation and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

Note 1. Interim Financial Statements

The accompanying Unaudited Condensed Consolidated Financial Statements include the accounts of LKQ Corporation and its subsidiaries (the Company). All significant intercompany transactions and accounts have been eliminated.

The accompanying Unaudited Condensed Consolidated Financial Statements have been prepared by the Company pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (SEC) applicable to interim financial statements. Accordingly, certain information related to the Company s significant accounting policies and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. These Unaudited Condensed Consolidated Financial Statements reflect, in the opinion of management, all material adjustments (which include only normal recurring adjustments) necessary to fairly state, in all material respects, the financial position, results of operations and cash flows of the Company for the periods presented.

Operating results for interim periods are not necessarily indicative of the results that can be expected for any subsequent interim period or for a full year. These interim financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto included in the Company s most recent report on Form 10-K for the year ended December 31, 2005 filed with the SEC.

All per share amounts and the number of shares for all periods have been retroactively adjusted to reflect the two-for-one stock split declared on December 15, 2005. See Note 3 for further discussion.

Note 2. Significant Accounting Policies

Receivables

The Company has recorded a reserve for uncollectible accounts of approximately $2.4 million and $2.1 million at September 30, 2006 and December 31, 2005, respectively.

Inventory

Inventory consists of the following (in thousands):

	September 30, 2006	December 31, 2005
Salvage products	$ 79,262	$ 69,444
Aftermarket products and refurbished wheels	41,978	30,238
Core facilities inventory	5,655	3,973
	$ 126,895	$ 103,655

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Intangibles

Intangible assets consist primarily of goodwill (the cost of purchased businesses in excess of the fair value of the net assets acquired) and covenants not to compete. The change in the carrying amount of goodwill during the nine months ended September 30, 2006 is as follows (in thousands):

Balance as of December 31, 2005	$	181,792
Business acquisitions	60,987	
Balance as of September 30, 2006	$	242,779

Investments

The Company holds common shares in Keystone Automotive Industries, Inc., which are classified as an available-for-sale investment security under Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). Accordingly, the investment is included in Other Assets at its fair value with the unrealized gain excluded from earnings and included in Accumulated other comprehensive income, net of applicable taxes. The fair value of the investment is estimated based upon the quoted market price for the securities. During March 2006, the Company sold a portion of its investment and has included the realized gain of $0.7 million in Other income. The unrealized loss on investment in equity securities reflected as a component of Accumulated other comprehensive income during the nine months ended September 30, 2006 is net of reclassification adjustments of $0.3 million, net of tax, for realized gains on the sale of securities included in net income.

Escrow Liability

In February 2004, in connection with a business acquisition, the Company issued 168,690 shares of its common stock, which were to be held in escrow for a period of two years pending resolution of certain seller representation and warranty provisions specified in the purchase agreement. The terms of the agreement granted the shareholders the option to sell any or all of these shares during the escrow period, provided that all proceeds from such sale were delivered to the Company. In September 2005, the shareholders sold all such shares held in escrow and delivered $2.6 million to the Company. In February 2006, the sellers representation and warranty provisions were resolved, and the escrowed funds plus accrued interest at an annual rate of 3% were paid to the sellers.

In January 2005, in connection with a business acquisition, the Company held $0.6 million in restricted cash. During the quarter ended March 31, 2005, the amount of cash restricted was reduced by $0.1 million. In accordance with the terms of the purchase agreement, the restrictions were to be removed by January 31, 2006 or the Company was to be reimbursed from funds held in escrow. These restrictions were not removed by the specified date and the Company received reimbursement from the sellers of $0.5 million during the quarter ended March 31, 2006, which, pending final release of the restricted cash, the Company had included in Escrow liability. During June 2006, the remaining restrictions were removed, and in July 2006, the Company reimbursed the sellers the $0.5 million.

Income Taxes

Income taxes provided are based upon the Company s anticipated annual effective income tax rate.

During 2006, the Internal Revenue Service completed its audit of the 2002 tax return of the Company. As a result of the completion of this audit and the statutory closing of 2002 and prior tax years, the Company recorded a tax benefit in the third quarter of 2006 of approximately $0.7 million consisting of the reversal of accrued income tax liabilities no longer deemed necessary.

Depreciation Expense

Included in Cost of Goods Sold is depreciation expense associated with certain wheel refurbishing and smelting operations.

