

KEYSTONE AUTOMOTIVE INDUSTRIES INC

Form 10-K

June 09, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended March 26, 2004

OR

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

For the transition period from _____ to _____

Commission File Number: 0-28568

KEYSTONE AUTOMOTIVE INDUSTRIES, INC.

(Exact name of registrant as specified in its charter)

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California
(State or other jurisdiction of
incorporation or organization)

95-2920557
(I.R.S. Employer

Identification Number)

700 East Bonita Avenue, Pomona, California 91767

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (909) 624-8041

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

None

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

Common Stock, no par value

(Title of Class)

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 No

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 the Form 10-K or any amendment to this form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

The aggregate market value of the voting stock held by nonaffiliates of the registrant based upon the closing sales price of its Common Stock on September 26, 2003 on the Nasdaq National Market was approximately \$309.4 million. For purposes of the foregoing calculation, shares of Common Stock held by each officer and director and by each person who may be deemed to be an affiliate have been excluded.

The number of shares of Common Stock outstanding as of June 1, 2004: 15,449,145.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III is incorporated by reference to portions of the Registrant's definitive proxy statement for the 2004 Annual Meeting of Stockholders which will be filed with the Securities and Exchange Commission within 120 days after the close of the 2004 fiscal year.

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FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve risks and uncertainties, such as statements of the Company s strategies, plans, objectives, expectations and intentions. The Company s actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth under Cautionary Statements in Item 1 below and elsewhere in this Annual Report. The Company has based its forward-looking statements on current expectations and projections about future events and assumes no obligation to update publicly any forward-looking information that may be made by or on behalf of the Company in this Annual Report on Form 10-K or otherwise, whether as a result of new information, future events or otherwise, except to the extent the Company is required to do so. The cautionary statements made in this Annual Report should be read as being applicable to all related forward-looking statements wherever they appear in this Annual Report.

PART I

ITEM 1. BUSINESS

General

Keystone Automotive Industries, Inc. (Keystone or the Company) is the nation s leading distributor of aftermarket collision replacement parts produced by independent manufacturers for automobiles and light trucks. Keystone distributes products primarily to collision repair shops throughout most of the United States and certain areas in Canada. In addition, the Company recycles and produces chrome plated and plastic bumpers and remanufactures alloy and steel wheels. The Company s principal product lines consist of automotive body parts, bumpers and remanufactured alloy wheels, as well as paint and other materials used in repairing a damaged vehicle. Keystone currently offers more than 19,000 stock keeping units to over 25,000 collision repair shop customers, out of an estimated 51,000 shops nationwide. Founded in Southern California in 1947, the Company operates a hub and spoke distribution system consisting of 125 distribution centers, 22 of which serve as regional hubs, and 15 depots, located in 38 states throughout the United States, as well as in the provinces of Ontario, Quebec and British Columbia in Canada. From these service centers, Keystone has approximately 1,700 customer service and salespersons who call on or have contact with collision repair shops. In addition, the Company operates nine wheel remanufacturing facilities and 42 plastic and steel bumper recycling facilities.

The Company became certified as an ISO 9001 distributor in September 2002. ISO 9001 implementation policies and procedures include quality and service, performance, customer satisfaction and complaint resolution. The Company believes that it is one of only a few companies in its industry which is ISO 9001 certified.

To emphasize the high quality of aftermarket parts distributed by Keystone, the Company instituted its Keystone Platinum Plus program in September 2000. This program covers only the highest quality parts, which are warranted for as long as the owner of the repaired vehicle maintains ownership. The Company believes that Platinum Plus is the first and only premium brand of independently produced collision replacement parts. To date, Platinum Plus product categories include radiators and condensers, wheels, grilles, lights, hoods, fenders and certain bumpers. The Company continually adds additional products to the Platinum Plus program.

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During the last fiscal year, the Company substantially increased its presence in Canada through the acquisition of Multipro Auto Body Parts, Inc. (MultiPro) in August 2003 and Quinte Bumper and Fender (Quinte) in January 2004. MultiPro distributes aftermarket collision replacement parts with locations in Drummondville, Montreal, Quebec, Ottawa and Sherbrooke while Quinte had locations in Trenton, Toronto, Ottawa and Montreal. MultiPro s and Quinte s locations in Montreal have been combined.

