LKQ CORP
Form 10-K
February 28, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

Commission File No. 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, Illinois**	**60602**
(Address of principal executive offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of each exchange on which registered
Common Stock, par value $.01 per share	Nasdaq National Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

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

Indicate by check mark whether the registrant is a shell company (as described in Rule 12b-2 of the Exchange Act). Yes o No x

The aggregate market value of the voting stock of the registrant held by stockholders who were not affiliates (as defined by regulations of the Securities and Exchange Commission) of the registrant was approximately $919,227,000 (based on the closing sale price on the Nasdaq National Market on June 30, 2006). At February 21, 2007, the registrant had issued and outstanding an aggregate of 53,310,817 shares of common stock.

Documents Incorporated by Reference

Those sections or portions of the registrant s proxy statement for the Annual Meeting of Stockholders to be held on May 7, 2007, described in Part III hereof, are incorporated by reference in this report.

PART I

SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K includes forward-looking statements. Words such as may, will, plan, should, expect, anticipate, belie estimate, intend, project and similar words or expressions are used to identify these forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. However, these forward-looking statements are subject to risks, uncertainties, assumptions and other factors that may cause our actual results, performance or achievements to be materially different. These factors include, among other things:

- fluctuations in the pricing of new OEM replacement parts;
- the availability and cost of inventory;
- variations in vehicle accident rates;
- increasing competition in the automotive parts industry;
- changes in state or federal laws or regulations affecting our business;
- changes in the types of replacements parts that insurance carriers will accept in the repair process;
- our ability to integrate and successfully operate recently acquired companies and any companies acquired in the future and the risks associated with these companies;
- fluctuations in fuel prices;
- changes in the demand for our products and the supply of our inventory due to severity of weather and seasonality of weather patterns;
- the amount and timing of operating costs and capital expenditures relating to the maintenance and expansion of our business, operations and infrastructure;
- declines in the values of our assets;
- uncertainty as to changes in U.S. general economic activity and the impact of these changes on the demand for our products;
- our ability to increase or maintain revenue and profitability at our facilities;
- uncertainty as to our future profitability;
- uncertainty as to the impact on our industry of any terrorist attacks or responses to terrorist attacks;
- our ability to operate within the limitations imposed by financing arrangements;
- our ability to obtain financing on acceptable terms to finance our growth; and
- our ability to develop and implement the operational and financial systems needed to manage our growing operations.

Other matters set forth in this Annual Report may also cause our actual future results to differ materially from these forward-looking statements. We cannot assure you that our expectations will prove to be correct. In addition, all subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements mentioned above. You should not place undue reliance on these forward-looking statements. All of these forward-looking statements are based on our expectations as of the date of this Annual Report. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Copies of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act are available free of charge through our website (www.lkqcorp.com) as soon as reasonably practicable after we electronically file the material with, or furnish it to, the SEC.

NOTE REGARDING STOCK SPLIT

On December 15, 2005, our Board of Directors declared a two-for-one split of the shares of our common stock payable as a stock dividend to the stockholders of record on January 3, 2006. We paid the stock dividend on January 13, 2006. All information regarding per share amounts and the number of shares of our common stock in this Annual Report reflects the two-for-one stock split.

ITEM 1. BUSINESS

Overview

We provide replacement systems, components, and parts needed to repair light vehicles (cars and light trucks). Buyers of light vehicle replacement products have the option to purchase from primarily three sources: new products produced by original equipment manufacturers (OEMs), which are commonly known as OEM products; new products produced by companies other than the OEMs, which are sometimes referred to generically as aftermarket products; and recycled products originally produced by OEMs, which we refer to as recycled OEM products. We participate in the market for recycled OEM products as well as the market for collision repair aftermarket products. We obtain aftermarket products and salvage vehicles from a variety of sources, and we dismantle the salvage vehicles to obtain a comprehensive range of vehicle products that we distribute into the light vehicle repair market. We recently entered the business of refurbishing and distributing aluminum alloy wheels, head lamps and tail lamps. We are not involved in the manufacture of automotive products and do not maintain any manufacturing or remanufacturing operations.

We believe we are the largest nationwide provider of recycled OEM products and related services, with sales, processing, and distribution facilities that reach most major markets in the U.S. We believe that we are the second largest nationwide provider of aftermarket collision replacement products and refurbished wheels. We believe there are opportunities for growth in both product lines through acquisitions and internal development.

We procure salvage vehicles, primarily at auctions, using our locally based professionals, proprietary processes, and a disciplined procurement system. In addition, as an alternative source of salvage vehicles, we obtain some inventory directly from insurance companies, vehicle manufacturers, and other suppliers. Once we have received proper title, which assures us that the vehicles have not been stolen, we dismantle such vehicles for recycled OEM products. We purchase aftermarket products from manufacturers, primarily in Taiwan, using a proprietary order management system.

Our customers include collision and mechanical repair shops and, indirectly, insurance companies, including extended warranty companies. The majority of our products and services are sold to collision repair shops, also known as body shops, and mechanical repair shops. We indirectly rely on insurance companies, which ultimately pay the collision repair shops for the repair of insured vehicles, as a source of business. These insurance companies exert significant influence in the vehicle repair decision, and increasingly look to a nationwide source for consistency, quality, and availability of replacement products. Because of their importance to the process, we have formed business relationships with certain insurance companies, and with certain extended warranty providers, in order to be their preferred light vehicle parts supplier. For example, with some insurance companies we have vehicle repair order estimate review programs in place and provide their claims adjusters a part quote and locator service. In addition, we provide them an outlet to dispose of certain total loss vehicles directly to us. We provide extended warranty companies a single national call desk to service their nationwide needs for mechanical products.

We believe we provide customers a value proposition that includes high quality products, extensive product availability due to our regional inventory trading zones, product costs lower than new OEM products, and quick delivery. We provide benefits to repair shops and insurance companies because the lower costs for our products enable many vehicles to be repaired rather than declared a total loss. By expanding our product offerings to include both recycled OEM products and aftermarket products we now offer customers a more extensive range of light vehicle replacement products. We believe this unique combination of recycled, aftermarket and refurbished product offerings allows us to serve as a one-stop solution for our customers looking for the most cost advantageous way to repair vehicles.

We believe that our business is environmentally responsible. Our recycled automotive products provide an alternative to the manufacture of new products, which would require the expenditure of significantly more resources and energy and would generate a substantial amount of additional pollution. Also, we recycle materials, such as fuel, motor oil, and freon, from the salvage vehicles that we procure.

Our History

We believe we were the first recycler of light vehicle products to achieve a national network and presence. Since our formation in 1998, we have grown through both internal development and acquisitions. Our acquisition strategy has been to target companies with strategic locations and significant market presence, strong management teams, a record of environmental compliance, solid growth prospects, and a reputation for quality and customer service. We currently have 67 locations in the U.S. that supply wholesale recycled OEM products. In February 2004, we expanded our product offerings by also becoming a supplier of aftermarket products and a provider of self-service retail recycled vehicle products. We currently have approximately 48 locations that supply aftermarket products, 20 of which are co-located at wholesale recycle facilities. We have 22 locations providing self-service retail recycled vehicle products. We also operate out of three locations in Central America. On January 31, 2006, we acquired an aluminum alloy wheel refurbishing and distribution business. Our wheel subsidiary currently operates six refurbishing and distribution facilities, one of which is co-located at an aftermarket facility. On January 1, 2007, we acquired a head and tail lamp refurbishing company.

For the year ended December 31, 2006, revenue derived from recycled OEM products and related services represented approximately 59.8% of our revenue, sales of aftermarket and refurbished products and services represented approximately 24.4% of our revenue, and sales of other products, such as scrap and other bulk products, represented approximately 15.8% of our revenue.

Our Strengths

We Provide a National Solution to Insurance Companies and Extended Warranty Providers.

We believe that our nationwide presence gives us a unique ability to service the major automobile insurance companies and extended warranty providers. Insurance companies and extended warranty providers operate generally at a national or regional level and play a critical role in the repair process. We believe we provide a direct benefit to these companies by lowering the cost of repairs, decreasing the time required to return the repaired vehicle to the customer, and providing a replacement product that is of comparable quality to the part replaced. Specifically, we assist insurance companies by purchasing insured total loss vehicles and by providing cost effective products through sales to collision repair shops, especially to repair shops that are part of an insurance company network. We also provide a review of vehicle repair order estimates to insurance companies so they may assess the opportunity to increase usage of recycled OEM, aftermarket, and refurbished products. For extended warranty providers, we provide a single national call desk to service their nationwide need for mechanical products.

We Believe We Have the Only National Network for Recycled OEM Products and it Would be Difficult to Replicate.

We have invested significant capital developing a national network of recycled OEM product facilities that serves most major metropolitan areas in the U.S. We have differentiated ourselves from our local competitors and made replication of our network difficult by developing our network through purchasing anchor companies that were among the largest companies in the industry. The difficulty and time required to obtain proper zoning, as well as dismantling and other environmental permits necessary to operate newly-sited facilities, would make establishing new facilities challenging. In addition, there are difficulties associated with recruiting and hiring an experienced management team that has strong industry knowledge and local relationships with customers. Finally, our national network allows us to enter new adjacent markets quickly by establishing redistribution facilities, which avoids the need for local dismantling capabilities and inventory.

We Benefit From a Local Presence.

Our network of facilities allows us to develop and maintain our relationships with local repair shops, while providing a level of service to insurance companies and national customers that is made possible by our nationwide presence. Our local presence allows us to provide daily deliveries that our customers require, using drivers who routinely deliver to the same customers. Our sales force and local delivery drivers develop and maintain critical personal relationships with the local repair shops that benefit from access to our wide selection of products which we are able to offer as a result of our regional inventory network.

We Have a Proven and Effective Procurement Process.

We have designed information systems and methodologies to procure salvage vehicles and aftermarket products cost-effectively. As our largest single expenditure, efficient procurement of salvage vehicles is critical to the growth, operating results and cash flow of our business. Our processes and know-how allow us to identify and value the parts that can be recycled on a damaged vehicle at auction and to determine rapidly the maximum price we will pay for the vehicle in order to achieve our target margins on resale of the recycled OEM products. We carefully analyze the market and obtain aftermarket products and salvage vehicles of the type whose parts are in demand at prices that we believe will allow us to sell products profitably. We have also taken advantage of our relationships with insurance companies and vehicle manufacturers to obtain salvage vehicles outside the auction process.

We Have a Broad and Deep Inventory of Products.

We believe that our customers place a high value on availability of a broad range of light vehicle replacement products. We also believe that our inventory of recycled OEM, aftermarket and refurbished products allows us to fill a higher percentage of our customers orders than our competitors. In addition, our ability to share inventory on a regional basis increases the availability of replacement products and also helps us to fill a higher percentage of our customers orders. We have developed regional trading zones within which we make our inventory available to our local facilities, mostly via overnight product transfers. We manage our inventory and purchasing on a regional basis to enhance the availability of the products that we believe will be in the highest demand within each region. Our broad and deep inventory furthers our ability to serve as a one-stop solution for our customers recycled OEM, aftermarket and refurbished product needs.

We Have Implemented Management Disciplines.

Our management and operations team is highly experienced, with many managers having spent their entire careers in the light vehicle recycling industry. We have developed and built procurement, operating, and financial systems that have allowed us to grow and develop our national network and implement professional management techniques and disciplines. As our business has grown, we have acquired additional management talent which has furthered the sharing of best practices throughout the company. In addition, our senior management team has extensive acquisition experience and will continue to use our disciplined approach in targeting growth opportunities.

Our Strategies

Strengthen our National Network Through Internal Growth and Acquisitions.

We intend to continue to expand our market coverage through a combination of internal development and acquisitions and to look for opportunities to expand into new regions and into adjacent markets. We plan to establish a presence in additional major metropolitan markets and a number of smaller markets in the U.S. We have applied an analytical and disciplined approach to our acquisition process and have targeted companies with strong management teams, a record of environmental compliance, solid growth prospects, and a reputation for quality and customer service.

Further Develop Business Relationships.

We intend to continue to develop business relationships with automobile insurance companies, extended warranty providers, and other industry participants. We believe that insurance companies and extended warranty providers, as payors for many repairs, will take a more active role in the selection of replacement products in the repair process in order to use lower cost alternatives to new OEM products. On behalf of certain insurance company customers, we provide a review of vehicle repair order estimates so they may assess the opportunity to increase usage of recycled OEM, aftermarket and refurbished products in the repair process, thereby reducing their costs. Our employees also provide quotes for our products to assist several insurance companies with their estimate and settlement processes. We also work with insurance companies and light vehicle manufacturers to procure salvage vehicles directly from them on a selected basis, which provides us an additional source of supply and provides them improved economics on salvage vehicle sales. We believe we are positioned to take advantage of the increasing importance of these industry participants and will continue to look for ways to enhance our relationships.

Continue to Improve our Operating Results.

We are working to improve our operating results by applying our business disciplines to our most recently acquired facilities, continuing to build our network, further centralizing certain functions, improving our use of technology, and increasing revenue at our lower volume facilities. Our higher volume facilities generally operate at a higher profitability level as a percentage of revenue. We believe we can improve the profitability level at our lower volume facilities by achieving the higher volumes and improved economies of scale that we realize at our higher volume facilities. We intend to continue to refine our procurement system, which uses methodologies that analyze demand levels for our products, existing inventory levels, and projected margins on an individual vehicle basis.

Further Develop our Technology and Business Processes.

We continue to emphasize the use of technology in our processes to improve efficiency and to increase the standardization of our business. Our technology and proprietary processes enhance procurement, pricing, and inventory management. We continue to develop our technology to allow us to better manage and analyze our inventory, to assist our sales people with up-to-date pricing and availability of our products, and to further enhance our procurement process. For example, many of our representatives responsible for procuring vehicles, whom we refer to as scouts, are equipped with handheld computing devices to assist them in appraising the vehicles prior to submitting a bid to purchase the vehicle.

Raise Industry Standards by Being the Industry Leader.

Since our inception, we have employed a professional approach to the light vehicle recycling business. We continue to seek new ways to improve our methodologies and to communicate our standards to our customers. We further believe that, by elevating industry standards in areas such as customer service, integrity, product quality and availability, delivery time, warranty support, environmental compliance, and appearance of facilities, we can help promote the acceptability of the use of recycled OEM, aftermarket and refurbished products.

Our Process

Our operations generally involve the procurement of inventory, vehicle processing (in the case of wholesale recycled OEM products), sales, and distribution. We also perform refurbishing of OEM wheel and lighting products. Such refurbishing work is primarily cosmetic.

Procurement of Inventory

We start the process of procuring recycled OEM products for our wholesale operations by acquiring severely damaged or totaled vehicles. We acquired approximately 111,400 salvage vehicles for our wholesale operations in 2006. We purchase the majority of our vehicles from salvage auctions. Wrecked vehicles are sold at salvage auctions held each weekday throughout the country. Salvage auctions provide an outlet for salvage vehicles to be processed and sold primarily to automotive recyclers and rebuilders. We pay third parties fees to tow the vehicles from the auction to our facilities. Salvage auctions charge fees both to the supplier of vehicles (primarily insurance companies) and to the purchaser (including us).

For the vast majority of our salvage auction purchases, we send a scout in advance of each auction to investigate the vehicles we would be interested in buying. The scout obtains key information such as the model, mileage, and damage assessment and determines which parts on the targeted vehicles are recyclable. This information is electronically forwarded to our bid specialists via handheld computing devices or facsimile transmissions. The bid specialists analyze the data in light of current demand for the parts in question, the levels of our inventory with respect to such parts, and the projected margins expected for each vehicle. The specialists then set a maximum bid price that our bidders use to purchase the vehicle at auction. We believe that this system provides a disciplined approach to procurement.