Stock-Based Compensation

On January 1, 2006, the Company adopted the provisions of SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), requiring it to recognize expense related to the fair-value of its share-based compensation awards (see Note 4). The Company elected to use the modified prospective transition method, pursuant to which prior periods are not restated. Compensation expense for all share-based payments granted or modified after the effective date is recognized prospectively based upon the requirements of SFAS 123R and compensation expense for all unvested share-based payments as of January 1, 2006 that were issued subsequent to the filing of the registration statement regarding the Company s initial public offering in October 2003 is recognized prospectively based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), net of estimated forfeitures. The Company has elected to recognize compensation expense on a straight-line basis over the requisite service period of the award.

Prior to the adoption of SFAS 123R, the Company accounted for its stock compensation arrangements under the provisions of SFAS 123, as amended by SFAS 148, Accounting for Stock-Based Compensation-Transition and Disclosures (SFAS 148), which allowed the application of existing accounting rules under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under APB 25, the Company recognized compensation expense based on an award s intrinsic value, the difference between the exercise price of the option and the fair market value of the underlying common stock at the time the options were granted. For nonqualified stock options granted with an exercise price equal to the market value of the stock on the date of grant, no compensation cost was recognized. As required by SFAS 148 prior to the adoption of SFAS 123R, the Company provided pro forma net income and pro forma earnings per share disclosures for stock-based awards, as if the fair-value-based method defined in SFAS 123 had been applied.

The following table sets forth the total stock-based compensation expense resulting from stock options included in our Unaudited Consolidated Statement of Income (in thousands):

	Three Months Ended September 30, 2006	**Nine Months Ended September 30, 2006**
Cost of goods sold	$ 4	$ 10
Facility and warehouse expenses	155	443
Selling, general and administrative expenses	213	1,014
	$ 372	$ 1,467

As a result of adopting SFAS 123R on January 1, 2006, the Company s net income for the three month and nine month periods ended September 30, 2006 was $0.2 million and $0.9 million lower, respectively, than if it had continued to account for stock-based compensation under APB 25. If the Company had not adopted SFAS 123R, basic earnings per share for the three month and nine month periods ended September 30, 2006 would have been $0.20 and $0.67 as compared to $0.20 and $0.65, respectively, and diluted earnings per share for the three month and nine month periods ended September 30, 2006 would have been $0.19 and $0.63 as compared to $0.19 and $0.61, respectively.

The Company has not capitalized any stock-based compensation cost during the nine months ended September 30, 2006. As of September 30, 2006, a total of $6.5 million in unrecognized compensation expense is expected to be recognized as follows:

Remainder of 2006	$ 0.9 million
2007	2.1 million
2008	1.4 million
2009	1.2 million
2010	0.9 million

The unrecognized compensation expense outlined above includes the fair value of the 120,000 options granted on October 2, 2006 under the provisions of the Stock Option and Compensation Plan for Non-Employee Directors.

The fair value of stock options has been estimated using the Black-Scholes option-pricing model. The following table summarizes the assumptions used to compute the weighted average fair value of stock option grants:

	Nine Months Ended September 30,			
	2006		**2005**	
Expected life (in years)	6.4		5.8	
Risk-free interest rate	4.33	%	3.93	%
Volatility	40.0	%	40.0	%
Dividend yield	0	%	0	%
Weighted average fair value of options granted	$ 9.19		$ 7.61	

Expected life The expected life represents the period that the Company s stock-based awards are expected to be outstanding. Due to the limited information available regarding historical exercise experience, the Company has elected to use the simplified expected term method as permitted by the Securities and Exchange Commission Staff Accounting Bulletin No. 107 (SAB 107).

Risk-free interest rate The Company bases the risk free interest rate used in the Black-Scholes option-pricing model on the implied yield currently available on U.S. Treasury zero-coupon issues with the same or substantially equivalent remaining term.

Expected volatility The Company uses the trading history and historical volatility of its common stock, and because of limited historical data available on the price of its own publicly traded shares, the volatility of similar entities whose share prices are publicly available, in determining an estimated volatility factor for the Black-Scholes option-pricing model.

Expected dividend yield The Company has not declared and has no plans to declare dividends and has therefore used a zero value for the expected dividend yield in the Black-Scholes option-pricing model.