Beginning in April 2004, the Company launched an e-commerce initiative offering certain of its parts on the web at getcrashparts.com and getradiators.com. The websites are designed for the retail consumer. The Company

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anticipates launching a separate website for hubcap and wheel offerings in the next few months at getwheelsandrim.com. The websites have been designed and launched working with a third party e-commerce provider. While there are competing websites, with its near nationwide distribution network, the Company believes that its parts offerings will have a competitive advantage. There can be no assurance that sales through the web will become material to the Company's operations. During fiscal 2004, the Company began offering certain of its aftermarket collision replacements parts to the public through catalogs at two large chain-store aftermarket parts retailers. To date, sales have not been material.

See **Cautionary Statements** below with respect to various risks facing the Company, including but not limited to the impact on the Company of (i) the decision in the State Farm Mutual Automobile Insurance Company (**State Farm**) class action lawsuit, (ii) actions by state legislatures and administrators relating to the use of aftermarket parts, (iii) the installation of an enterprise-wide management information system and (iv) class action litigation filed against two Canadian auto insurance companies in January 2000 relating to their specification of aftermarket parts.

The Company makes available its quarterly, annual and other periodic and current reports required by the Securities and Exchange Commission (the **SEC**), and any amendments to such reports, as well as other information about the Company, on its corporate website (www.keystone-auto.com), free of charge, to individuals interested in acquiring such reports. The reports can be accessed at www.keystone-auto.com (under **Investor Info**) as soon as reasonably practicable after the reports are electronically filed with the Sec.

Industry Overview

History. The Company estimates that the wholesale market for aftermarket collision parts is about \$1.5 billion in annual expenditures, or approximately 13% of the collision parts market. In addition, the Company estimates that annual wholesale sales of paint and related supplies and equipment for collision repair currently account for approximately \$2.4 billion. Substantially all of the remainder of the collision parts market consists of parts produced by original equipment manufacturers (**OEMs**). A substantial number of collision parts are available exclusively from **OEMs** and are likely to remain so. The growth in sales of aftermarket collision parts over the last decade has been due primarily to the increased availability of quality parts and to cost containment efforts by the insurance industry.

Before 1980, automotive collision parts were manufactured almost exclusively by **OEMs**. During the 1960s and 1970s, due to prohibitive tariffs in Taiwan on imported automobiles and restrictions on foreign ownership of manufacturing facilities in Taiwan, certain Taiwanese automobile manufacturers commenced producing automobiles for sale in Taiwan, which created the need for additional parts manufacturers to supply the assembly lines. Since the early 1980s, these Taiwanese manufacturers have sought to reduce the effect on their business of the cyclical demand for new automobiles by producing aftermarket collision parts.

The Company estimates that approximately 85% of all automobile collision repair work is paid for in part by insurance. Accordingly, major insurance companies exert significant influence over the selection of collision parts used by collision repair shops. The availability of aftermarket collision parts has been a major factor in the insurance industry's efforts to contain the escalating cost of collision repairs.

Aftermarket collision parts generally sell for between 20% and 40% less than comparable **OEM** parts, resulting in substantial savings for insurance companies by providing consumers with less expensive aftermarket parts and creating competition, often resulting in lower prices for comparable **OEM** parts. This also positively impacts insurance premiums for consumers. The Company believes that it may be somewhat insulated from downturns in the general economy as a result of the fact that it is estimated that approximately 85% of all automobile collision repair work is paid for in part by insurance.

Quality Assurance. In 1987, the Certified Automotive Parts Association (CAPA) was founded to provide insurance companies, distributors, collision repair shops and consumers with an objective method of

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evaluating the functional equivalence of aftermarket collision parts and OEM collision parts. CAPA, a non-profit association of insurance companies, manufacturers, importers, distributors, collision repair shops and consumer groups, establishes the specifications for, tests and certifies the quality of aftermarket automotive collision parts. Through independent testing laboratories, CAPA develops engineering specifications for aftermarket collision parts based upon an examination of OEM parts; certifies the factories, manufacturing processes and quality control procedures used by independent manufacturers; and certifies the materials, fit and finish of specific aftermarket collision parts. Most major insurance companies have adopted policies recommending or requiring the use of parts certified by CAPA, when available. The Company distributes parts certified by CAPA when available and actively participates with CAPA, insurance companies and consumer groups in encouraging independent manufacturers of collision parts to seek CAPA certification.

The Company currently meets the requirements of the Manufacturers Qualification and Validation Program (MQVP). MQVP defines expectations and part quality requirements for manufacturers, suppliers and distributors of aftermarket collision parts. The Company s implementation of the ISO 9001 program and participation in MQVP reflects its commitment to quality parts and customer satisfaction.