We also obtain salvage vehicles and parts from insurance companies, vehicle manufacturers, abandoned vehicle programs, and other salvage sources. Some of these arrangements allow us to acquire salvage vehicles directly from the insurance company or vehicle manufacturer at a cost calculated as a percentage of revenue from such vehicles, which is remitted as products are sold from these vehicles. These arrangements eliminate the fees we and the insurance company would otherwise pay to the salvage auction and provide us inventory with a lower initial expenditure of capital.

We acquire inventory for our self-service retail recycled OEM products operations from a variety of sources, including but not limited to auctions, towing companies, municipalities, insurance carriers, charitable organizations and the general public. In 2006, we purchased approximately 138,700 salvage vehicles for our retail operations.

We purchase aftermarket products from independent manufacturers. Approximately 55% of our aftermarket products are purchased and imported directly from manufacturers in Taiwan. Approximately 45% of our aftermarket products are purchased from locations in the U.S., however, we believe that the majority of these products are manufactured in Taiwan and other Asian countries. No single supplier currently provides more than 21% of our aftermarket products. We use a proprietary order management system to procure our aftermarket inventory. The system prompts inventory purchases based on stocking levels and historical sales data. We believe that the system helps us to procure our aftermarket inventory efficiently and to maintain one of the highest fulfillment rates in the aftermarket products industry.

Our refurbished products are processed from cores obtained from our recycled OEM locations and from brokers. The higher quality cores are then refurbished. For popular wheels, we also purchase aftermarket wheels from outside vendors to fill demand.

Vehicle Processing

Vehicle processing for our wholesale operations involves dismantling a salvage vehicle into recycled OEM products ready for delivery. When a salvage vehicle arrives at one of our facilities, an inventory specialist identifies, catalogs, and schedules the vehicle for dismantling. We do not dismantle any vehicle until we have received proper title documentation, thereby assuring that the vehicle was not stolen.

The dismantler removes components that will become products for sale. Products that are placed directly on inventory shelves generally include such items as the engine, transmission, hood, trunk lid, head and tail lamp assemblies, rear bumper, and doors. We remove all recyclable items including fluids, freon, batteries, tires, and catalytic converters. These items are sold to recyclers and reprocessors. Dismantlers also perform any required cutting of the vehicle frame or body.

Each inventory item is entered into our inventory tracking system, inspected for quality, tagged for identification, and prepared for storage and delivery to our customers. Mechanical products not in a condition to be sold as recycled products or that are in surplus supply are separated and sold in bulk to parts remanufacturers. The remaining vehicle hulks and components, such as fabrics, rubber, plastics, and glass, are delivered to automobile shredders, crushers, and scrap processors.

Sales

As of December 31, 2006, we employed 462 full-time sales staff in our wholesale recycled OEM products operations. Of these, 429 were located at sales desks at our facilities and generally are responsible for accepting incoming calls from, and selling our inventory to, our customers. We put all of our sales personnel through a thorough training program. Most of our sales personnel are paid primarily on a commission basis. In addition, as of December 31, 2006, we had approximately 33 traveling sales staff who visit our customers and focus on business development in various markets. In our aftermarket products operations, sales orders are accepted by either our local delivery drivers or by our dedicated aftermarket and refurbished products sales call centers.

We are continually reviewing and revising the pricing of our recycled OEM products. Our pricing specialists take into consideration factors such as location, recent demand, inventory quantity, inventory turnover, new OEM product prices, recycled OEM product prices, aftermarket and refurbished product prices, and remanufactured part prices, with the goal of optimizing revenue. We update the pricing of our aftermarket and refurbished products at least annually when we update our product catalogs or when standard pricing guides are provided to estimating systems. We may adjust prices during the year in response to material price changes of OEM products.

The inventory base of each of our facilities, supplemented by the inventory sharing system within our regional trading zones, gives us what we believe to be a competitive advantage through our ability to meet our customers requirements more frequently than smaller competitors.

Distribution

Each sale results in the generation of a work order. A dispatcher is then responsible for ensuring product accuracy, printing the final invoice, and including the products on the appropriate truck route for delivery to the customer. We operate a delivery fleet of medium-sized trucks and smaller trucks and vans. These trucks deliver products to our customers within a specified territory, typically on a daily basis. In markets where we offer recycled OEM, aftermarket and refurbished products, we deliver all of our product types on the same delivery routes to help minimize distribution costs.

Additionally, we have developed an internal distribution network to allow our sales representatives to sell recycled OEM, aftermarket and refurbished products from the inventory of nearby facilities within our regional trading zones, thus improving our ability to fulfill customer requests and to improve inventory turnover. We operate approximately 64 recycled OEM product and 36 aftermarket product and refurbished wheel product transfers between our facilities within our regional trading zones each weekday.

Our Products

When we procure salvage vehicles, we focus on vehicles for which the insured repair market has the most recycled OEM product demand. These tend to be popular types of vehicles such as sport utility vehicles and pickup trucks, and automobile models with high sales volume. These vehicles generally are a few model years old, as insurers tend to use new OEM products on repairs of vehicles that are one to two years old. Similarly, insurers are less likely to authorize the repair of vehicles more than ten model years old. The degree of damage is not a significant factor in our process as we only assign value to the undamaged products when we prepare our bids.

Our most popular recycled OEM products include engines, transmissions, vehicle front end assemblies, doors, trunk lids, bumper assemblies, wheels, head and tail lamp assemblies, mirrors, fenders, and axles.

When we obtain a mechanical product, wheels or certain lighting products from a dismantled vehicle and determine that we have an excess supply of such product or it is defective, the mechanical item is then sold in bulk to mechanical remanufacturers, while the wheel and lighting items are sent to our refurbishment locations. We refer to these items as core products. The majority of the mechanical products are transferred to our core facility in Houston, Texas where we sort them by product and model type. Examples of such products are engine blocks and heads, transmissions, starters, alternators, and air conditioner compressors. The wheels and lighting items are sent to our refurbishing facilities.

When we procure aftermarket products and refurbish wheels and lights, we focus on products that are in the most demand by the insured repair market. Our most popular aftermarket products are head lamps, tail lamps, grilles, hoods, and mirrors. We also focus on aftermarket and refurbished products that would best complement our recycled OEM product inventory.

Our Customers

Insurance Companies

We consider automobile insurance companies our customers, as they are a key demand driver for our products. Our products are delivered directly to the repair shop or installer, because insurance companies and extended warranty providers generally do not take receipt of repair parts. While insurance companies do not pay for our products directly, the insurance company does ultimately pay for the repair of the insured vehicle. As a result, the insurance company often exerts significant influence in the decision-making process as to how a damaged vehicle is repaired, and the cost level of the product used in the repair process. Insurance companies are also concerned with customer satisfaction with the repair process and the total time to return the repaired vehicle to its owner.

Repair Shops and Others

We sell the majority of our products wholesale to collision repair shops and mechanical repair shops. The majority of these customers tend to be individually-owned small businesses, although over the last few years there has been a trend toward consolidation resulting in the formation of several national and regional repair companies. We also sell our products to automobile dealerships and fleet management groups. In addition, we sell our products to individual retail customers at our self-service retail locations and at certain of our wholesale recycled OEM, aftermarket and refurbished product locations.

Remanufacturers

A mechanical part that is not suitable for sale as a replacement part, or that is a product for which we have an excess supply, is sold to mechanical remanufacturers in bulk shipments. Examples of mechanical parts we sell in this manner are engine blocks and heads, transmissions, starters, alternators, and air conditioner compressors. Remanufacturers usually are significantly larger companies than repair shops. Our sales to them tend to be large orders and are dependent on their needs for a certain product line.

Our Employees

As of December 31, 2006, we had approximately 4,100 employees performing operational functions and approximately 170 corporate and regional employees. In July 2006, approximately 60 of our employees at our Totowa, New Jersey facility voted to be represented by a union. Since shortly after the vote, we have been in negotiations with the union regarding a collective bargaining agreement. No agreement has been reached. Other than the employees in Totowa, New Jersey, none of our employees is a member of a union or participates in other collective bargaining arrangements.

Our Facilities

Our corporate headquarters are located at 120 North LaSalle Street, Suite 3300, Chicago, Illinois 60602. In February 2004, we entered into a new lease, which became effective on August 1, 2004, to remain in our current office space. The term of the new lease is ten years, but either party can terminate the lease in July 2009. The primary functions performed at our corporate headquarters are financial, accounting, treasury, marketing, business development, human resources, information systems support, and legal. In addition to our corporate headquarters, we have numerous operating facilities that handle recycled OEM products, aftermarket and refurbished products, and self-service retail products. A majority of these facilities are leased.

Recycled OEM Parts

Our wholesale recycled OEM parts facilities are located among eight geographic regions. A typical facility has processing, sales and distribution operations, including a large warehouse with multiple bays to dismantle vehicles, indoor and outdoor storage areas, and administrative and sales offices. Equipment typically used at each facility includes hydraulic lifts, forklifts and loaders, and hand tools to dismantle vehicles. We also have facilities that operate primarily as redistribution centers. As of February 23, 2007, we conducted our wholesale recycled OEM parts operations from 67 facilities, 53 of which include a combination of processing, sales and redistribution operations, and 14 of which are primarily redistribution facilities. We also have three recycled OEM parts facilities in Central America.

Aftermarket Parts

We conduct our aftermarket parts business from facilities that serve as sales, warehousing or distribution centers for these parts. As of February 23, 2007, we conducted our aftermarket parts operations from approximately 48 facilities, 20 of which are co-located at wholesale recycle facilities. The largest of these facilities are located in Columbus, Ohio; Charlotte, North Carolina; Dallas, Texas; Oakland, California; Pennsauken, New Jersey; Totowa, New Jersey; Landover, Maryland; Atlanta, Georgia; Chicago, Illinois; Webster, Massachusetts and Topeka, Kansas.

Refurbished Parts

We refurbish wheels at four facilities located in Connecticut, Florida, Indiana and Michigan. We also distribute wheels from two locations, one in Illinois (located within our Chicago aftermarket warehouse) and one in Michigan. As a result of a 2007 acquisition, we refurbish head lamps and tail lamps at a facility in Grand Rapids, Michigan.

Self-Service Retail Parts

Our self-service retail parts facilities typically consist of several acres of vehicles stored outdoors and a retail building through which customers access the vehicles. As of February 23, 2007, we conducted our self-service retail parts operations from 22 facilities in the United States.

Competition

We operate in a highly competitive industry. We consider all suppliers of light vehicle products to be competitors, including participants in the recycled OEM product market, OEMs, parts remanufacturers, suppliers of aftermarket and refurbished products, and internet-based suppliers. We believe the principal areas of competition in our industry include pricing, product quality, service, and availability of inventory.

We compete with more than 6,000 domestic light vehicle product recyclers, most of which are single-unit operators. We believe most of the light vehicle parts recyclers in the U.S. have less than $3.0 million in annual revenue. In some markets, smaller competitors have organized affiliations to share marketing and distribution resources. Greenleaf LLC, a light vehicle recycling business started by Ford Motor Company, is our largest competitor in the light vehicle OEM product recycling business. Schnitzer Steel Industries, Inc., a company with operations in the steel manufacturing, metals recycling, and vehicle product recycling businesses, purchased Greenleaf on September 30, 2005. Schnitzer Steel is a significant operator in the self-service retail recycling business.

We also compete with distributors of aftermarket and refurbished collision light vehicle products. The largest distributor of these products in the U.S. is Keystone Automotive Industries, Inc.

Manufacturers of new original equipment parts sell the majority of light vehicle replacement products. We believe, however, that as the insurance and repair industries come to appreciate the advantages of recycled OEM, aftermarket and refurbished products, those products can account for a larger percentage of total vehicle replacement product sales.

Information Technology

We use a single third party facility management system in most of our wholesale recycled OEM operations. We believe that a single system helps us with the continued implementation of standard operating procedures, training efficiency, employee transferability, access to a national inventory database, management reporting, and data storage. It also eliminates the need to create multiple versions of proprietary applications and systems support processes.

The major features of our facility management system include inventory control, customer selling and billing, sales analysis, vehicle tracking, and profitability reporting. The system also supports an electronic exchange system for identifying and locating parts at other selected recyclers and facilitates brokered sales to fill customer orders for items not in stock.

We have separate third party providers for our financial systems such as financial and budget reporting, general ledger accounting, accounts payable, payroll, and fixed assets. We utilize the same common financial systems throughout the majority of our operations.

We currently protect our local customer, inventory, and corporate consolidated data, such as financial information, e-mail files, and other user files, with daily backups. These backups are stored off site with a third party data protection vendor.

We have consolidated our facility management systems onto regional system platforms. The hardware for all such platforms is located at a single data center. The center is in a secure environment with around-the-clock monitoring; redundant power backup; and multiple, diverse data and telecommunication routing. Facility management system data is mirrored (replicated) off site in real time to a disaster recovery facility located in a different part of the country. This disaster recovery facility is also housed in a secure environment with around-the-clock monitoring; redundant power backup; and multiple, diverse data and telecommunications routing.

Currently our aftermarket, refurbishing, and self-service retail operations each use a separate facility management system.

Regulation

Environmental Compliance

Our operations and properties, including the maintenance of our delivery vehicles, are subject to extensive federal, state, and local environmental protection and health and safety laws and regulations. These environmental laws govern, among other things, the emission and discharge of hazardous materials into the ground, air, or water; the exposure to hazardous materials; and the generation, handling, storage, use, treatment, identification, transportation, and disposal of industrial by-products, waste water, storm water, and mercury and other hazardous materials.

We have made and will continue to make capital and other expenditures relating to environmental matters. We have an environmental management process designed to facilitate and support our compliance with these requirements. We cannot assure you, however, that we will at all times be in complete compliance with such requirements.

Although we presently do not expect to incur any capital or other expenditures relating to environmental controls or other environmental matters in amounts that would be material to us, we may be required to make such expenditures in the future. Environmental laws are complex, change frequently and have tended to become more stringent over time. Accordingly, we cannot assure you that environmental laws will not change or become more stringent in the future in a manner that could have a material adverse effect on our business.

Contamination resulting from vehicle recycling processes can include soil and ground water contamination from the release, storage, transportation, or disposal of gasoline, motor oil, antifreeze, transmission fluid, CFCs from air conditioners, other hazardous materials, or metals such as aluminum, cadmium, chromium, lead, and mercury. Contamination can migrate on-site or off-site which can increase the risk, and the amount, of any potential liability.

In addition, many of our facilities are located on or near properties with a history of industrial use which may have involved hazardous materials. As a result, some of our properties may be contaminated. Some environmental laws hold current or previous owners or operators of real property liable for the costs of cleaning up contamination, even if these owners or operators did not know of and were not responsible for such contamination. These environmental laws also impose liability on any person who disposes of, treats, or arranges for the disposal or treatment of hazardous substances, regardless of whether the affected site is owned or operated by such person, and at times can impose liability on companies deemed under law to be a successor to such person. Third parties may also make claims against owners or operators of properties, or successors to such owners or operators, for personal injuries and property damage associated with releases of hazardous or toxic substances.

When we identify a potential material environmental issue during our acquisition due diligence process, we analyze the risks, and, when appropriate, perform further environmental assessment to verify and quantify the extent of the potential contamination. Furthermore, where appropriate, we have established financial reserves for certain environmental matters. In addition, at times we, or one of the sellers from whom we purchased a business, have undertaken remediation projects. We do not anticipate, based on currently available information and current laws, that we will incur liabilities in excess of reserves to address environmental matters. However, in the event we discover new information or if laws change, we may incur significant liabilities, which may exceed our reserves.