Estimated forfeitures When estimating forfeitures, the Company considers voluntary and involuntary termination behavior as well as analysis of its historical option forfeitures.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123, including the effect of accelerating the vesting schedules of certain options granted in 2004 and 2005 (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 6,603	$ 22,631
Add: Stock-based compensation expense, net of tax, included in net income as reported		25
Less: Total stock-based compensation expense determined using the Black-Scholes option pricing model, net of related tax effects	(172)	(4,569)
Pro forma net income	$ 6,431	$ 18,087
Earnings per share:		
Basic - as reported	$ 0.16	$ 0.54
Basic - pro forma	$ 0.15	$ 0.43
Diluted - as reported	$ 0.14	$ 0.48
Diluted - pro forma	$ 0.13	$ 0.39

Prior to the adoption of SFAS 123R, the Company included all tax benefits associated with stock-based compensation as operating cash flows in the Statement of Cash Flows. SFAS 123R requires any reduction in taxes payable resulting from tax deductions that exceed the recognized compensation expense (excess tax benefits) to be classified as financing cash flows. The Company has included $5.7 million of excess tax benefits in its cash flows from financing activities for the nine months ended September 30, 2006. During the nine months ended September 30, 2005, excess tax benefits of $3.6 million were included in net cash provided by operating activities.

Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amends Accounting Research Bulletin No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to inventory be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company has adopted SFAS 151 and its adoption did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). SFAS 154 replaces Accounting Principles Board Opinion No. 20 Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements-An Amendment of APB Opinion No. 28. SFAS 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. SFAS 154 requires retrospective application of the direct effect of a voluntary change in accounting principle to prior periods financial statements where it is practicable to do so. SFAS 154 also redefines the term restatement to mean the correction of an error by revising previously issued financial statements. SFAS 154 is effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005 unless adopted early. The Company has adopted SFAS 154 and its adoption did not have a material impact on the Company s consolidated financial position, results of operations or cash flows, except to the extent that the statement subsequently requires retrospective application of a future item.

In July 2006, the FASB issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 provides guidance on the measurement, recognition, and disclosure of tax positions taken or expected to be taken in a tax return and requires that a tax position should only be recognized if it is more-likely-than-not that the position will be sustained upon examination by the appropriate taxing authority. FIN 48 also provides guidance on derecognition, classification, interest and penalties, transition and disclosure. The cumulative effect of applying the provisions of FIN 48 will be reported as an adjustment of beginning retained earnings in the period of adoption. FIN 48 will be effective for the Company s fiscal year beginning January 1, 2007. The Company is currently assessing the impact of FIN 48 on the Company s consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of SFAS 157 on the Company s consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements no. 87, 106, and 132(R) (SFAS 158). SFAS 158 requires companies to recognize on a prospective basis the funded status of their defined benefit pension and postretirement plans as an asset or liability and to recognize changes in that funded status in the year in which the changes occur as a component of other comprehensive income, net of tax. As required, the Company will adopt SFAS 158 on December 31, 2006. The Company does not expect the adoption of this statement to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides interpretive guidance on how public companies quantify financial statement misstatements, including misstatements that were not material to prior years financial statements. SAB 108 will be effective in the Company s annual financial statements for its fiscal year ending December 31, 2006. The Company does not expect the adoption of SAB 108 to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

Note 3. Capital Structure

On February 14, 2001, the Company issued warrants to purchase 3,922,224 shares of its common stock at an exercise price of $1.00 per share to certain stockholder guarantors in exchange for their guaranty of $10 million of the debt outstanding under the Company s credit agreement. The warrants became exercisable upon issuance and were to expire on February 14, 2006. Warrants to purchase 785,072 shares of the Company s stock were outstanding at December 31, 2005, all of which were exercised prior to the expiration date. The stockholder guaranties were cancelled in June 2002 when the Company entered into a new credit facility.

On December 15, 2005, the Company s Board of Directors approved a two-for-one split of the Company s common stock payable as a stock dividend. Each stockholder of record at the close of business on January 3, 2006 received an additional share of common stock for every outstanding share held. The payment date was January 13, 2006, and the common stock began trading on a split-adjusted basis on January 17, 2006.

Note 4. Stock-Based Compensation Plans

The Company has three stock-based compensation plans, the LKQ Corporation 1998 Equity Incentive Plan (the Equity Incentive Plan), the Stock Option and Compensation Plan for Non-Employee Directors (the Director Plan), and a separate stock option plan for our Chief Executive Officer (the CEO Plan).

A summary of transactions in the Company s stock-based compensation plans for the nine months ended September 30, 2006 is as follows:

	Options Available for Grant	Number of Shares Outstanding	Weighted Average Exercise Price
Balance, December 31, 2005	4,493,820	7,516	