Strategy

The Company s growth strategy involves a combination of increased sales to existing customers, increased penetration of markets Keystone is currently serving, the introduction of new products and acquisitions and start-ups. Higher sales of existing products reflects increased demand for our premium brand Platinum Plus product line and a concerted effort by the sales force to sell our full line of products to each of our customers. The Platinum Plus product line and the Company s participation in quality programs such as CAPA and MQVP are key to increasing our penetration of existing markets. While Keystone has the largest distribution network of any aftermarket crash parts distributor, it believes that there are important markets not now served which can be accessed either through the acquisition of an existing distributor or the opening a new distribution center.

Products

The Company distributes more than 19,000 stock keeping units of aftermarket collision parts and repair materials for most popular models of domestic and foreign automobiles and light trucks, generally for the eight most recent model years. The Company s principal product lines consist of automotive body parts, bumpers, paint and other materials, remanufactured alloy wheels, autoglass and light truck accessories. In addition, the Company recycles, produces and distributes new and remanufactured plastic and chrome bumpers to wholesale bumper distributors and to distributors of truck accessories.

Automotive Body Parts. The Company distributes automotive and light truck parts manufactured by multiple foreign and domestic manufacturers, including fenders, hoods, radiators and condensers and head and tail light assemblies. These products accounted for approximately \$255.2 million, or 50.9% of the Company s net sales in the fiscal year ended March 26, 2004.

Bumpers. The Company distributes new and remanufactured plastic bumper covers and steel bumpers manufactured by multiple domestic and foreign manufacturers. For the fiscal year ended March 26, 2004, sales of plastic and steel bumpers accounted for approximately \$147.2 million, or 29.4% of the Company s net sales. The Company believes that it is one of the nation s largest non-OEM providers of new and recycled chrome plated bumpers for the collision repair and restoration markets.

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Beginning in the late 1970s and the early 1980s, manufacturers of new automobiles began changing from an almost exclusive use of chrome plated steel bumpers to painted plastic bumpers. By the 1996 model year, manufacturers were using painted plastic bumpers almost exclusively for their automobiles. Chrome plated steel bumpers are still used extensively on light trucks and sport utility vehicles. On an annual basis, the Company electroplates approximately 220,000 steel plated bumpers for automobiles and light trucks at two locations.

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Bumpers used in the operations include new steel stampings, collision-damaged bumpers that require straightening and replating and older model or antique bumpers that require restoration and replating. The bumper repair and replating process generally includes some or all of the following steps: straightening or reforming to original dimensions; welding breaks or cracks; surface grinding to remove rust and corrosion; chemical stripping to remove the original electroplated finishes; metal polishing and buffing; electroplating layers of copper, nickel and chromium; and inspecting and packaging. Plastic bumper covers are remanufactured at 52 locations throughout the country. The remanufacturing process generally includes cleaning, repairing, sanding, priming and curing the damaged bumper cover.

Paint and Related Materials. The Company distributes paint and other materials used in repairing a damaged vehicle, including sandpaper, abrasives, masking products and plastic filler. The paint and other materials distributed by the Company are purchased from numerous domestic suppliers. For the fiscal year ended March 26, 2004, sales of paint and other materials accounted for approximately \$58.9 million, or 11.8% of the Company's net sales. Certain of these products are distributed under the name Keystone.

Wheels and Related Products. The Company operates 11 facilities which remanufacture collision damaged alloy wheels. According to industry sources, the percentage of new automobiles equipped with alloy wheels, as opposed to steel wheels and hubcaps, has increased from approximately 11% in 1985 to 55% for the 2001 model year. The average wholesale cost of a new replacement alloy wheel is approximately \$225, compared to an average wholesale cost of approximately \$125 for a remanufactured alloy wheel. The alloy wheel remanufacturing process generally includes some or all of the following steps: straightening, welding minor dents or chips, machining, painting and applying clear powder coat. In addition, the Company sells steel wheels, caps and wheel covers. For the fiscal year ended March 26, 2004, sales of wheels and related products accounted for approximately \$39.6 million, or 7.9% of the Company's net sales.

Distribution, Marketing and Sales

The Company's distribution system is designed to provide responsive customer service and to foster long-term customer relations.