Title Laws

In some states, when a vehicle is deemed a total loss, a salvage title is issued. Whether states issue salvage titles is important to the light vehicle recycling industry because an increase in vehicles that qualify as salvage vehicles provides greater availability and typically lowers the price of such vehicles. Currently, these titling issues are a matter of state law. In 1992, the U.S. Congress commissioned an advisory committee to study problems relating to vehicle titling, registration, and salvage. Since then, legislation has been introduced seeking to establish national uniform requirements in this area, including a uniform definition of a salvage vehicle. The light vehicle recycling industry will generally favor a uniform definition, since it will avoid inconsistencies across state lines, and will generally favor a definition that expands the number of damaged vehicles that qualify as salvage. However, certain interest groups, including repair shops and some insurance associations, may oppose this type of legislation. National legislation has not yet been enacted in this area, and there can be no assurance that such legislation will be enacted in the future.

National Stolen Passenger Motor Vehicle Information System

In 1992, Congress enacted the Anti Car Theft Act to deter trafficking in stolen vehicles. This law included the establishment of the National Stolen Passenger Motor Vehicle Information System to track and monitor stolen automotive parts. In April 2002, the Department of Justice published for comment proposed regulations to implement the National Stolen Passenger Motor Vehicle Information System. The proposed regulations require, among other things, that insurance companies, salvagers, dismantlers, recyclers, and repairers inspect salvage vehicles for the purpose of collecting the vehicle identification number and the part number for any covered major part that possesses the vehicle identification number. The requirement to collect this information would place substantial burdens on light vehicle recyclers, including us, that otherwise would not normally exist. It would place similar burdens on repair shops, which may further discourage the use by such shops of recycled products. The Department of Justice s comment period for the proposed regulations ended in June 2002, but final regulations have not been issued.

Legislation Affecting Automotive Repair Parts

Most states have laws that restrict the use of aftermarket parts in collision repair work. These restrictions range from the requirement to disclose to the vehicle owner the use of aftermarket parts in the repair process to the requirement to have aftermarket parts certified by an independent testing organization. Some jurisdictions have laws that prohibit or restrict the sale of certain recycled OEM products that we provide, such as airbags. Additional laws of this kind may be introduced in the future. An increase in the number of states passing such legislation or the passing of legislation with prohibitions or restrictions that are more severe than current laws could have a material adverse impact on our business. Additionally, Congress could enact federal legislation restricting the use of aftermarket and recycled automotive parts in the repair process.

Seasonality

Our operating results are subject to quarterly variations based on a variety of factors, influenced primarily by seasonal changes in weather patterns. During the winter months we tend to have higher demand for our products because there are more weather related accidents. In addition, the cost of salvage vehicles tends to be lower as more weather related accidents occur generating a larger supply of total loss vehicles.

ITEM 1A. RISK FACTORS

Risks Relating to Our Business

We face intense competition from local, national, and internet-based light vehicle products providers, and this competition could negatively affect our business.

The light vehicle replacement products industry is highly competitive and is served by numerous suppliers of OEM products, recycled OEM products, aftermarket products, and refurbished products. Within each of these categories of suppliers, there are local owner-operated companies, larger regional suppliers, national providers, and internet-based suppliers. Providers of light vehicle replacement products that have traditionally sold only certain categories of such products may decide to expand their product offerings into other categories of light vehicle replacement products, which may further increase competition. Some of our current and potential competitors may have more operational expertise; greater financial, technical, manufacturing, distribution, and other resources; longer operating histories; lower cost structures; and better relationships in the insurance and vehicle repair industries. In certain regions of the U.S., local light vehicle recycling companies have formed cooperative efforts to compete in the recycled OEM products industry. As a result of these factors, our competitors may be able to provide products that we are unable to supply, provide their products at lower costs, or supply products to customers that we are unable to serve.

An adverse change in our relationships with auction companies or our suppliers could increase our expenses and hurt our ability to serve our customers.

Most of our salvage inventory is obtained from vehicles offered at salvage auctions by several companies that own auction facilities in numerous locations across the U.S. We do not have contracts with any auction company. According to industry analysts, three companies control over 65% of the salvage auction market in the U.S. In some localities, the automotive auction business may be even more highly concentrated. If an auction company prohibited us from participating in its auctions, or significantly raised its fees, our business could be adversely affected through higher costs or the resulting potential inability to service our customers. Moreover, we are facing increased competition in the purchase of salvage vehicles from shredders and scrap recyclers, internet-based buyers, and others. This increase in the number of bidders may increase our cost of goods sold for recycled OEM products.

We also acquire some of our inventory directly from insurance companies, original equipment manufacturers, aftermarket parts manufacturers, and others. To the extent that these suppliers decide to discontinue these arrangements, our business could be adversely affected through higher costs or the resulting potential inability to service our customers.

In addition, we purchase aftermarket parts primarily from foreign manufacturers in Taiwan. In the event that our business relationships with these suppliers deteriorated or terminated, or in the event that the importing of products into the U.S. from Taiwan or the exporting of products by Taiwan to the U.S. was disrupted, our business could be adversely affected through higher costs or the resulting inability to service our customers.

We may not be able to sell our products due to existing or new laws and regulations prohibiting or restricting the sale of recycled OEM or aftermarket products.

Some jurisdictions have enacted laws prohibiting or severely restricting the sale of certain recycled OEM products that we provide, such as airbags. These and other jurisdictions could enact similar laws or could prohibit or severely restrict the sale of additional recycled OEM products. Restrictions on the products we are able to sell could decrease our revenue and have an adverse effect on our business and operations.

We became involved in the aftermarket products business upon the closing of an acquisition in February 2004. Since 1998, most states have passed laws that prohibit or limit the use of aftermarket products in collision repair work and/or require enhanced disclosure or vehicle owner consent before using aftermarket products in such repair work. Additional legislation of this kind may be introduced in the future. If additional laws prohibiting or restricting the use of aftermarket products are passed, it could have an adverse impact on our aftermarket products business.

Certain organizations test the quality and safety of light vehicle replacement products. In the event that such organizations decide that a particular vehicle product does not meet applicable quality or safety standards, we may decide to discontinue sales of such product or insurance companies may decide to discontinue authorization of repairs using such product. Such events could adversely affect our business.

If our business relationships with insurance companies end, we may lose important sales opportunities.

We rely on business relationships with several insurance companies. These insurance companies encourage vehicle repair facilities to use products we provide. Our arrangements with these companies may be terminated at any time. We rely on these relationships for sales to some collision repair shops, and a termination of these relationships may result in a loss of sales, which could adversely affect our results of operations.

We are subject to environmental regulations and incur costs relating to environmental matters.

We are subject to various federal, state, and local environmental protection and health and safety laws and regulations governing, among other things:

- the emission and discharge of hazardous materials into the ground, air, or water;
- the exposure to hazardous materials; and
- the generation, handling, storage, use, treatment, identification, transportation, and disposal of industrial by-products, waste water, storm water, and mercury and other hazardous materials.

We are also required to obtain environmental permits from governmental authorities for certain of our operations. If we violate or fail to obtain or comply with these laws, regulations, or permits, we could be fined or otherwise sanctioned by regulators. We could also become liable if employees or other third parties are improperly exposed to hazardous materials.

Under certain environmental laws, we could be held responsible for all of the costs relating to any contamination at, or migration to or from, our or our predecessors past or present facilities and at third party waste disposal sites. These laws often impose liability even if the owner or operator did not know of, or was not responsible for, the release of such hazardous substances.

Environmental laws are complex, change frequently, and have tended to become more stringent over time. Our costs of complying with current and future environmental and health and safety laws, and our liabilities arising from past or future releases of, or exposure to, hazardous substances, may adversely affect our business, results of operations, or financial condition.

Governmental agencies may refuse to grant or renew our operating licenses and permits.

Our operating subsidiaries must obtain licenses and permits from state and local governments to conduct their operations. When we develop or acquire a new facility, we must seek the approval of state and local units of government. Governmental agencies often resist the establishment of a vehicle recycling facility in their communities. There can be no assurance that future approvals or transfers will be granted. In addition, there can be no assurance that we will be able to maintain and renew the licenses and permits our operating subsidiaries currently hold.

Proposed regulations under the National Stolen Passenger Motor Vehicle Information System could harm our business.

In 1992, Congress enacted the Anti Car Theft Act to deter trafficking in stolen vehicles. This law included the establishment of the National Stolen Passenger Motor Vehicle Information System to track and monitor stolen automotive parts. In April 2002, the Department of Justice published for comment proposed regulations to implement this system. The proposed regulations require, among other things, that insurance companies, salvagers, dismantlers, recyclers, and repairers inspect salvage vehicles for the purpose of collecting the vehicle identification number and the part number for any covered major part that possesses the vehicle identification number. The requirement to collect this information would place burdens and costs on us that otherwise would not normally exist, and could discourage our customers from purchasing our products if the proposed regulations are adopted.

We could be subject to product liability claims.

If customers of repair shops that purchase our products are injured or suffer property damage, we could be subject to product liability claims. The successful assertion of this type of claim could have an adverse effect on our business or financial condition.

We may lose business if recent litigation involving the use of aftermarket parts results in insurance companies modifying arrangements affecting the use of recycled OEM or aftermarket products in the repair process.

In an Illinois lawsuit involving State Farm Mutual Automobile Insurance Company (*Avery v. State Farm*), a jury decided in October 1999 that State Farm breached certain insurance contracts with its policyholders by using non-OEM parts to repair damaged vehicles when use of such parts did not restore the vehicle to its pre-loss condition. The jury found that State Farm misled its customers by not disclosing the use of non-OEM parts and the alleged inferiority of those parts. The jury assessed damages against State Farm of $456 million, and the judge assessed an additional $730 million of disgorgement and punitive damages for violations of the Illinois Consumer Fraud Act. In April 2001, the Illinois Appellate Court upheld the verdict but reduced the damage award by $130 million because of duplicative damage awards. On August 18, 2005, the Illinois Supreme Court reversed the awards made by the circuit court and found, among other things, that the plaintiffs had failed to establish any breach of contract on the part of State Farm. The U.S. Supreme Court declined to hear an appeal of this case. As a result of this case, some insurance companies had reduced or eliminated their use of aftermarket products. Although our products are primarily recycled OEM parts, we entered the aftermarket products business through an acquisition in February 2004. Our financial results could be affected, perhaps adversely, if insurance companies modified or terminated the arrangements pursuant to which repair shops buy aftermarket or recycled OEM products from us due to a fear of similar claims with respect to such products.

If the number of vehicles involved in accidents declines, our business could suffer.

Because our business depends on vehicle accidents for both the supply of recycled OEM products and the demand for repairs using our products, factors which influence the number and/or severity of accidents, including, but not limited to, the number of vehicles on the road, the number of miles driven, the ages of drivers, the use of cellular telephones and other electronic equipment by drivers, the congestion of traffic, the occurrence and severity of certain weather conditions, the use of alcohol and drugs by drivers, and the condition of roadways, impact our business. In this regard, a number of states and municipalities have adopted, or are considering adopting, legislation banning the use of handheld cellular telephones while driving and such restrictions could lead to a decline in accidents. Moreover, an increase in fuel prices may cause the number of vehicles on the road to decline as motorists seek alternative transportation options and this also could lead to a decline in accidents.

We may not be able to successfully acquire new operations or integrate future acquisitions, which could cause our business to suffer.

We may not be able to successfully complete potential strategic acquisitions if we cannot reach agreement on acceptable terms or for other reasons. If we buy a company or a division of a company, we may experience difficulty integrating that company s or division s personnel and operations, which could negatively affect our operating results. In addition:

- the key personnel of the acquired company may decide not to work for us;
- we may experience business disruptions as a result of information technology systems conversions;
- we may experience additional financial and accounting challenges and complexities in areas such as tax planning, treasury management, and financial reporting;
- we may be held liable for environmental risks and liabilities as a result of our acquisitions, some of which we may not have discovered during our due diligence;
- our ongoing business may be disrupted or receive insufficient management attention; and

- we may not be able to realize the cost savings or other financial benefits we anticipated.

In connection with future acquisitions, we may assume the liabilities of the companies we acquire. These liabilities, including liabilities for environmental-related costs, could materially and adversely affect our business. We may have to incur debt or issue equity securities to pay for any future acquisition, the issuance of which could involve the imposition of restrictive covenants or be dilutive to our existing stockholders.

Our credit facility imposes certain operating and financial restrictions on us and our subsidiaries and requires us to meet certain financial tests.

Our credit facility contains certain operating and financial restrictions that limit or prohibit us from engaging in certain transactions, including the following:

- incurring or guarantying additional debt;

- paying dividends or other distributions to our stockholders or redeeming, repurchasing, or retiring our capital stock or subordinated obligations;

- making investments and capital expenditures;

- creating liens on our assets;

- selling, transferring, leasing, licensing, or otherwise disposing of assets other than in the ordinary course of business;

- engaging in transactions with stockholders and affiliates;

- engaging in mergers, consolidations, or acquisitions;

- engaging in any material line of business substantially different from, and unrelated to, those lines of business currently carried on by us; and

- making changes to our equity capital structure or amending our certificate of incorporation, bylaws, or any stockholder rights agreement.

The credit facility also requires that we satisfy certain financial tests. The failure to comply with any of these covenants would cause a default under the credit facility. A default, if not waived, could result in acceleration of our debt, in which case the debt would become immediately due and payable. If this occurs, we may not be able to repay our debt or borrow sufficient funds to refinance it. Even if new financing were available, it may be on terms that are less attractive to us than our existing credit facility or it may not be on terms that are acceptable to us.

Our future capital needs may require that we seek debt financing or additional equity funding that, if not available, could cause our business to suffer.

We may need to raise additional funds in the future to, among other things, fund our existing operations, improve or expand our operations, respond to competitive pressures, or make acquisitions. From time to time, we may raise additional funds through public or private financing, strategic alliances, or other arrangements. If adequate funds are not available on acceptable terms, we may be unable to meet our business or strategic objectives or compete effectively. If we raise additional funds by issuing equity securities, stockholders may experience dilution of their ownership interests, and the newly issued securities may have rights superior to those of the common stock. If we raise additional funds by issuing debt, we may be subject to further limitations on our operations. If we fail to raise capital when needed, our business will be negatively affected.

Our annual and quarterly performance may fluctuate.

Our revenue, cost of goods sold, and operating results have fluctuated on a quarterly and annual basis in the past and can be expected to continue to fluctuate in the future as a result of a number of factors, some of which are beyond our control. Future factors that may affect our operating results include, but are not limited to, the following:

- fluctuations in the pricing of new OEM replacement products;
- the availability and cost of inventory;
- variations in vehicle accident rates;
- competition in the vehicle replacement parts industry;
- changes in state or federal laws or regulations affecting our business;
- changes in the types of replacement parts that insurance carriers will accept in the repair process;
- our ability to integrate and manage our acquisitions successfully;
- fluctuations in fuel prices;
- changes in the demand for our products and the supply of our inventory due to severity of weather and seasonality of weather patterns;
- the amount and timing of operating costs and capital expenditures relating to the maintenance and expansion of our business, operations, and infrastructure; and
- declines in the values of our assets.

Due to the foregoing factors, our operating results in future periods can be expected to fluctuate. Accordingly, our results of operations may not be indicative of future performance. These fluctuations in our operating results may cause our results to fall below the expectations of public market analysts and investors, which could cause our stock price to decline.

If we lose our key management personnel, we may not be able to successfully manage our business or achieve our objectives.

Our future success depends in large part upon the leadership and performance of our executive management team and key employees at the operating level. If we lose the services of one or more of our executive officers or key employees, or if one or more of them decides to join a competitor or otherwise compete directly or indirectly with us, we may not be able to successfully manage our business or achieve our business objectives. If we lose the services of any of our key employees at the operating or regional level, we may not be able to replace them with similarly qualified personnel, which could harm our business.

We rely on information technology in critical areas of our operations and a disruption relating to such technology could harm our business.

We use information technology systems owned by other companies for management of our facilities and our financial functions. In the event that the providers of these systems terminate their relationships with us, we could suffer disruptions to our operations.

In addition, we continually monitor these systems to find areas for improvement. In the event that we decided to switch providers or to implement our own systems, we may also suffer disruptions to our business. We may be unsuccessful in the development of our own systems, and we may underestimate the

costs and expenses of developing and implementing our own systems. Also, our revenue may be hampered during the period of implementing an alternative system, which period could extend longer than we anticipated.

If we experience problems with our fleet of trucks, our business could be harmed.

We use a fleet of trucks to deliver the majority of the products we sell. We are subject to the risks associated with providing trucking services, including inclement weather, disruptions in the transportation infrastructure, availability and price of fuel, liabilities arising from accidents to the extent we are not covered by insurance, and insurance premium increases. In addition, our failure to deliver products in a timely and accurate manner could harm our reputation and brand, which could have a material adverse effect on our business.

If we determine that our goodwill has become impaired, we may incur significant charges to our pre-tax income.

Goodwill represents the excess of cost over the fair market value of net assets acquired in business combinations. In the future, goodwill and intangible assets may increase as a result of future acquisitions. Goodwill and intangible assets are reviewed at least annually for impairment. Impairment may result from, among other things, deterioration in the performance of acquired businesses, adverse market conditions, and adverse changes in applicable laws or regulations, including changes that restrict the activities of the acquired business. As of December 31, 2006, our total goodwill, subject to future impairment testing, was approximately $246.2 million.

Challenges to the validity of aftermarket products could adversely effect our business.

Original equipment manufacturers have attempted to use claims of intellectual property infringement against manufacturers and distributors of aftermarket products to restrict or eliminate the sale of aftermarket products that are the subject of the claims. The original equipment manufacturers have brought such claims in federal court and with the United States International Trade Commission.

In December 2005, Ford Global Technologies, LLC initiated a complaint with the International Trade Commission against six companies, including a competitor of ours, Keystone Automotive Industries, Inc., alleging that certain aftermarket parts imported into the United States infringed on 14 design patents held by Ford Global. We were not named in the complaint, although the outcome would affect all persons and entities who import or distribute the parts, including us. In December 2006, an administrative law judge of the International Trade Commission preliminarily ruled that seven of the Ford Global design patents were valid and that the importation of automotive parts covered by these seven patents violated Section 337 of the Tariff Act of 1930. The ruling of the administrative law judge is not final. It will be reviewed by the International Trade Commission. If the International Trade Commission agrees with the ruling, it will issue an order prohibiting further importation of automotive parts covered by the patents. The parties to the action can appeal the Commission s final decision to the United States Circuit Court of Appeals for the Federal Circuit.

To the extent that the original equipment manufacturers are successful with intellectual property infringement claims, we could be restricted or prohibited from selling certain aftermarket products which could have an adverse effect on our business. If we are subsequently named as a defendant in any such claims, we would likely incur significant expenses defending the claims. Even if we are not named in any such claims, written allegations that we are infringing another party s intellectual property rights could involve significant expense to investigate.

Risks Relating to Our Common Stock

Our executive officers, directors, and their affiliates hold a large percentage of our stock and their interests may differ from other stockholders.

As of December 31, 2006, our executive officers, directors, and their affiliates, in the aggregate, beneficially owned approximately 21% of our common stock. If they were to act together, these stockholders would have significant influence over most matters requiring approval by stockholders, including the election of directors, any amendments to our certificate of incorporation, and certain significant corporate transactions. These stockholders may take these actions even if they are opposed by our other stockholders. In addition, without the consent of these stockholders, we could be delayed or prevented from entering into transactions that may be viewed as beneficial to us or our other stockholders.

Future sales of our common stock may depress our stock price.

We and our stockholders may sell shares of common stock in the future. We may also issue shares of common stock in connection with the exercise of outstanding options or in connection with future acquisitions. Certain of our existing stockholders are parties to a registration rights agreement that provides such holders with the right to require us to effect the registration of their shares of common stock in specific circumstances. In addition, if we propose to register any of our common stock under the Securities Act of 1933, whether for our own account or otherwise, some existing stockholders may be entitled to include their shares of common stock in that registration. We cannot predict the size of future issuances of our common stock or the effect, if any, that future issuances and sales of shares of our common stock will have on the price of our common stock. Sales of substantial amounts of common stock (including shares issued in connection with an acquisition), or the perception that such sales could occur, may cause the price of our common stock to fall.

Delaware law and our charter documents may impede or discourage a takeover, which could affect the price of our stock.

The anti-takeover provisions of our certificate of incorporation and bylaws and Delaware law could, together or separately, impose various impediments to the ability of a third party to acquire control of us, even if a change in control would be beneficial to our existing stockholders. Our certificate of incorporation and bylaws have provisions that could discourage potential takeover attempts and make attempts by stockholders to change management more difficult. Our incorporation under Delaware law and these provisions could also impede a merger, takeover, or other business combination involving us or discourage a potential acquiror from making a tender offer for our common stock, which, under certain circumstances, could reduce the price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our properties are described in Item 1 Business Our Facilities above, and such description is incorporated by reference to this Item 2. Our properties are sufficient to meet our present needs, and we do not anticipate any difficulty in securing additional space to conduct operations or additional office space, as needed, on terms acceptable to us.

ITEM 3. LEGAL PROCEEDINGS

We are from time to time subject to various claims and lawsuits incidental to our business. In the opinion of management, currently outstanding claims and suits, in the aggregate, will not have a material adverse effect on our consolidated financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the Nasdaq National Market under the symbol LKQX. At December 31, 2006, there were approximately 62 record holders of our common stock. We became a public company and began trading on the Nasdaq National Market on October 3, 2003. The following table sets forth, for the periods indicated, the range of the high and low sales prices of shares of our common stock on the Nasdaq National Market.

	High	**Low**
2005		
First Quarter	$ 10.09	$ 8.25
Second Quarter	14.03	9.45
Third Quarter	16.15	12.90
Fourth Quarter	17.83	14.00
2006		
First Quarter	23.08	17.44
Second Quarter	23.64	17.84
Third Quarter	23.40	18.18
Fourth Quarter	25.49	20.40

We have not paid any dividends on our common stock. We intend to continue to retain our earnings to finance our growth and for general corporate purposes. We do not anticipate paying any dividends in the foreseeable future. In addition, our credit facility contains, and future financing agreements may contain, financial covenants and limitations on payment of any cash dividends or other distributions of assets.

The following graph compares the percentage change in the cumulative total returns on our common stock, the NASDAQ Stock Market (U.S.) Index and the following group of peer companies (the Peer Group): Copart Inc., Keystone Automotive Industries Inc., and Aftermarket Technology Corp., for the period beginning on October 3, 2003 (the first day of trading following our initial public offering) and ending on December 31, 2006 (which was the last day of our 2006 fiscal year). The stock price performance in the following graph is not necessarily indicative of future stock price performance. The graph assumes that the value of an investment in the Company s common stock, the NASDAQ Stock Market (U.S.) Index and the Peer

Group was each $100 on October 3, 2003 and that all dividends, where applicable, were reinvested.

Comparison of Cumulative Return
Among LKQ Corporation, the NASDAQ Stock Market (U.S.) Index and the Peer Group

	10/02/03	12/31/03	12/31/04	12/31/05	12/31/06
LKQ Corporation	$ 100	$ 120	$ 134	$ 231	$ 307
NASDAQ Stock Market (U.S.) Index	$ 100	$ 109	$ 119	$ 121	$ 133
Peer Group	$ 100	$ 134	$ 189	$ 184	$ 227

The following table provides information about our common stock that may be issued under all of our equity compensation plans as of December 31, 2006.

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by stockholders	6,988,290	$ 8.14	3,925,164
Equity compensation plans not approved by stockholders		$	
Total	6,988,290		3,925,164

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial data should be read together with Management s Discussion and Analysis of Financial Condition and Results of Operations and our audited consolidated financial statements and related notes included elsewhere in this Annual Report on Form 10-K.

	Year Ended December 31, 2002	2003	2004	2005	2006
	(In thousands, except per share data)				
Statements of Operations Data:					
Revenue	$ 287,125	$ 327,974	$ 424,756	$ 547,392	$ 789,381
Cost of goods sold	154,574	174,238	227,140	289,788	431,832
Gross Margin	132,551	153,736	197,616	257,604	357,549
Facility and warehouse expenses	35,778	38,679	47,815	60,113	86,298
Distribution expenses	28,530	35,263	47,927	61,480	80,088
Selling, general and administrative expenses	42,385	48,289	60,095	74,495	102,174
Depreciation and amortization	5,014	5,446	6,872	8,574	11,823
Total operating expenses	111,707	127,677	162,709	204,662	280,383
Operating income	20,844	26,059	34,907	52,942	77,166
Other (income) expense					
Interest, net	2,908	2,023	1,505	1,887	5,824
Other, net	(332)	(117)	(455)	(628)	(1,479)
Income before provision for income taxes and cumulative effect of change in accounting principle	18,268	24,153	33,857	51,683	72,821
Provision for income taxes	7,263	9,577	13,284	20,796	28,426
Income before cumulative effect of change in accounting principle	11,005	14,576	20,573	30,887	44,395
Cumulative effect of change in accounting principle, net of tax(a)	(49,899)				
Net income (loss)	$ (38,894)	$ 14,576	$ 20,573	$ 30,887	$ 44,395
Basic earnings (loss) per share:					
Income before cumulative effect of change in accounting principle	$ 0.31	$ 0.45	$ 0.51	$ 0.70	$ 0.84
Net income (loss)	$ (1.10)	$ 0.45	$ 0.51	$ 0.70	$ 0.84
Diluted earnings (loss) per share:					
Income before cumulative effect of change in accounting principle	$ 0.28	$ 0.40	$ 0.46	$ 0.63	$ 0.80
Net income (loss)	$ (1.00)	$ 0.40	$ 0.46	$ 0.63	$ 0.80
Shares used in per share calculation basic(b)	35,308	32,536	40,105	44,019	52,827
Shares used in per share calculation diluted(b)	38,798	36,516	44,827	48,715	55,817

	Year Ended December 31, 2002	2003	2004	2005	2006
	(In thousands)				
Other Financial Data:					
Net cash provided by operating activities	$ 17,740	$ 20,949	$ 25,901	$ 37,533	$ 52,381
Net cash used in investing activities	(6,746)	(12,222)	(87,823)	(126,022)	(110,657)
Net cash provided by (used in) financing activities	(11,997)	6,770	47,452	90,050	59,134
Capital expenditures(c)	8,402	13,200	93,025	136,342	116,844
Depreciation and amortization	5,014	5,446	6,872	8,574	12,086
EBITDA(d)	26,190	31,622	42,234	62,144	90,731

	Year Ended December 31, 2002	2003	2004	2005	2006
	(In thousands)				
Balance Sheet Data:					
Total assets	$ 176,747	$ 203,154	$ 288,275	$ 439,426	$ 564,355
Working capital	50,670	74,184	77,879	103,776	122,420
Long-term obligations, including current portion	34,205	3,997	50,262	47,477	100,447
Stockholders equity	121,129	174,011	204,071	341,220	401,202

(a) We recorded a non-cash Goodwill impairment charge of $49,899,000 in 2002.

(b) We repurchased 4,000,000 shares of our common stock in February 2003 and repurchased an additional 3,114,996 shares of our common stock in May 2003. In addition, we sold 10,000,000 shares of our common stock on October 2, 2003 in connection with our initial public offering. Accordingly, the shares used in the per share calculation for basic and diluted earnings per share in 2003 do not fully reflect the impact of these transactions. We also sold 6,435,000 shares of our common stock on October 4, 2005 in connection with a follow-on public offering. Accordingly, the shares used in the per share calculation for basic and diluted earnings per share in 2005 do not fully reflect the impact of this transaction.

(c) Includes acquisitions and non-cash property additions.

(d) EBITDA consists of income (loss) before provision for income taxes and cumulative effect of change in accounting principle plus depreciation and amortization, interest expense, and stockholder loan guarantee fee, less interest income. We have presented EBITDA information solely as a supplemental disclosure because we believe it provides a helpful analysis of our operating results. EBITDA should not be construed as an alternative to operating income, net income (loss) or net cash provided by (used in) operating activities, as determined in accordance with accounting principles generally accepted in the United States. In addition, not all companies that report EBITDA information calculate EBITDA in the same manner as we do and, accordingly, our calculation is not necessarily comparable to similarly named measures of other companies and may not be an appropriate measure for performance relative to other companies.

The following table reconciles EBITDA to net income (loss):

	Year Ended December 31, 2002	2003	2004	2005	2006
	(In thousands)				
Net income (loss)	$ (38,894)	$ 14,576	$ 20,573	$ 30,887	$ 44,395
Cumulative effect of change in accounting principle, net of tax	49,899				
Depreciation and amortization	5,014	5,446	6,872	8,574	12,086
Interest, net	2,908	2,023	1,505	1,887	5,824
Provision for income taxes	7,263	9,577	13,284	20,796	28,426
Earnings before interest, taxes, depreciation and amortization (EBITDA)	$ 26,190	$ 31,622	$ 42,234	$ 62,144	$ 90,731

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

We provide replacement systems, components, and parts needed to repair light vehicles (cars and light trucks). Buyers of light vehicle replacement products have the option to purchase from primarily three sources: new products produced by original equipment manufacturers (OEMs), which are commonly known as OEM products; new products produced by companies other than the OEMs, which are sometimes referred to as aftermarket products; and recycled products originally produced by OEMs, which we refer to as recycled OEM products. We participate in the market for recycled OEM products as well as the market for collision repair aftermarket products. We obtain aftermarket products and salvage vehicles from a variety of sources, and we dismantle the salvage vehicles to obtain a comprehensive range of vehicle products that we distribute into the light vehicle repair market. We recently entered the business of refurbishing and distributing aluminum alloy wheels, head lamps and tail lamps. These acquisitions allowed us to expand our product offerings to our customers. We are not involved in the manufacture of automotive products and do not maintain any manufacturing or remanufacturing operations.

Our revenue, cost of goods sold, and operating results have fluctuated on a quarterly and annual basis in the past and can be expected to continue to fluctuate in the future as a result of a number of factors, some of which are beyond our control. Factors that may affect our operating results include, but are not limited to:

- fluctuations in the pricing of new OEM replacement products;
- the availability and cost of inventory;
- variations in vehicle accident rates;
- competition in the vehicle replacement parts industry;
- changes in state or federal laws or regulations affecting our business;
- changes in the types of replacement parts that insurance carriers will accept in the repair process;
- our ability to integrate and manage our acquisitions successfully;
- fluctuations in fuel prices;
- changes in the demand for our products and the supply of our inventory due to severity of weather and seasonality of weather patterns;
- the amount and timing of operating costs and capital expenditures relating to the maintenance and expansion of our business, operations, and infrastructure; and
- declines in the value of our assets.

Due to the foregoing factors, our operating results in future periods can be expected to fluctuate. Accordingly, our historical results of operations may not be indicative of future performance.

Acquisitions

Since our inception in 1998 we have pursued a growth strategy of both organic growth and acquisitions. We have pursued acquisitions that we believe will help drive profitability, cash flow and stockholder value. Our principal focus for acquisitions is companies that will expand our geographic presence and our ability to provide a wider choice of alternative light vehicle replacement products and services to our customers.

During 2004, we acquired six businesses (five in the recycled OEM automotive parts business and one in the aftermarket automotive parts business) for an aggregate of approximately $61.7 million in cash, $2.4 million in notes issued and 373,396 shares of our common stock. These business acquisitions enabled us to serve new markets, expand our presence in certain markets, become a significant provider of aftermarket automotive replacement parts and become a provider of self-service retail automotive parts. One of the acquisitions had operations in Guatemala and Costa Rica. The revenue of the Central American businesses is not material, but we are using these facilities as a platform to sell certain types of products into Central America from our U.S. based recycled OEM automotive replacement parts facilities.