Distribution System. The Company has developed a national hub and spoke distribution system consisting of 125 distribution centers, 22 of which serve as regional hubs, and 15 depots. Each regional hub receives container shipments directly from foreign and domestic manufacturers. Using the Company's fleet of approximately 1,450 delivery trucks, each regional hub makes regular shipments to the distribution centers in its region, which in turn make regular deliveries to its repair shop customers. By maintaining a fleet of delivery trucks, the Company ensures rapid delivery within its distribution system and to its customers. In addition, each distribution center can order products directly from any hub or distribution center. The Company manages its inventory and the ordering, shipment, storage and delivery of products through centralized information systems that allow the regional hubs and distribution centers to obtain timely information regarding the location and availability of products. The continuing increase in the number of makes and models of automobiles and light trucks and the number of aftermarket collision parts has increased the pressure on distributors to maintain larger inventories. The Company believes that its hub and spoke distribution system allows it to offer its customers one of the broadest available selections of aftermarket collision parts and to fill most orders within 24 hours.

Sales and Marketing Staff. The Company has a marketing staff, which operates from its corporate headquarters, and has over 1,700 sales and customer service representatives and route salespersons who operate from its distribution centers. The marketing staff develops all marketing and promotional materials, assists the service centers in recruiting and training sales representatives, route salespersons and customer service representatives and supports general managers of its service centers, sales representatives and route salespersons with computerized analyses of sales by product, route and customer. In addition, the marketing staff conducts educational programs for regional insurance executives and claims adjusters to explain the role of aftermarket collision parts in containing the escalating costs of claims and in order to facilitate the implementation of insurance companies' policies favoring aftermarket collision parts.

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The general managers of the Company's service centers are actively involved in customer calls. The Company believes that this local control and expertise have contributed significantly to its growth. Through periodic training programs and performance reviews, the Company seeks to enhance the professionalism and technical expertise of its route salespersons. As a result, the Company believes that its route salespersons are highly attendant to the needs of the Company's customers.

Marketing Programs. The Company offers various marketing programs to foster closer customer relations, including a warranty program in which the Company generally warrants its products against defects in material and workmanship for as long as the repair shop's customer owns the vehicle.

Customers

The Company's current customers consist primarily of more than 25,000 collision repair shops located in all 50 states, the District of Columbia and in the provinces of Ontario, Quebec and British Columbia in Canada, none of which accounted for more than 1% of the Company's net sales during the fiscal year ended March 26, 2004. The Company also distributes its bumpers to wholesale distributors and to manufacturers of truck accessories. The size of its customer base reduces the Company's dependence on any single customer and its national scope tends to mitigate the effects of regional economic changes and regional weather patterns. The Company estimates that there are over 51,000 collision repair shops nationwide.

The Company's regional hubs also sell collision parts to local distributors who may compete with the Company. These sales accounted for less than 10% of the Company's net sales during the fiscal year ended March 26, 2004 and no distributor accounted for more than 1% of the Company's net sales for such fiscal year.

Suppliers

The products distributed by the Company are manufactured by over 60 manufacturers, and no single supplier provided as much as 10% of the products purchased by the Company during fiscal 2004. The Company believes that it is one of the largest customers of each of its ten largest suppliers. In fiscal 2004, by dollar amount, approximately 62% of the products distributed by the Company were manufactured in the United States or Canada, and approximately 38% were imported directly or indirectly from manufacturers in Taiwan. The Company's orders from domestic suppliers generally are received within 10 days and orders from foreign manufacturers generally are received in between 45 and 90 days.

In August 2000, the Company entered into a purchase agreement with its principal supplier of automobile lighting products under the Platinum Plus line. The agreement automatically renews for additional 12 month periods unless written notice is given by either party. In late 2003, the Company also entered into manufacture/supply agreements with substantially all of the major suppliers of Platinum Plus products, however, no one agreement is material to the Company. These agreements also automatically renew for additional 12 month periods unless written notice is given by either party. Other than as set forth above, the Company has no manufacturing agreements with any of its suppliers. While Keystone competes with other distributors for production capacity, the Company believes that its sources of supply and its relationships with its suppliers are satisfactory. Although alternative suppliers exist for most products distributed by the Company, the loss of several of the larger suppliers could have a material adverse effect on the Company until alternative suppliers were located and commenced providing products.

Management Information Systems

The Company continues to install its enterprise-wide management information system, consolidating the 13 systems under which the Company once operated. As of June 1, 2004, only four of the legacy systems remain, excluding Canada and recent acquisitions. This continues to be an extremely costly and time-consuming process and an effective implementation is necessary to enable the Company to continue to grow and prosper in the future. In January 2002 the Company entered into an agreement with Prelude Systems, Inc. (Prelude) for the

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purchase of a software package which will enable the Company to migrate to an enterprise-wide system. The Company has also entered into other software license agreements and engaged service providers to enable it to fully implement the Prelude system. The Prelude system includes, among other capabilities, modules for financial reporting (general ledger and accounts payable and receivable), order entry, purchasing and distribution management (inventory and warehouse management and replenishment). Keystone has adopted the Prelude modules with limited customization.