During 2005, we acquired eight businesses (four in the recycled OEM automotive parts business and four in the aftermarket automotive parts business) for an aggregate of approximately $108.0 million in cash, $6.4 million in notes issued and $9 million contingently payable based on the achievement of certain future financial results. Certain terms of one of the contingent payment agreements were modified in 2006 such that $1.0 million was immediately paid and the maximum remaining amount contingently payable was reduced to $4.0 million. These business acquisitions enabled us to serve new markets and expand our presence in existing markets.

During 2006, we acquired ten businesses (one in the wheel refurbishing and distribution business, two in the aftermarket automotive parts business and seven in the recycled OEM automotive parts business) for an aggregate of approximately $71.1 million in cash and $7.2 million in notes issued. These business acquisitions enabled us to expand our product offerings to our customers, serve new markets and expand our presence in existing markets.

In the first quarter of 2007, we acquired two businesses (one in the recycled OEM automotive parts business and one that refurbishes head lamps and tail lamps). These business acquisitions enabled us to expand our presence in existing markets, serve new market areas and expand our product line offering.

Sources of Revenue

Since 2004, our revenue from the sale of light vehicle replacement products and related services has ranged between 84% and 92% of our total revenue. We sell the majority of our light vehicle replacement products to collision repair shops and mechanical repair shops. Our light vehicle replacement products include, for example, engines, transmissions, front-ends, doors, trunk lids, bumpers, hoods, fenders, grilles, valances, wheels, head lamps, and tail lamps. We sell extended warranty contracts for certain mechanical products. These contracts cover the cost of parts and labor and are sold for periods of six months, one year, or two years. We defer the revenue from such contracts and recognize it ratably over the term of the contracts. The demand for our products and services is influenced by several factors, including the number of vehicles in operation, the number of miles being driven, the frequency and severity of vehicle accidents, availability and pricing of new parts, seasonal weather patterns, and local weather conditions. Additionally, automobile insurers exert significant influence over collision repair shops as to how an insured vehicle is repaired and the cost level of the products used in the repair process. Accordingly, we consider automobile insurers to be key demand drivers of our products. We provide insurance companies services that include the review of vehicle repair order estimates, as well as direct quotation services to their adjusters. There is no standard price for recycled OEM products, but rather a pricing structure that varies from day to day based upon such factors as product availability, quality, demand, new OEM replacement product prices, the age of the vehicle being repaired, and competitor pricing. The pricing for aftermarket and refurbished products is determined based on a number of factors, including availability, quality, demand, new OEM replacement product prices, and competitor pricing.

Since 2004, approximately 8% to 16% of our revenue has been obtained from other sources. These include bulk sales to mechanical remanufacturers, scrap sales, and sales of damaged vehicles that we sell to vehicle repairers. Our revenue from other sources has increased since 2004 primarily due to higher scrap sales from our self-service retail and wheel operations and to higher bulk sales of certain products.

When we obtain mechanical products from dismantled vehicles and determine they are damaged, or when we have a surplus of a certain mechanical product type, we sell them in bulk to mechanical remanufacturers. The majority of these products are sorted by product type and model type. Examples of such products are engine blocks and heads, transmissions, starters, alternators, and air conditioner compressors. After we have recovered all the products we intend to resell, the remaining materials are crushed and sold to scrap processors.

Cost of Goods Sold

Our cost of goods sold for recycled OEM products includes the price we pay for the salvage vehicle and, where applicable, auction, storage, and towing fees. We are facing increased competition in the purchase of salvage vehicles from shredders and scrap recyclers, internet-based buyers, and others. Our cost of goods sold also includes labor and other costs we incur to acquire and dismantle such vehicles. Since 2004, our labor and labor-related costs related to acquisition and dismantling have accounted for approximately 10% of our cost of goods sold for vehicles we dismantle. The acquisition and dismantling of salvage vehicles is a manual process and, as a result, energy costs are not material.

Our cost of goods sold for aftermarket products includes the price we pay for the parts, freight, and other inventoried costs such as import fees and duties, where applicable. Our aftermarket products are acquired from a number of vendors located primarily overseas, with the majority of our overseas vendors located in Taiwan. Our cost of goods sold for refurbished wheels includes the price we pay for wheel cores, freight, and costs to refurbish the wheels, including overhead and depreciation costs.

In the event we do not have a recycled OEM product or suitable aftermarket product in our inventory, we attempt to purchase the part from a competitor. We refer to these parts as brokered products. Since 2004, the revenue from brokered products that we sell to our customers has ranged from 5% to 8% of our total revenue. The gross margin on brokered product sales as a percentage of revenue is generally less than half of what we achieve from sales of our own inventory because we must pay higher prices for these products.

Some of our mechanical products are sold with a standard six-month warranty against defects. We record the estimated warranty costs at the time of sale using historical warranty claim information to project future warranty claims activity and related expenses. Our warranty activity during 2005 and 2006 was as follows (in thousands):

Balance as of January 1, 2005	$ 280
Warranty expense	2,507
Warranty claims	(2,452)
Balance as of December 31, 2005	335
Warranty expense	2,853
Warranty claims	(2,778)
Balance as of December 31, 2006	$ 410

We also sell separately priced extended warranty contracts for certain mechanical products. The expense related to extended warranty claims is recognized when the claim is made.

Expenses

Our facility and warehouse expenses primarily include our costs to operate our processing, redistribution, self-service, and warehouse facilities. These costs include labor for both plant management and facility and warehouse personnel, stock-based compensation, facility rent, property and liability insurance, utilities, and other occupancy costs.

Our distribution expenses primarily include our costs to deliver our products to our customers. Included in our distribution expense category are labor costs for drivers, local delivery and transfer truck rentals and subcontractor costs, vehicle repairs and maintenance, insurance, and fuel.

Our selling and marketing expenses primarily include our advertising, promotion, and marketing costs; salary and commission expenses for sales personnel; sales training; telephone and other communication expenses; and bad debt expense. Since 2004, personnel costs have accounted for approximately 77% to 81% of our selling and marketing expenses. Most of our recycled OEM product sales personnel are paid on a commission basis. The number and quality of our sales force is critical to our ability to respond to our customers needs and increase our sales volume. Our objective is to continually evaluate our sales force, develop and implement training programs, and utilize appropriate measurements to assess our selling effectiveness.

Our general and administrative expenses include primarily the costs of our corporate and regional offices that provide corporate and field management, treasury, accounting, legal, payroll, business development, human resources, and information systems functions. These costs include wages and benefits for corporate, regional and administrative personnel, stock-based compensation, long term incentive compensation, accounting, legal and other professional fees, office supplies, telephone and other communication costs, insurance and rent.

Seasonality

Our operating results are subject to quarterly variations based on a variety of factors, influenced primarily by seasonal changes in weather patterns. During the winter months we tend to have higher demand for our products because there are more weather related accidents. In addition, the cost of salvage vehicles tends to be lower as more weather related accidents occur generating a larger supply of total loss vehicles.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the U.S. The preparation of these financial statements requires us to make estimates, assumptions, and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, assumptions, and judgments, including those related to revenue recognition, warranty costs, inventory valuation, allowance for doubtful accounts, goodwill impairments, self-insurance programs, contingencies, asset impairments, stock-based compensation, and taxes. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. The results of these estimates form the basis for our judgments about the carrying values of assets and liabilities and our recognition of revenue. Actual results may differ from these estimates.

Revenue Recognition

We recognize and report revenue from the sale of light vehicle replacement products when they are shipped and title has transferred, subject to a reserve for returns, discounts, and allowances that management estimates based upon historical information. A replacement product would ordinarily be returned within a few days of shipment. Our customers may earn discounts based upon sales volumes or sales volumes coupled with prompt payment. Allowances are normally given within a few days following product shipment. We analyze historical returns and allowances activity by comparing the items to the original invoice amounts and dates. We use this information to project future returns and allowances on products sold.

We also sell separately priced extended warranty contracts for certain mechanical products. Revenue from these contracts is deferred and recognized ratably over the term of the contracts.

Warranty Reserves

We issue a standard six-month warranty against defects on some of our mechanical products. We record an accrual for standard warranty claims at the time of sale using historical warranty claim information to project future warranty claims activity and related expenses. We analyze historical warranty claim activity by referencing the claims made and aging them from the original product sale date. We use this information to project future warranty claims on actual products sold that are still under warranty at the end of an accounting period. A 10% increase in our historical 2006 annual warranty claims would result in an additional annual expense of approximately $0.3 million.

Inventory Accounting

Salvage Inventory. Salvage inventory is recorded at the lower of cost or market. Our salvage inventory cost is established based upon the price we pay for a vehicle, and includes buying; dismantling; and, where applicable, auction, storage, and towing fees. Inventory carrying value is determined using the average cost to sales percentage at each of our facilities and applying that percentage to the facility s inventory at expected selling prices. The average cost to sales percentage is derived from each facility s historical vehicle profitability for salvage vehicles purchased at auction or from contracted rates for salvage vehicles acquired under direct procurement arrangements.

Aftermarket and Refurbished Wheel Inventory. Aftermarket and refurbished wheel inventory is recorded at the lower of cost or market. Our aftermarket inventory cost is based on the average price we pay for parts, and includes expenses incurred for freight and buying, where applicable. For items purchased from foreign sources, import fees and duties and transportation insurance are also included. Our refurbished wheel inventory cost is based on the average price we pay for wheel cores, and includes expenses incurred for freight, buying and refurbishing overhead.

For all inventory, our carrying value is reduced regularly to reflect the age and current anticipated demand for our products. If actual demand differs from our estimates, additional reductions to our inventory carrying value would be necessary in the period such determination is made.

Allowance for Doubtful Accounts

We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make required payments. The allowance for doubtful accounts is based on our assessment of the collectibility of specific customer accounts, the aging of the accounts receivable, and our historical experience. Our allowance for doubtful accounts at December 31, 2006 was approximately $2.6 million, which represents 5.0% of gross receivables. If actual defaults are higher than our historical experience, our allowance for doubtful accounts may be insufficient to cover the uncollectible receivables, which would have an adverse impact on our operating results in the period of occurrence. A 10% change in the 2006 annual write-off rate would result in a change in the estimated allowance for doubtful accounts of approximately $0.2 million. For our light vehicle replacement parts operations, our exposure to uncollectible accounts receivable is limited because the majority of our sales are to a large number of small customers that are generally geographically dispersed. We also have certain customers in our light vehicle replacement parts operations that pay for products at the time of delivery. The aluminum smelter and our mechanical core operation sell in larger quantities to a small number of distributors, foundry customers and remanufacturers. As a result, our exposure to uncollectible accounts receivable is greater in these operations. We control credit risk through credit approvals, credit limits, and monitoring policies.

Goodwill Impairment

We record goodwill as a result of our acquisitions. Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, which we refer to as SFAS 142, requires us to analyze our goodwill for impairment at least annually. The determination of the value of goodwill requires us to make estimates and assumptions that affect our consolidated financial statements. In assessing the recoverability of our goodwill, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets. We perform goodwill impairment tests on an annual basis and between annual tests whenever events may indicate that an impairment exists. In response to changes in industry and market conditions, we may be required to strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses, which could result in an impairment of goodwill.

We utilize outside professionals in the valuation industry to validate our assumptions and overall methodology used to determine the fair value estimates used in our goodwill impairment testing. As of December 31, 2006, we had $246.2 million in goodwill subject to future impairment tests. If we were required to recognize goodwill impairments in future periods, we would report those impairment losses as part of our operating results. We determined that no adjustments were necessary when we performed our annual impairment testing in the fourth quarters of 2006, 2005 and 2004. A 10% decrease in the fair value estimates used in the fourth quarter of 2006 impairment test would not have changed this determination.

Self-Insurance Programs

We self-insure a portion of employee medical benefits under the terms of our employee health insurance program. We also self-insure a portion of automobile, general liability, and workers compensation claims. We have purchased stop-loss insurance coverage that limits our exposure to both individual claims as well as our overall claims. The cost of the stop-loss insurance is expensed over the contract periods.

We record an accrual for the claims expense related to our employee medical benefits, automobile, general liability, and workers compensation claims based upon the expected amount of all such claims. If actual claims are higher than what we anticipated, our accrual might be insufficient to cover our claims costs, which would have an adverse impact on our operating results in that period. If we were to incur claims up to our aggregate stop-loss insurance coverage during the open policy years, we would have an additional expense of approximately $13.3 million.

Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business resulting from litigation, claims and other commitments, and from a variety of environmental and pollution control laws and regulations. We consider the likelihood of loss or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. We accrue an estimated loss contingency when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. We determine the amount of reserves, if any, with the assistance of our outside legal counsel. We regularly evaluate current information available to us to determine whether the accruals should be adjusted. If the amount of an actual loss were greater than the amount we have accrued, the excess loss would have an adverse impact on our operating results in the period that the loss occurred. If the loss contingency is subsequently determined to no longer be probable, the amount of loss contingency previously accrued would be included in our operating results in the period such determination was made.

Accounting for Income Taxes

All income tax amounts reflect the use of the liability method. Under this method, deferred tax assets and liabilities are determined based upon the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities for financial and income tax reporting purposes. We operate in multiple tax jurisdictions with different tax rates, and we determine the allocation of income to each of these jurisdictions based upon various estimates and assumptions. In the normal course of business we will undergo tax audits by various tax jurisdictions. Such audits often require an extended period of time to complete and may result in income tax adjustments if changes to the allocation are required between jurisdictions with different tax rates. Although we have recorded all probable income tax contingencies in accordance with SFAS No. 5, Accounting for Contingencies and SFAS No. 109, Accounting for Income Taxes, these accruals represent estimates that are subject to the inherent uncertainties associated with the tax audit process, and therefore include contingencies.

We record a provision for taxes based upon our effective income tax rate. We record a valuation allowance to reduce our deferred tax assets to the amount that we expect is more likely than not to be realized. We consider historical taxable income, expectations, and risks associated with our estimates of future taxable income and ongoing tax planning strategies in assessing the need for a valuation allowance. We had a valuation allowance of $0.9 million, $0.7 million, and $0.5 million at December 31, 2006, 2005 and 2004, respectively, against our deferred tax assets. Should we determine that it is more likely than not that we would be able to realize all of our deferred tax assets in the future, an adjustment to the net deferred tax asset would increase income in the period such determination was made. Conversely, should we determine that it is more likely than not that we would not be able to realize all of our deferred tax assets in the future, an adjustment to the net deferred tax assets would decrease income in the period such determination was made.

Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123R, Share-Based Payment (SFAS 123R), a revision of SFAS 123. SFAS 123R supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and amends SFAS 95, Statement of Cash Flows. SFAS 123R requires us to measure compensation cost for all share-based payments (including employee stock options) at fair value and to recognize the cost over the vesting period, and was effective for us on January 1, 2006. In March 2005, the Securities and Exchange Commission (the SEC) issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC staff position concerning the application of SFAS 123R, including interpretive guidance. We implemented the provisions of SFAS 123R and SAB 107 in the first quarter of 2006 using the modified prospective 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 our registration statement for our 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 123, Accounting for Stock-Based Compensation, net of estimated forfeitures. We have elected to recognize compensation expense for all awards on a straight-line basis over the requisite service period of the award. The impact of adopting SFAS 123R on 2006 results was as follows:

- A reduction of income before income taxes by $2.4 million;
- A reduction of net income by $1.4 million; and
- A reduction of diluted earnings per share by $0.03.

Prior to January 1, 2006, we accounted for our stock option plans under the intrinsic value method as defined in APB 25 and related interpretations. Compensation cost was recognized in net income for options granted under our plans only when the exercise price was less than the market price of the underlying common stock on the date of grant. For nonqualified stock options granted under our plans with an exercise price equal to the market value of the stock on the date of grant, no compensation cost was recognized in our financial statements. Rather, stock-based compensation expense was included as a pro forma disclosure in the notes to our financial statements. Pro forma disclosures of net earnings and earnings per share continue to be provided for periods prior to January 1, 2006.

For valuing our stock option awards under SFAS 123R, several key factors and assumptions are required for use in the valuation models currently utilized. We have been in existence since early 1998 and have been a public company since October 2003. As a result, we do not have the historical data necessary to consider using a lattice valuation model at this time. We have therefore elected to use the Black-Scholes valuation model, using the guidance in SAB 107 for determining our expected term and volatility assumptions. For expected term, we have what SAB 107 defines as plain-vanilla stock options, and therefore used a simple average of the vesting period and the contractual term for options granted in 2006 as permitted by SAB 107. Volatility is a measure of the amount by which our stock price is expected to fluctuate during the expected term of the option. For volatility, we considered our own volatility for the limited time we have been a public company as well as the disclosed volatilities of companies that are considered comparable to us. Our forfeiture assumption is based on historical forfeiture rates both pre-IPO and since we have been a public company. SFAS 123R requires that forfeitures be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The dividend yield represents the dividend rate expected to be paid over the option s expected term, and we currently have no plans to pay dividends. The risk-free interest rate is based on zero-coupon U.S. government issues available at the time each option is granted that have a remaining life approximately equal to the option s expected life. Key assumptions used in determining the fair value of stock options granted in 2006 were: expected term of 6.2 years, risk-free interest rate of 4.38%, dividend yield of 0%, forfeiture rate of 7%, and volatility of 40%.

Recently Issued Accounting Pronouncements

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an Amendment of ARB No. 43, Chapter 4 (SFAS 151). SFAS 151 amended ARB 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) must be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 was effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We adopted SFAS 151 and its adoption did not have an impact on our 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 replaced 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 was effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005. We adopted SFAS 154 and its adoption did not have an impact on our 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. FIN 48 provides 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. This interpretation 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, and will be effective for our fiscal year beginning January 1, 2007. We are currently assessing the impact of FIN 48 on our 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. We are currently assessing the impact of SFAS 157 on our consolidated financial position, results of operations, and 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 was effective for our fiscal year ending December 31, 2006, and the adoption of SAB 108 did not have an impact on our consolidated financial position, results of operations, or cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value, and amends SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the impact of SFAS 159 on our consolidated financial position, results of operations, and cash flows.

Segment Reporting

Over 99% of our operations are conducted in the U.S. During 2004, we acquired a recycled OEM products business with locations in Guatemala and Costa Rica. Revenue generated and properties located outside of the U.S. are not material. We manage our operations geographically. Our light vehicle replacement products operations are organized into ten operating segments, eight for recycled OEM products, one for aftermarket products and one for refurbished wheels. These segments are aggregated into one reportable segment because they possess similar economic characteristics and have common products and services, customers, and methods of distribution. Our light vehicle replacement products operations account for over 90% of our revenue, earnings, and assets.

Results of Operations

The following table sets forth statement of income data as a percentage of total revenue for the periods indicated:

	Year Ended December 31,					
	2006		2005		2004	
Statement of Income Data:						
Revenue	100.0	%	100.0	%	100.0	%
Cost of goods sold	54.7	%	52.9	%	53.5	%
Gross margin	45.3	%	47.1	%	46.5	%
Facility and warehouse expenses	10.9	%	11.0	%	11.3	%
Distribution expenses	10.1	%	11.2	%	11.3	%
Selling, general and administrative expenses	12.9	%	13.6	%	14.1	%
Depreciation and amortization	1.5	%	1.6	%	1.6	%
Operating income	9.8	%	9.7	%	8.2	%
Other expense, net	0.6	%	0.2	%	0.2	%
Income before provision for income taxes	9.2	%	9.4	%	8.0	%
Net income	5.6	%	5.6	%	4.8	%

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Revenue. Our revenue increased 44.2%, from $547.4 million in 2005 to $789.4 million in 2006. The increase in revenue was primarily due to the higher volume of products we sold and business acquisitions. Organic revenue growth was approximately 11.6% in 2006. We continued to expand our services to the insured repair industry and added local delivery routes and transfer routes that helped us to increase our market penetration. We have also continued to integrate the sale and distribution of our aftermarket and wheel product offerings with recycled parts in more locations in order to provide a wider selection of products to our customers. Business acquisitions completed in 2006 and the full year impact of our 2005 acquisitions accounted for approximately $178.4 million of incremental revenue for the year.

Cost of Goods Sold. Our cost of goods sold increased 49.0%, from $289.8 million in 2005 to $431.8 million in 2006. As a percentage of revenue, cost of goods sold increased from 52.9% to 54.7%. The increase in cost of goods sold was primarily due to increased volume of products sold. Our cost of goods sold percentage increase was due primarily to our acquisition of Transwheel Corporation. We were required to write-up the value of Transwheel s finished goods and work in process inventories for refurbished wheels in accordance with SFAS 141. In addition, Transwheel s aluminum smelter that is used to economically dispose of wheels that cannot be refurbished operates at a low gross margin. This smelter had revenue of $28.2 million at a gross margin of 7.1% in 2006. Without these two items related to Transwheel, our cost of goods sold percentage would have increased from 52.9% in 2005 to 53.3% in 2006.

Gross Margin. Our gross margin increased 38.8%, from $257.6 million in 2005 to $357.5 million in 2006. Our gross margin increased primarily due to increased volume. As a percentage of revenue, gross margin decreased from 47.1% to 45.3%. Our gross margin as a percentage of revenue decreased due primarily to the factors noted above in *Cost of Goods Sold*.

Facility and Warehouse Expenses. Facility and warehouse expenses increased 43.6%, from $60.1 million in 2005 to $86.3 million in 2006. Our acquisitions accounted for $20.6 million of the increase. Our remaining facility and warehouse expenses increased primarily due to $3.3 million in higher wages and fringe benefits resulting from increased headcount and stock option expenses (which we were first required

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to expense in 2006) for field personnel. The balance of the increase primarily related to higher insurance reserves and legal claims experience, repairs and maintenance and utilities expenses. As a percentage of revenue, facility and warehouse expenses decreased from 11.0% to 10.9%.

Distribution Expenses. Distribution expenses increased 30.3%, from $61.5 million in 2005 to $80.1 million in 2006. Our acquisitions accounted for $12.7 million of the increase. Our remaining distribution expenses increased as we operated approximately 6% more daily transfer routes between our salvage facilities due to the increase in parts volume. In addition, higher wages primarily from an increase in the number of employees, increased fuel costs, truck rentals and repairs, delivery supplies, and contracted salvage transfer services accounted for the remaining growth in distribution expenses. Fuel prices increased approximately 12.8% in 2006 compared to 2005. While fuel costs accounted for approximately $1.4 million of the increase in distribution expenses, they represented only 1.7% of our consolidated revenue. As a percentage of revenue, our distribution expenses decreased from 11.2% to 10.1%.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses increased 37.2%, from $74.5 million in 2005 to $102.2 million in 2006. Our acquisitions accounted for $18.3 million of the increase. The majority of the remaining expense increase was a result of an increase in labor and labor-related expenses of $3.8 million due primarily to higher sales commission expenses and increased headcount, $1.8 million for the expensing of stock options that began for the first time in 2006, and $1.8 million related to our new 2006 long term incentive plan, $0.5 million for higher insurance and legal claims experience, and higher sales promotion, professional fees, credit card processing fees, and data, telephone and e-commerce expenses. Our selling expenses tend to rise as revenue increases due to our commissioned sales forces. As a percentage of revenue our selling, general, and administrative expenses decreased from 13.6% to 12.9%.

Depreciation and Amortization. Depreciation and amortization increased 37.9%, from $8.6 million in 2005 to $11.8 million in 2006. Our acquisitions accounted for $2.2 million of the increase in depreciation and amortization. As a percentage of revenue, depreciation and amortization decreased from 1.6% in 2005 to 1.5% in 2006.

Operating Income. Operating income increased 45.8% from $52.9 million in 2005 to $77.2 million in 2006. As a percentage of revenue, operating income increased from 9.7% to 9.8%. We incurred stock option expense that totaled $2.4 million in 2006. In addition, our cost of goods sold in 2006 was higher due to our Transwheel acquisition as we noted above in *Cost of Goods Sold*. Without the effect of these items, our operating income as a percentage of revenue would have improved to 10.3% in 2006 compared to 9.7% in 2005.

Other (Income) Expense. Net other expense increased 245.3% from $1.3 million in 2005 to $4.3 million in 2006. Net interest expense increased 208.8% to $5.8 million in 2006 from $1.9 million in 2005. Our average bank borrowings increased approximately $39.2 million during 2006 as compared to 2005, due primarily to acquisitions. In addition, our average effective interest rate on our bank debt also increased in 2006. Other income increased to $1.5 million in 2006 from $0.6 million in 2005. Included in other income in 2006 is a gain of $0.7 million on the sale of equity securities compared to $0.3 million in 2005. As a percentage of revenue, net other expense increased from 0.2% in 2005 to 0.6% in 2006.

Provision for Income Taxes. The provision for income taxes increased 36.7%, from 20.8 million in 2005 to $28.4 million in 2006, due primarily to improved operating results. Our effective tax rate was 39.0% in 2006 and 40.2% in 2005. The decrease in the effective tax rate was due primarily to the reversal in the third quarter of 2006 of $0.7 million of accrued income tax liabilities no longer deemed necessary with the statutory closing of certain tax years. Without the third quarter reversals, the effective tax rate would have been 40.0%. In addition, state tax adjustments were recorded in the second quarter of 2005 that increased the effective tax rate in 2005.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Revenue. Our revenue increased 28.9%, from $424.8 million in 2004 to $547.4 million in 2005. The increase in revenue was primarily due to the higher volume of products we sold and business acquisitions. Organic revenue growth was approximately 12.2% in 2005. We continued to expand our services to the insured repair industry and added local delivery routes and transfer routes that helped us to increase our market penetration. We have also continued to integrate our aftermarket and recycled parts inventories in more locations in order to provide a wider selection of products to our customers. Business acquisitions completed in 2005 and the full year impact of our 2004 acquisitions accounted for approximately $70.6 million of incremental revenue for the year.

Cost of Goods Sold. Our cost of goods sold increased 27.6%, from $227.1 million in 2004 to $289.8 million in 2005. As a percentage of revenue, cost of goods sold decreased from 53.5% to 52.9%. The increase in cost of goods sold was primarily due to increased volume of products sold. The decrease in cost of goods sold percentage was due primarily to improved pricing and availability of wholesale salvage vehicles, coupled with improved procurement and inventory management.

Gross Margin. Our gross margin increased 30.4%, from $197.6 million in 2004 to $257.6 million in 2005. Our gross margin increased primarily due to increased volume. As a percentage of revenue, gross margin increased from 46.5% to 47.1%. Our gross margin as a percentage of revenue increased due primarily to the factors noted above in *Cost of Goods Sold*.

Facility and Warehouse Expenses. Facility and warehouse expenses increased 25.7%, from $47.8 million in 2004 to $60.1 million in 2005. Our acquisitions accounted for $9.1 million of the increase. Our remaining facility and warehouse expenses increased primarily due to higher wages resulting from increased headcount and incentive compensation expense for field personnel, and higher repairs and maintenance and supplies expenses. As a percentage of revenue, facility and warehouse expenses decreased from 11.3% to 11.0%.

Distribution Expenses. Distribution expenses increased 28.3%, from $47.9 million in 2004 to $61.5 million in 2005. Our acquisitions accounted for $7.2 million of the increase. Our remaining distribution expenses increased as we operated approximately 8% more daily transfer routes between our salvage facilities due to the increase in parts volume. For the year ended December 31, 2005, we increased the amount of product we moved between our facilities by approximately 24%, the majority of which was on our own transfer trucks. In addition, higher wages, primarily from an increase in the number of employees, increased fuel costs, auto insurance, truck rentals and repairs, delivery supplies, and contracted salvage transfer services, partially offset by lower freight costs, accounted for the remaining growth in distribution expenses. Fuel prices increased approximately 33% in 2005 compared to 2004. While fuel costs accounted for approximately $2.3 million of the increase in distribution expenses, they represented only 1.7% of our consolidated revenue. We renegotiated our freight rates with substantially all of our common carriers in the fourth quarter of 2004, and we directed our sales force to recoup more of our shipping and handling costs. As a percentage of revenue, our distribution expenses decreased from 11.3% to 11.2%.

Selling, General, and Administrative Expenses. Selling, general, and administrative expenses increased 24.0%, from $60.1 million in 2004 to $74.5 million in 2005. Our acquisitions accounted for $8.0 million of the increase. The majority of the remaining expense increase was a result of an increase in labor and labor-related expenses of $3.3 million due primarily to increased headcount, increased incentive compensation expense of $1.1 million, higher insurance and legal claims experience of $0.9 million, and higher sales promotion, bad debts, telephone and e-commerce expenses, partially offset by lower costs associated with being a public company. Our selling expenses tend to rise as revenue increases due to our commissioned sales forces. We incurred approximately $2.5 million in costs related to being a public company in 2005 compared to $2.8 million in 2004. The cost reductions were primarily from lower

premiums for directors and officers liability insurance, and lower accounting and legal fees. As a percentage of revenue our selling, general, and administrative expenses decreased from 14.1% to 13.6%.

Depreciation and Amortization. Depreciation and amortization increased 24.8%, from $6.9 million in 2004 to $8.6 million in 2005. Our acquisitions accounted for $1.0 million of the increase in depreciation and amortization. As a percentage of revenue, depreciation and amortization was 1.6% in 2005 and 2004.

Operating Income. Operating income increased 51.7%, from $34.9 million in 2004 to $52.9 million in 2005. As a percentage of revenue, operating income increased from 8.2% to 9.7%.

Other (Income) Expense. Net other expense increased 19.9%, from $1.1 million in 2004 to $1.3 million in 2005. Net interest expense increased 25.3% to $1.9 million in 2005 from $1.5 million in 2004. Interest expense was related primarily to debt incurred to fund acquisitions. The increase in net interest expense was due to both higher average debt levels and higher interest rates in 2005. In addition, included in interest expense in 2004 was $0.3 million in debt issuance costs that were written off. These costs were attributable to our previous secured bank credit facility that was terminated in February 2004. See Liquidity and Capital Resources below for further discussion of changes in our bank credit facilities. Included in other income in 2005 was approximately $0.3 million in gain on the sale of investment securities. Included in other income in 2004 are approximately $0.4 million of proceeds from a corporate owned life insurance policy. We use corporate owned life insurance policies to fund our obligations under our nonqualified deferred compensation plan. As a percentage of revenue, net other expense was 0.2% in 2005 and 2004.

Provision for Income Taxes. The provision for income taxes increased 56.6%, from $13.3 million in 2004 to $20.8 million in 2005 due primarily to improved operating results. Our effective tax rate was 40.2% in 2005 and 39.2% in 2004. The increase in our effective income tax rate in 2005 was due primarily to the receipt of nontaxable life insurance proceeds of approximately $0.4 million in the fourth quarter of 2004.

Liquidity and Capital Resources

Our primary sources of ongoing liquidity are cash flow from our operations and our credit facility. At December 31, 2006, we had cash and equivalents amounting to $4.0 million, and we had $86.0 million outstanding under our $135 million unsecured bank credit facility. We generated $52.4 million in cash flow from operating activities in 2006 and, based on our current plans, we expect to generate positive cash flow from operating activities for 2007. We believe that cash flow from operating activities and availability under our credit facility will be adequate to fund our short term liquidity needs. Under an accordion option feature in our bank agreement, we can increase the total credit facility to $150 million, subject to the approval of our bank group. In addition, with a senior debt to EBITDA ratio of approximately 1.1 at the end of 2006, we believe we would be able to further increase our debt capacity significantly if needed.