Management installed the system at five locations in California starting on July 1, 2002 as beta sites and adjustments to the system were made during this first implementation phase. The Company began rolling out the system to other locations in July 2002. Through June 1, 2004, the system had been installed in 85 locations, leaving 56 locations on legacy systems, excluding Canada and certain recent acquisitions. Based upon the projected rollout, excluding Canada and recent acquisition locations, complete installation of the system company-wide is now expected by November 2004.

It is estimated that total costs from inception through the complete roll-out, including Canada and recent acquisition locations, will be approximately \$19.4 million, which includes hardware, software, infrastructure and employee related expenses. Through March 26, 2004, the Company had capitalized approximately \$10.3 million of costs, primarily for software licenses and hardware. The Company estimates that the total amount to be capitalized through implementation will be \$13.0 million. The balance of the costs will be expensed as incurred. The cost and timing for, and effectiveness of, a project such as the Company is undertaking are subject to numerous uncertainties some of which are beyond the control of the Company and others of which cannot be foreseen at the present time. Consequently, the ultimate functionality may not meet the needs of the operations and the cost and timing to implement the Prelude system Company-wide may vary greatly from the estimates set forth above.

Competition

Based upon industry estimates, the Company believes that approximately 74% of collision parts by dollar amount are supplied by OEMs, compared with an estimated 13% by distributors of aftermarket collision parts and 13% by distributors of salvage parts. See **Cautionary Statements** below for a discussion of a recent court decision which is impacting the market share of aftermarket collision parts. The Company encounters intense competition from OEMs, all of which have substantially greater financial, distribution, marketing and other resources, including greater brand recognition and a broader selection of collision parts, than the Company. Accordingly, OEMs are in a position to exert pricing and other competitive pressure on the Company. The distribution industry for aftermarket collision parts is highly fragmented. The Company's competitors generally are independently owned distributors having from one to three distribution centers. In addition to intense competition from OEMs, the Company expects to encounter significant competition in the future from other distributors of aftermarket parts including automobile dealerships, distributors of salvage parts and buying groups.

The Company competes with OEMs on the basis of price and perceived product quality, and it competes with distributors of aftermarket collision parts primarily on the basis of the competitive advantages provided by its position as the market leader with a nationwide distribution system, its Platinum Plus product line, experienced executive management and service center managers, entrepreneurial corporate culture, superior customer service, its relationship with certain insurance companies, and, to a lesser extent, on the basis of price.

The Company's chrome bumper plating operations compete in the wholesale bumper distribution segment of the market with many small chrome bumper platers or distributors in virtually every geographical market in which it operates. The Company competes with small chrome bumper platers and distributors primarily on the basis of quality and service. Over the last 10 years, there has been a significant decrease in the number of small bumper platers as a result of the decreasing use of chrome plated bumpers on new automobiles and the increasing environmental requirements for electroplaters. The Company believes that this trend will continue, creating more sales opportunities for larger regional chrome bumper platers, who are capable of meeting the increased financial and environmental requirements.

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The Company also encounters competition from the OEMs who supply new replacement bumpers to the collision repair market and it competes with these OEMs on the basis of price and perceived product quality.

Government Regulation and Environmental Hazards

The Company is subject to increasing restrictions imposed by various federal, state and local laws and regulations. Various state and federal regulatory agencies, such as the Occupational Safety and Health Administration, the United States Environmental Protection Agency (EPA) and the Department of Transportation have jurisdiction over the Company's operations with respect to matters including worker safety, community and employee right-to-know laws, and laws regarding clean air and water. In addition, in part as a result of the State Farm decision described in

Cautionary Statements below and the attendant publicity, certain state legislatures and regulators are considering imposing, or have imposed, restrictions on the use of aftermarket collision parts. The General Accounting Office (GAO) report to the United States Congress, released in January 2001, captioned NHTSA's Ability to Detect and Recall Defective Replacement Crash Parts is Limited may eventually result in hearings in Congress and possible legislation which could be adverse to the interests of Keystone. See Cautionary Statements Federal and State Action below for additional information about governmental activities with respect to aftermarket collision replacement parts.

See Cautionary Statements Compliance with Government Regulations; Environmental Hazards below for information with respect to the Company's environmental exposure.

Employees

At May 28, 2004, the Company had 3,430 full-time employees, of whom 376 were engaged in corporate management and administration, 1,695 in sales and customer service, 656 in warehousing and shipping and 703 in remanufacturing. None of the Company's employees are covered by collective bargaining agreements. The Company considers its relations with its employees to be satisfactory.

Cautionary Statements

Litigation Impacting Aftermarket Collision Replacement Parts. Over the past fifteen years, there have been numerous lawsuits brought relating to the use of aftermarket parts in repairing motor vehicles. Initially, these cases were brought primarily by automobile original equipment manufacturers (OEMs) against manufacturers and distributors of aftermarket parts seeking to protect their trademarks, copyrights and other proprietary interests in replacement parts. In more recent years, class action attorneys have commenced numerous cases against insurance companies, primarily alleging a violation of the insurance contract and state consumer protection laws because of the specification of aftermarket crash parts for the repair of policyholders' vehicles. Plaintiffs' attorneys allege that aftermarket parts are inferior to OEM parts and thus are incapable of restoring a vehicle to its pre-loss condition as required by many insurance policies.

The leading case involving aftermarket crash parts *Avery v. State Farm Insurance Company* was brought in Marion, Illinois in July 1997 (Madison County). In that case, plaintiffs asserted claims for breach of contract, consumer fraud and equitable relief relating to State Farm's practice at that time of sometimes specifying aftermarket parts rather than OEM parts when adjusting claims for the damage to insured vehicles. It was alleged that this practice breached State Farm's insurance agreements with its policyholders and was a violation of the Illinois Consumer Fraud and Deceptive Business Practices Act. In October 1999, after a lengthy trial, the jury in *Avery* awarded plaintiffs compensatory damages of approximately \$586 million. In addition, the judge assessed punitive damages against State Farm of over \$600 million. In April 2001, the

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Appellate Court of Illinois, Fifth District, upheld the verdict, reducing damages by \$130 million, resulting in an aggregate award of \$1.06 billion. Thereafter, a Petition for Allowance of Appeal to the Illinois Supreme Court was filed by State Farm. In October 2002, the Illinois Supreme Court agreed to hear the appeal. The parties have filed their briefs and conducted oral argument. A decision by the Illinois Supreme Court is expected within the next few months. Since *Avery* is the only class action case involving aftermarket parts to proceed to trial, the decision in this case is likely to have a major impact on the future of aftermarket parts litigation.

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Shortly after the verdict in the *Avery* case, State Farm and many other insurance companies suspended their practice of specifying non-OEM crash parts on repair estimates. In early 2001, however, certain insurance companies announced that they were again going to specify certain aftermarket parts in the repair of insured vehicles. While several insurance companies are once again specifying non-OEM parts, the action of insurance companies following the State Farm decision has had, and continues to have, an adverse impact on the Company's sales and net income.

Until May 2002, the Company had not been a party to any of the lawsuits filed against insurance companies. On March 18, 2002, a Philadelphia Court certified a 50-state class of all Erie Insurance Company (Erie) policyholders whose vehicles had been repaired with one or more of 25 specific parts or had received monetary compensation based on the value of these parts between 1994 and the date the complaint was filed. Plaintiff alleged, among other things, that she was the holder of an Erie automobile insurance policy, that her vehicle had been in an accident, and at the direction of Erie certain of the parts used to repair her vehicle were aftermarket parts rather than original equipment manufacturer parts. Plaintiff alleged that the aftermarket parts were defective, inferior and substandard compared to OEM parts and therefore failed to restore her vehicle to its pre-loss condition and value, in violation of her insurance contract and in violation of Pennsylvania consumer protection laws. In May 2002, Keystone, along with 44 other manufacturers and distributors of aftermarket crash parts, were joined by Erie as additional defendants in the class action filed in the Philadelphia County Court of Common Pleas, captioned *Foultz v. Erie Insurance Exchange and Erie Insurance Company, et al.*

Erie alleged that Keystone and the other additional defendants are liable to the policyholders and to Erie by way of indemnification, based upon breach of express and implied warranties, for misrepresenting the quality of their aftermarket parts, negligence and violation of Pennsylvania consumer protection law. No specific amount of damages were sought by plaintiff on behalf of the class or by Erie.