Our liquidity needs are primarily to fund working capital requirements and expand our facilities and network. The procurement of inventory is the largest operating use of our funds. We normally pay for salvage vehicles acquired at salvage auctions and under some direct procurement arrangements at the time that we take possession of the vehicles. We normally pay for aftermarket parts purchases at the time of shipment or on standard payment terms, depending on the manufacturer and payment options offered. Wheel cores acquired from third parties are normally paid on standard payment terms. We acquired approximately 84,600, 97,600, and 111,400 wholesale salvage vehicles in 2004, 2005, and 2006, respectively. In addition, we acquired approximately 27,700, 55,800 and 138,700 salvage vehicles for our self-service retail operations in 2004, 2005 and 2006, respectively. Our purchases of aftermarket parts and wheels totaled approximately $23.4 million, $46.0 million and $94.5 million in 2004, 2005 and 2006, respectively.

We completed the sale of 6.4 million shares of our common stock at a price of $14.50 per share in a public offering in October 2005. This resulted in approximately $87.9 million of cash proceeds to us, net of underwriting discounts and commissions and expenses of the offering. In connection with the offering, certain members of management exercised stock options to purchase 600,000 shares of our common stock, resulting in approximately $2.1 million of proceeds to us. We used all of the proceeds from the offering and the option exercises to pay down our then outstanding bank debt and invested the remaining proceeds in short term cash equivalents until we used them for general corporate purposes, which included three acquisitions completed by the end of 2005. We have since used the remaining proceeds for business acquisitions during 2006.

We intend to continue to evaluate markets for potential growth through the internal development of redistribution centers, processing facilities, and warehouses, through further integration of aftermarket, refurbished and recycled OEM product facilities, and through selected business acquisitions. Our future liquidity and capital requirements will depend upon numerous factors, including the costs and timing of our internal development efforts and the success of those efforts, the costs and timing of expansion of our sales and marketing activities, and the costs and timing of future business acquisitions.

Net cash provided by operating activities totaled $52.4 million in 2006, compared to $37.5 million in 2005. Cash was provided by net income adjusted for non-cash items. Working capital uses of cash included increases in receivables, inventory, prepaid expenses and other assets, and a decrease in accounts payable, partially offset by increases in accrued liabilities and other noncurrent liabilities. Receivables increased due to our increased sales volume, partially offset by repayments of employee relocation loans and other receivables. Inventory increased to support our increased volume and to expand the geographic availability of aftermarket and wheel products to a number of locations. Accounts payable decreased due primarily to the timing of payments. Accruals increased primarily due to increases in self-insurance and legal claims reserves, and interest and property tax accruals. Other noncurrent liabilities increased primarily due to liabilities of $1.8 million associated with the new long term incentive plan and increases of $1.0 million in employee deferred compensation liabilities.

Net cash used in investing activities totaled $110.7 million in 2006, compared to $126.0 million in 2005. We invested $73.5 million of cash for acquisitions in 2006 compared to $103.8 million in 2005. We repaid $2.6 million from escrow liabilities in 2006 compared to receiving $2.6 million deposited in 2005, all related to a 2004 acquisition. Net property and equipment purchases increased $10.5 million in 2006, due primarily to land acquisitions and facility expansions.

Net cash provided by financing activities totaled $59.1 million in 2006, compared to $90.0 million in 2005. Exercises of stock options and warrants totaled $6.3 million in 2006 and $11.8 million in 2005. Included in 2005 net cash from financing activities is $87.9 million from the sale of 6.4 million shares of common stock in a public offering. In addition, we had net borrowings of $48.0 million under our credit facility in 2006, compared to net repayments of $9.0 million in 2005. Repayments of long-term debt obligations increased $1.9 million in 2006. The excess tax benefit from share-based payment arrangements provided $7.1 million of cash in 2006 and is shown in cash flow from financing activities in accordance with SFAS 123R. These tax benefits for periods prior to the adoption of SFAS 123R were included in cash flow from operating activities and totaled $6.2 million in 2005.

Net cash provided by operating activities totaled $37.5 million in 2005, compared to $25.9 million in 2004. Cash was provided by net income adjusted for non-cash items. Working capital uses of cash included increases in receivables and inventory, and decreases in accounts payable, partially offset by increases in escrow liabilities, accruals and income taxes payable. Receivables increased due to our increased sales volume, partially offset by repayments of employee relocation loans and other receivables. Inventory increased to support our increased volume and to add aftermarket products to some of our wholesale recycled salvage locations. Accounts payable decreased as we accelerated payments to certain foreign vendors in order to realize improved pricing on certain aftermarket product purchases. Escrow liabilities increased as a result of the deposit in escrow with us of $2.6 million in cash as collateral in connection with an acquisition by us. Accrued liabilities increased primarily due to the timing of wage payments, higher incentive compensation accruals, and higher self-insurance reserves for workers compensation and auto liability claims. Income taxes payable increased primarily due to higher levels of taxable income.

Net cash used in investing activities totaled $126.0 million in 2005, compared to $87.8 million in 2004. We invested $103.8 million of cash in eight acquisitions in 2005 compared to $61.6 million in six acquisitions in 2004. We received $2.6 million in proceeds from the escrow deposit. We also realized $0.7 million in increased proceeds from the sale of property and equipment and $0.4 million from the sale of investment securities in 2005.

Net cash provided by financing activities totaled $90.0 million in 2005, compared to $47.5 million in 2004. Included in 2005 net cash from financing activities is $87.9 million from the sale of 6.4 million shares of common stock in a public offering. Exercises of stock options and warrants totaled $11.8 million in 2005 and $4.9 million in 2004. In addition, we had net repayments of $9.0 million under our credit facility in 2005, compared to net borrowings of $47.0 million in 2004. Repayments of long-term debt obligations decreased $3.9 million in 2005.

On February 17, 2004, we entered into a new unsecured revolving credit facility that was originally scheduled to mature in February 2007, replacing a secured credit facility that would have expired on June 30, 2005. The new credit facility initially had a maximum availability of $75.0 million, which was amended to $100 million on January 31, 2005. On June 1, 2005, the agreement was further amended to increase the maximum availability to $135 million, extend the maturity date to June 1, 2010, and modify certain other terms. In order to make any borrowing under the credit facility, after giving effect to any such borrowing, we must be in compliance with all of the covenants under the credit facility, including, without limitation, a senior debt to EBITDA ratio, which cannot exceed 3.00 to 1.00. The credit facility contains customary covenants, including, among other things, limitations on payment of cash dividends, restrictions on our payment of other dividends and on purchases, redemptions, and acquisitions of our stock, limitations on additional indebtedness, certain limitations on acquisitions, mergers, and consolidations, and the maintenance of certain financial ratios. We were in compliance with all covenants throughout all of 2006 and 2005. The interest rate on advances under the credit facility may be, at our option, either the bank prime lending rate, on the one hand, or the Interbank Offering Rate (IBOR) plus an additional percentage ranging from .875% to 1.625%, on the other hand. The percentage added to IBOR is dependent upon our total funded debt to EBITDA ratio for the trailing four quarters.

We may in the future borrow additional amounts under our credit facility or enter into new or additional borrowing arrangements. We anticipate that any proceeds from such new or additional borrowing arrangements will be used for general corporate purposes, including to develop and acquire businesses and redistribution facilities; to further the integration of our aftermarket, wheel refurbishing and recycled OEM product facilities; to expand and improve existing facilities; to purchase property, equipment, and inventory; and for working capital.

As part of the consideration for business acquisitions completed during 2006, we issued promissory notes totaling approximately $7.2 million. The notes bear interest at annual rates of 3.5% to 5.0%, and interest is payable at maturity.

As part of the consideration for business acquisitions completed during 2005, we issued promissory notes totaling approximately $6.4 million. The notes bear interest at annual rates of 3.0% to 3.5%, and interest is payable at maturity. We also assumed certain liabilities in connection with a business acquisition, which included a promissory note with a remaining principal balance of $0.2 million. The annual interest rate on that note is 5.1%.

We estimate that our capital expenditures for 2007, excluding business acquisitions, will be between $45.0 and $50.0 million. We expect to use these funds for several major facility expansions, improvement of current facilities, real estate acquisitions and systems development projects. We anticipate that net cash provided by operating activities for 2007 will be in excess of $55.0 million.

We believe that our current cash and equivalents, cash provided by operating activities and funds available under our credit facility will be sufficient to meet our current operating and capital requirements. However, we may, from time to time, raise additional funds through public or private financing, strategic relationships, or other arrangements. There can be no assurance that additional funding, or refinancing of our credit facility, if needed, will be available on terms attractive to us, or at all. Furthermore, any additional equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants. Our failure to raise capital if and when needed could have a material adverse impact on our business, operating results, and financial condition.

Off-Balance Sheet Arrangements and Future Commitments

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt that would be required to be disclosed pursuant to Item 303 of Regulation S-K under the Securities Exchange Act of 1934. Additionally, we have not entered into any derivative contracts nor do we have any synthetic leases.

The following table represents our future commitments under contractual obligations as of December 31, 2006:

	Total (In millions)	**Less than 1 Year**	**1-3 Years**	**3-5 Years**	**More than 5 Years**
Contractual obligations					
Long-term debt	$ 122.4	$ 9.1	$ 6.5	$ 106.8	$ 0.0
Operating leases	75.7	19.6	31.0	14.6	10.5
Purchase obligations	3.0	0.0	0.0	0.0	3.0
Other long-term obligations					
Deferred compensation plans	4.1	0.0	0.0	0.0	4.1
Long term incentive plan	1.8	0.0	0.9	0.6	0.3
Totals	$ 207.0	$ 28.7	$ 38.4	$ 122.0	$ 17.9

Our long-term debt under contractual obligations above includes interest on the balance outstanding under our variable rate credit facility as of December 31, 2006. The $86.0 million outstanding at December 31, 2006 was assumed to remain unpaid until the facility matures on June 1, 2010, and interest was computed at the average effective rate of 6.52% at December 31, 2006.

The interest rate on advances under the credit facility (our primary debt outstanding) may be, at our option, either the bank prime lending rate, on the one hand, or the Interbank Offering Rate (IBOR) plus an additional percentage ranging from .875% to 1.625%, on the other hand. The percentage added to IBOR is dependent upon our total funded debt to EBITDA ratio (as defined) for the trailing four quarters.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our results of operations are exposed to changes in interest rates primarily with respect to borrowings under our credit facility, where interest rates are tied to either the prime rate or IBOR. As of December 31, 2006, we had $86.0 million outstanding under our credit facility. We do not, as a matter of policy, enter into derivative contracts for trading or speculative purposes. Based upon our variable rate debt at December 31, 2006, a hypothetical 1% increase in interest rates would result in an annual increase in interest expense of approximately $0.9 million.

The Company is also exposed to currency fluctuations with respect to the purchase of aftermarket parts in Taiwan. While all transactions with manufacturers based in Taiwan are conducted in U.S. dollars, changes in the relationship between the U.S. dollar and the New Taiwan dollar might impact the purchase price of aftermarket parts. We might not be able to pass on any price increases to customers. Under our present policies, we do not attempt to hedge this currency exchange rate exposure.

Our investment in our Central American operations is not material, and we do not attempt to hedge our foreign currency risk related to such operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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INDEX TO FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of LKQ Corporation:

We have audited the accompanying consolidated balance sheets of LKQ Corporation and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, of stockholders equity and other comprehensive income, and of cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule included in Item 15 in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of LKQ Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1, effective January 1, 2006, the Company changed its method of accounting for stock-based compensation upon adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2007 expressed an unqualified opinion on management s assessment of the effectiveness of the Company s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

DELOITTE & TOUCHE LLP

Chicago, Illinois
February 28, 2007

LKQ CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

(In thousands, except share and per share data)

	December 31, 2006		2005	
Assets				
Current Assets:				
Cash and equivalents	$	4,031	$	3,173
Restricted cash			450	
Receivables, net	49,254		39,500	
Inventory	124,541		103,655	
Deferred income taxes	2,619		2,122	
Prepaid expenses	3,369		2,437	
Total Current Assets	183,814		151,337	
Property and Equipment, net	127,084		97,218	
Intangibles				
Goodwill	246,232		181,792	
Other intangibles, net	68		88	
Deferred Income Taxes			2,146	
Other Assets	7,157		6,845	
Total Assets	$	564,355	$	439,426
Liabilities and Stockholders Equity				
Current Liabilities:				
Accounts payable	$	19,192	$	15,496
Escrow liability	50		2,611	
Accrued expenses				
Accrued payroll-related liabilities	10,939		10,115	
Accrued procurement liability	1,414		2,537	
Other accrued expenses	17,151		11,062	
Income taxes payable	304		819	
Deferred revenue	3,859		3,440	
Current portion of long-term obligations	8,485		1,481	
Total Current Liabilities	61,394		47,561	
Long-Term Obligations, Excluding Current Portion	91,962		45,996	
Deferred Income Tax Liability	1,848			
Other Noncurrent Liabilities	7,332		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, 53,299,827 and 51,414,314 shares issued at December 31, 2006 and 2005, respectively.	533		514	
Additional paid-in capital	323,189		307,304	
Warrants			80	
Retained earnings	76,422		32,027	
Accumulated other comprehensive income	1,058		1,295	
Total Stockholders Equity	401,202		341,220	
Total Liabilities and Stockholders Equity	$	564,355	$	439,426

The accompanying notes are an integral part of the consolidated financial statements.

LKQ CORPORATION AND SUBSIDIARIES

Consolidated Statements of Income

(In thousands, except per share data)

	Year Ended December 31, 2006	2005	2004
Revenue	$ 789,381	$ 547,392	$ 424,756
Cost of goods sold	431,832	289,788	227,140
Gross margin	357,549	257,604	197,616
Facility and warehouse expenses	86,298	60,113	47,815
Distribution expenses	80,088	61,480	47,927
Selling, general and administrative expenses	102,174	74,495	60,095
Depreciation and amortization	11,823	8,574	6,872
Operating income	77,166	52,942	34,907
Other (income) expense:			
Interest expense	5,955	2,228	1,551
Interest income	(131)	(341)	(46)
Other income, net	(1,479)	(628)	(455)
Total other expense	4,345	1,259	1,050
Income before provision for income taxes	72,821	51,683	33,857
Provision for income taxes	28,426	20,796	13,284
Net income	$ 44,395	$ 30,887	$ 20,573
Net income per share:			
Basic	$ 0.84	$ 0.70	$ 0.51
Diluted	$ 0.80	$ 0.63	$ 0.46

The accompanying notes are an integral part of the consolidated financial statements.

LKQ CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In thousands)

	Year Ended December 31, 2006	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 44,395	$ 30,887	$ 20,573
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	12,086	8,574	6,872
Gain on sale of property and equipment	(20)	(159)	119
Share-based compensation expense	2,461	42	202
Writeoff of debt issuance costs			346
Deferred income taxes	3,618	1,667	3,487
Gain on early extinguishment of debt			(49)
Gain on interest rate swap			(91)
Gain on sale of investment securities	(719)	(335)	
Excess tax benefit from exercise of stock options	(7,101)		
Changes in operating assets and liabilities, net of effects from purchase transactions:			
Receivables	(4,133)	(2,429)	(2,143)
Inventory	(8,671)	(8,554)	(5,175)
Prepaid expenses and other assets	(1,242)	(996)	175
Accounts payable	(2,469)	(2,166)	(3,091)
Accrued expenses	4,052	4,780	3,297
Income taxes payable	7,071	5,431	1,866
Deferred revenue	224	838	205
Other noncurrent liabilities	2,829	(47)	(692)
Net cash provided by operating activities	52,381	37,533	25,901
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of property and equipment	(36,152)	(26,218)	(25,670)
Proceeds from sale of property and equipment	250	825	103
Expenditures for intangible assets		(3)	(5)
Purchase of investment securities			(650)
Proceeds from sale of investment securities	848	433	
Repayment of escrow	(2,561)		
Proceeds from conversion of escrow		2,561	
Decrease in restricted cash in escrow	450	149	
Cash used in acquisitions	(73,492)	(103,769)	(61,601)
Net cash used in investing activities	(110,657)	(126,022)	(87,823)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from the sale of common stock		87,898	
Proceeds from exercise of stock options	5,477	10,033	3,186
Proceeds from exercise of warrants	785	1,764	1,756
Excess tax benefit from exercise of stock options	7,101		
Debt issuance costs		(302)	(249)
Net borrowings (repayments) under line of credit	48,000	(9,000)	47,000
Repayments of long-term debt obligations	(2,229)	(343)	(4,241)
Net cash provided by financing activities	59,134	90,050	47,452
Net increase (decrease) in cash and equivalents	858	1,561	(14,470)
Cash and equivalents, beginning of period	3,173	1,612	16,082
Cash and equivalents, end of period	$ 4,031	$ 3,173	$ 1,612
Supplemental disclosure of cash flow information:			
Notes issued in connection with business acquisitions	$ 7,200	$ 6,355	$ 2,379
Notes assumed in connection with business acquisitions		203	1,175
Stock issued in connection with business acquisitions			3,375
Cash paid for income taxes, net of refunds	18,125	13,706	7,783
Cash paid for interest	4,278	2,252	1,179

The accompanying notes are an integral part of the consolidated financial statements.