On April 29, 2003, after the Pennsylvania Superior and Supreme Courts refused to consider an appeal of the class certification order, Erie reached a settlement with plaintiffs. Erie agreed to pay \$6,250,000. Keystone did not contribute toward the settlement and Erie agreed, without prejudice, to dismiss all claims against the additional defendants, including Keystone. On January 7, 2004, the Court conducted a final hearing regarding the fairness of the settlement. On January 25, 2004, the Court issued a final order approving the settlement. On March 10, 2004, the plaintiffs filed a formal discontinuance against the additional defendants, including Keystone. Although this litigation is effectively ended, the possibility does exist that Erie could bring suit against the additional defendants for indemnity and/or contribution.

Currently, there are a number of other aftermarket parts cases pending in various jurisdictions across the country. The Company has not been made a party in any of these cases. There can be no assurance, however, that Keystone will not be brought into one of these cases or some other aftermarket parts case in the future.

On January 30, 2000, a class action was filed in Quebec against two auto insurers, Groupe Desjardins, ING Canada and AXA Canada, relating to their specification of aftermarket parts in the repair of vehicles. The case is modeled after the State Farm case and the Plaintiffs are relying in part on the judgment in that case. The case is expected to proceed to trial in late 2004.

A substantial portion of the Company's business consists of the distribution of aftermarket crash parts to collision repair shops. The vast majority of the customers of the repair shops are covered by insurance policies. In the event that the State Farm verdict is repeated in other similar cases, with the result that aftermarket crash parts are no longer specified by insurance companies to repair insured vehicles, the aggregate cost to consumers will be substantial and the impact on Keystone would be material and adverse. Should this occur, OEMs would likely have monopoly pricing power with respect to many of the products required to repair damaged vehicles. In addition, if the Company were to become a defendant in additional aftermarket parts cases, the costs of defense and the potential for liability could have a material adverse impact on the Company.

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The Company believes that substantially all of the aftermarket crash parts that it distributes are of similar quality to OEM crash parts and when installed in a competent manner by collision repair shops, vehicles are restored to their pre-loss condition. In addition, the Company provides a limited warranty against defects in materials and workmanship with respect to the parts it distributes for as long as the owner at the time repairs are made continues to own the vehicle.

Other Litigation. In November 2002, General Motors Corporation instituted suit against Keystone and a Taiwan-based manufacturer in the Federal District Court for the Eastern District of Michigan, Southern Division. The complaint alleges that Keystone is distributing replacement grilles for General Motors vehicles with a placeholder matched exactly to the Chevrolet Bow Tie design emblem and the GMC mark emblem, which infringes on General Motors' federal, state and common law trademarks. The suit claims this violates the Lanham Act and constitutes unfair competition under Michigan law. General Motors is seeking damages in an unspecified amount as well as certain equitable relief, including an injunction. See Item 3. Legal Proceedings below.

Federal and State Action. To date, legislation had passed in eight states requiring some form of consent from the vehicle owner prior to installing aftermarket collision replacements parts. During the past five years, legislation was introduced or considered in over 25 states seeking to prohibit or limit the use of aftermarket parts in collision repair work and/or require consent or special disclosure before using aftermarket parts. During 2003, 42 separate bills were introduced in 20 states. Of these bills, the legislatures in North Carolina and Rhode Island enacted laws affecting the use of aftermarket parts by providing that aftermarket parts must be equal (Rhode Island) or equivalent (North Carolina) in fit, quality and performance to the comparable OEM part.

During 2004, 34 bills have been introduced in 16 states, including 17 bills in eight states which were carried over from 2003. Only 22 bills remain active and no bills have passed to date. These bills generally affect the use of aftermarket parts in one or more of the following ways: consent of the vehicle owner to the use of aftermarket parts, notification to the vehicle owner before aftermarket parts are used, restriction on the use of aftermarket parts to older model years or requiring aftermarket parts to meet certain standards in comparison to the OEM part they would be replacing.

To date, state laws and regulations have not had a material impact on the Company's overall business. However, if a number of states were to adopt legislation prohibiting or restricting the use of aftermarket crash parts, it could have a material adverse impact on the Company.

In addition, during 2000, a U.S. Congressman requested that the General Accounting Office review the role of the National Highway and Transportation Safety Administration in regulating the safety and quality of replacement automotive parts. A GAO report was released in January 2001. The report may lead to Congressional hearings and possible future legislation, which could be adverse to the interests of the Company.

In September of 2001, the California State Senate authorized the Department of Consumers Affairs to conduct a study regarding the certification of aftermarket automobile crash parts. The Bureau of Automotive Repair conducted the study and released its findings on January 1, 2003. The report contains both positive and negative findings regarding aftermarket parts. On the one hand, the report does not recommend additional regulation of the specification of aftermarket parts or regulatory oversight of the organizations that ensure the quality of aftermarket parts. On the other hand, the report states that insurance companies do not pay for necessary modifications to aftermarket parts and recommends that the entity certifying the quality of aftermarket parts provide a warranty that would pay such additional costs.