LKQ CORPORATION AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity and Other Comprehensive Income

(In thousands)

	Common Stock Shares Issued	Amount	Additional Paid-In Capital	Warrants	Retained Earnings / (Accumulated Deficit)	Accumulated Other Comprehensive Income	Total Stockholders Equity
BALANCE, January 1, 2004	38,954	$ 389	$ 191,408	$ 508	$ (19,433)	$ 1,139	$ 174,011
Net income					20,573		20,573
Unrealized loss on investment in equity securities, net of tax						(127)	(127)
Foreign currency translation						(32)	(32)
Total comprehensive income							20,414
Stock issued in acquisitions	373	4	3,371				3,375
Stock issued as director compensation	5		45				45
Equity-related compensation expense			157				157
Expiration of warrants issued in acquisitions			12	(12)			
Exercise of warrants issued in acquisitions	100	1	882	(133)			750
Exercise of stockholder guarantor warrants	1,006	10	1,098	(102)			1,006
Exercise of stock options, including related tax benefits of $1,127	693	7	4,306				4,313
BALANCE, December 31, 2004	41,131	$ 411	$ 201,279	$ 261	$ 1,140	$ 980	$ 204,071
Net income					30,887		30,887
Unrealized gain on investment in equity securities, net of tax						339	339
Foreign currency translation						(24)	(24)
Total comprehensive income							31,202
Sale of common stock	6,435	65	87,833				87,898
Equity-related compensation expense			42				42
Exercise of warrants issued in acquisitions	116						
Exercise of stockholder guarantor warrants	1,764	18	1,927	(181)			1,764
Exercise of stock options, including related tax benefits of $6,210	1,968	20	16,223				16,243
BALANCE, December 31, 2005	51,414	$ 514	$ 307,304	$ 80	$ 32,027	$ 1,295	$ 341,220
Net income					44,395		44,395
Unrealized gain (loss) on investment in equity securities, net of tax						(214)	(214)
Foreign currency translation						(23)	(23)
Total comprehensive income							44,158
Stock issued as director compensation	4		72				72
Stock-based compensation expense			2,389				2,389
Exercise of stockholder guarantor warrants	785	8	857	(80)			785
Exercise of stock options, including related tax benefits of $7,101	1,097	11	12,567				12,578
BALANCE, December 31, 2006	53,300	$ 533	$ 323,189	$	$ 76,422	$ 1,058	$ 401,202

The accompanying notes are an integral part of the consolidated financial statements.

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LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements

Note 1. Summary of Significant Accounting Policies

Company Overview

LKQ Corporation, a Delaware corporation, believes it is the largest nationwide provider of recycled light vehicle original equipment manufacturer (OEM) products and related services and the second largest nationwide provider of aftermarket collision replacement products and refurbished wheels. LKQ Corporation operates over 100 facilities offering its customers a broad range of replacement systems, components, and parts to repair light vehicles.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of LKQ Corporation and its subsidiaries (the, Company). All intercompany transactions and accounts have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Per Share Amounts

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 2 for further discussion.

Revenue Recognition

The majority of the Company s revenue is derived from the sale of recycled OEM products and aftermarket products. Revenue is recognized when the products are shipped and title has transferred, subject to a reserve for estimated returns, discounts and allowances that management estimates based upon historical information. The Company has recorded a reserve for estimated returns, discounts and allowances of approximately $4.0 million and $3.1 million at December 31, 2006 and 2005, respectively. Revenue from the sale of separately-priced extended warranty contracts is reported as Deferred revenue and recognized ratably over the term of the contracts.

Shipping & Handling

Revenue also includes amounts billed to customers related to shipping and handling of approximately $8.8 million, $7.6 million and $5.9 million during the years ended December 31, 2006, 2005 and 2004, respectively. Distribution expenses in the accompanying consolidated statements of income are the costs incurred to prepare and deliver products to customers.

Cash and Equivalents

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents. Cash equivalents are carried at cost, which approximates market value.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

Restricted Cash

In connection with a business acquisition on January 31, 2005, the Company held approximately $0.6 million in restricted cash. During the year ended December 31, 2005, the amount of cash restricted was reduced by $0.1 million. During June 2006, the remaining restrictions were removed.

Receivables

The Company has recorded a reserve for uncollectible accounts of approximately $2.6 million and $2.1 million at December 31, 2006 and 2005, respectively. The reserve is based upon management s assessment of the collectibility of specific customer accounts, the aging of the accounts receivable and historical experience. Receivables include travel advances and relocation loans to employees of approximately $0.1 million and $0.2 million at December 31, 2006 and 2005, respectively.

Concentrations of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash and equivalents and accounts receivable. The majority of cash and equivalents are maintained with several major financial institutions. Concentrations of credit risk with respect to accounts receivable are limited because a large number of geographically diverse customers make up the Company s customer base. The Company controls credit risk through credit approvals, credit limits, and monitoring procedures.

Inventory

A salvage product is a recycled vehicle part suitable for sale as a replacement part. A core is a recycled mechanical part that is not suitable for sale as a replacement part without further remanufacturing work. Salvage inventory and cores are recorded at the lower of cost or market. Cost is established based upon the price the Company pays for a vehicle, and includes average costs for buying, dismantling, and where applicable, auction fees and storage, and towing. Inventory carrying value is determined using the average cost to sales percentage at each of the Company s facilities and applying that percentage to the facility s inventory at expected selling prices. The average cost to sales percentage is derived from each facility s historical vehicle profitability for salvage vehicles purchased at auction or from contracted rates for salvage vehicles acquired under certain direct procurement arrangements.

An aftermarket product is a new vehicle product manufactured by a company other than the OEM. Cost is established based upon the average price for purchased parts, and includes expenses incurred for freight and buying, where applicable. For items purchased from foreign companies, import fees and duties and transportation insurance are also included. Refurbished wheel inventory cost is based upon the average price paid for wheel cores, and also includes expenses incurred for freight, buying and refurbishing overhead. Aftermarket products and refurbished wheels inventory is recorded at the lower of cost or market.

For all inventory, carrying value is reduced regularly to reflect the age of the inventory and current anticipated demand. If actual demand differs from management estimates, additional reductions to inventory carrying value would be necessary in the period such determination is made.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

Inventory consists of the following (in thousands):

	December 31, 2006	2005
Salvage products	$ 77,807	$ 69,444
Aftermarket products and refurbished wheels	40,451	30,238
Core facilities inventory	6,283	3,973
	$ 124,541	$ 103,655

Property and Equipment

Property and equipment are recorded at cost. Expenditures for major additions and improvements are capitalized. As property and equipment are sold or retired, the applicable cost and accumulated depreciation are removed from the accounts and any resulting gain or loss thereon is recognized. Construction in progress consists primarily of building and land improvements at existing Company facilities. Depreciation is calculated using the straight-line method over the estimated useful lives or, in the case of leasehold improvements, the term of the related lease, including renewal periods, if shorter. Other estimated useful lives are as follows:

Land improvements	10 20 years
Buildings and improvements	20 40 years
Furniture, fixtures and equipment	5 20 years
Computer equipment and software	3 10 years
Vehicles and trailers	3 10 years

Property and equipment consists of the following (in thousands):

	December 31, 2006	2005
Land and improvements	$ 31,521	$ 28,145
Buildings and improvements	40,159	35,345
Furniture, fixtures and equipment	46,931	31,685
Computer equipment and software	13,156	10,680
Vehicles and trailers	12,876	11,769
Leasehold improvements	15,242	9,533
	159,885	127,157
Less Accumulated depreciation	(43,069)	(35,129)
Construction in progress	10,268	5,190
	$ 127,084	$ 97,218

Intangibles

Intangible assets consist primarily of goodwill (the cost of purchased businesses in excess of the fair value of the identifiable net assets acquired), covenants not to compete and trademarks.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

Goodwill and intangible assets with indefinite useful lives should not be amortized but instead should be tested for impairment at least annually. The Company has performed annual impairment tests during the fourth quarter of 2006, 2005 and 2004. The results of these tests indicated that goodwill was not impaired.

The changes in the carrying amount of goodwill are as follows (in thousands):

Balance as of January 1, 2004	$ 50,799
Business acquisitions	49,520
Balance as of December 31, 2004	100,319
Adjustment of previously recorded goodwill	(1,508)
Business acquisitions	82,981
Balance as of December 31, 2005	181,792
Adjustment of previously recorded goodwill	4,543
Business acquisitions	59,897
Balance as of December 31, 2006	$ 246,232

Other intangible assets totaled approximately $0.2 million at December 31, 2006 and 2005, respectively. Accumulated amortization of other intangible assets at December 31, 2006 and 2005 was approximately $0.1 million. Amortization expense was approximately $20,000, $19,000 and $8,000 during the years ended December 31, 2006, 2005 and 2004, respectively. Covenants not to compete are amortized over the lives of the respective agreements on a straight-line basis. Estimated annual amortization expense for the years ended December 31, 2007 through 2009 is approximately $20,000, for the year ended December 31, 2010 is approximately $3,000, and for the year ended December 31, 2011 is approximately $2,000.

Impairment of Long-Lived Assets

Long-lived assets are reviewed for possible impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. If such review indicates that the carrying amount of long-lived assets is not recoverable, the carrying amount of such assets is reduced to fair value. There were no adjustments to the carrying value of long-lived assets during the years ended December 31, 2006, 2005 or 2004.

Investments

The Company holds common shares of 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 of approximately $2.2 million and $2.7 million at December 31, 2006 and 2005, respectively, with the unrealized gain excluded from earnings and included in Accumulated other comprehensive income, net of applicable taxes. The fair value of this investment at December 31, 2006 and 2005 was estimated based upon the quoted market price for these securities. The Company has sold a portion of its investment and included the realized gains of $0.7 million and $0.3 million in Other (income) expense for the years ended December 31, 2006 and 2005, respectively.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

Fair Value of Financial Instruments

SFAS No. 107, Disclosures About Fair Value of Financial Instruments, requires disclosure of the fair value of certain financial instruments. The Company s financial instruments, excluding the available-for-sale securities discussed above, include cash and equivalents, trade receivables, accounts payable, debt and, through August 2004, an interest rate swap. The carrying amounts of financial instruments approximate fair value.

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 as collateral for the accuracy of certain representations and warranties. 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 seller s representation and warranty provisions were resolved, and the escrowed funds plus accrued interest at an annual rate of 3% were returned to the sellers.

Accrued Expenses

The Company has entered into certain arrangements whereby salvage vehicles are obtained directly from major insurance companies and automotive manufacturers at a cost calculated as a percentage of the revenue generated from each vehicle. Accrued expenses include an estimated liability of approximately $1.4 million and $2.5 million at December 31, 2006 and 2005, respectively, for salvage inventory procured under such arrangements.

The Company self-insures for a portion of employee medical benefits under the terms of its employee health insurance program. The Company has purchased stop-loss insurance coverage in order to limit its exposure to employee medical benefit claims. Other accrued expenses include an estimated liability of approximately $1.1 million and $1.5 million at December 31, 2006 and 2005, respectively, for expenses incurred but not yet paid under the program.

The Company also self-insures for a portion of general liability and workers compensation claims under the terms of its current insurance program, which began on April 1, 2002. On April 1, 2003, the Company began self-insuring for a portion of automobile claims. The Company has purchased stop-loss insurance coverage in order to limit its exposure to automobile, general liability and workers compensation claims. Other accrued expenses include an estimated liability of approximately $7.4 million and $5.4 million, net of claims deposits of $1.0 million and $0.7 million, at December 31, 2006 and 2005, respectively, for expenses incurred but not yet paid under the program. If the Company were to incur claims up to its aggregate stop-loss insurance coverage during the open policy years, it would have an additional expense of approximately $13.3 million.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

Product Warranties

The Company generally warrants certain mechanical parts against defects for a period of six months. Based on historical warranty claims, the Company accrues the estimated costs of the warranty coverage at the time of sale.

A rollforward of the warranty reserve is as follows (in thousands):

Balance as of January 1, 2005	$ 280
Warranty expense	2,507
Warranty claims	(2,452)
Balance as of December 31, 2005	335
Warranty expense	2,853
Warranty claims	(2,778)
Balance as of December 31, 2006	$ 410

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Accordingly, deferred income taxes have been provided to show the effect of temporary differences between the tax bases of assets and liabilities and their reported amounts in the financial statements. A valuation allowance is provided for deferred tax assets if it is more likely than not that these items will either expire before the Company is able to realize their benefit, or that future deductibility is uncertain. Income taxes provided during interim periods are based upon the Company s anticipated annual effective income tax rate.

Other Noncurrent Liabilities

Other Noncurrent Liabilities include approximately $4.1 million and $2.8 million at December 31, 2006 and 2005, respectively, related to employee deferred compensation plans as discussed in Note 5 and approximately $1.8 million at December 31, 2006 related to a long term incentive plan for certain key employees as discussed in Note 12.

Other Noncurrent Liabilities also include approximately $0.8 million and $1.0 million at December 31, 2006 and 2005, respectively, related to unasserted claims that are deemed probable of assertion. In the event the unasserted claims are asserted and resolved for amounts different than those accrued, or are determined to no longer be probable in future periods, the amounts so determined would be adjusted to income in the periods such determination is made. During the years ended December 31, 2006 and 2005, approximately $0.1 million and $0.5 million, respectively, was recognized in income due to the favorable resolution of certain unasserted claims.

Depreciation Expense

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

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

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 3). 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 for 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. When estimating forfeitures, the Company considers voluntary and involuntary termination behavior as well as analysis of its historical option 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 $2.4 million ($1.4 million, net of tax) stock-based compensation expense resulting from stock options included in our Consolidated Statement of Income (in thousands):

	Year Ended December 31, 2006
Cost of goods sold	$ 13
Facility and warehouse expenses	599
Selling, general and administrative expenses	1,777
	$ 2,389

As a result of adopting SFAS 123R on January 1, 2006, the Company s net income for the three month and twelve month periods ended December 31, 2006 was $0.6 million and $1.4 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 twelve month periods ended December 31, 2006 would have been $0.20 and $0.87 as compared to $0.19 and $0.84, respectively, and diluted earnings per share for the three month and twelve month periods ended December 31, 2006 would have been $0.19 and $0.82 as compared to $0.18 and $0.80, respectively.

LKQ CORPORATION AND SUBSIDIARIES
Notes to Consolidated Financial Statements (Continued)

Note 1. Summary of Significant Accounting Policies (Continued)

The Company has not capitalized any stock-based compensation cost during the year ended December 31, 2006. As of December 31, 2006, a total of $5.6 million in unrecognized compensation expense related to outstanding stock options is expected to be recognized as follows:

2007	$ 2.0 million
2008	1.4 million
2009	1.2 million
2010	0.9 million
2011	0.1 million

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:

	Year Ended December 31,		
	2006	**2005**	**2004**