Prelude Software System Installation. The Company continues to install its enterprise-wide management information system, consolidating the remaining five systems under which the Company now operates. This continues to be an extremely costly and time-consuming process and an

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effective implementation is necessary to enable the Company to continue to grow and prosper in the future. See Business Management Information

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Systems above for a detailed description of recent activities with respect to such a system. There can be no assurance that the timing and cost to install the system Company-wide will not significantly exceed current estimates or that the functionality will meet the Company's requirements.

Continued Acceptance of Aftermarket Collision Replacement Parts. Based upon industry sources, the Company estimates that approximately 85% of automobile collision repair work is paid for in part by insurance; accordingly, the Company's business is highly dependent upon the continued acceptance of aftermarket collision replacement parts by the insurance industry and the governmental agencies that regulate insurance companies and the ability of insurers to recommend the use of such parts for collision repair jobs, as opposed to OEM parts. As described above, the use of many of the products distributed by the Company is being disputed in various forums.

Dependence on Key and Foreign Suppliers. The Company is dependent on a relatively small number of suppliers. Although alternative suppliers exist for substantially all products distributed by the Company, the loss of several suppliers could have a material adverse effect on the Company until alternative suppliers are located and have commenced providing products. In fiscal 2004, approximately 62% of the products distributed by the Company were manufactured in the United States or Canada and approximately 38% were imported directly or indirectly from manufacturers in Taiwan. As a result, the Company's operations are subject to the customary risks of doing business abroad, including, among other things, transportation delays (see below) political instability, expropriation, currency fluctuations and the imposition of tariffs, import and export controls and other non-tariff barriers (including changes in the allocation of quotas), as well as the uncertainty regarding future relations between China and Taiwan.

Shipping. The Company's operations are dependent on a continued source of supply of the many automotive body parts which are presently only available from Taiwan. These products are transported to the United States aboard container ships which dock primarily in the Los Angeles, California area. Any disruption in shipping for any prolonged period, such as might result from an act of terrorism or labor strike, would likely have a material adverse impact on the Company's sales and earnings. Hostilities between China and Taiwan could also have an adverse impact on the Company's source of supply. In addition, contracts with shipping companies are negotiated on an annual basis normally beginning in April. The recently negotiated contracts did not reflect any material price increases but a material increase in shipping rates could adversely impact the Company's results of operations. Finally, because of the increase in global shipping, the Company is concerned that sufficient containers will be available to transport inventory. Delays in receiving needed inventory could have a material adverse impact on the Company.

Competition. The Company competes directly with, and encounters intense competition from, OEMs, all of which have substantially greater financial, distribution, marketing and other resources, including greater brand recognition and a broader selection of collision replacement parts. Accordingly, OEMs are in a position to exert pricing and other competitive pressures on the Company and other independent distributors, which could have a material adverse effect on the results of operations of the Company. The aftermarket collision replacement parts distribution industry is highly fragmented. Typically, the Company's other competitors are independently owned distributors having from one to three distribution centers. The Company anticipates that it will encounter significant competition in the future, including competition from automobile dealerships, distributors of salvage parts, buying groups and other distributors.

Compliance with Government Regulations; Environmental Hazards. The Company is subject to increasing restrictions imposed by various federal, state and local laws and regulations. Various state and federal regulatory agencies, such as the Occupational Safety and Health Administration, the EPA and the United States Department of Transportation, have jurisdiction over the Company's operations with respect to matters including worker safety, community and employee right-to-know laws, and laws regarding clean air and water. Under various federal, state and local laws and regulations, an owner or lessee of real estate or the operator of a business may be liable for the costs of removal or remediation of certain hazardous or toxic substances located on or in, or

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emanating from, property owned or used in the business, as well as related costs of investigation and property damage. Such laws often impose such liability without regard to whether the owner, lessee or operator knew of, or was responsible for, the presence of such hazardous or toxic substances. Other than as described below with respect to its bumper plating operations, the Company does not currently generate substantial hazardous waste in the ordinary course of its business. The Company believes that it currently is in substantial compliance with all applicable laws and regulations, and is not aware of any material environmental problem at any of its current or former facilities. No assurance can be given, however, that the Company's prior activities or the activities of a prior owner or operator of an acquired service center or other facility did not create a material environmental problem for which the Company could be responsible or that future uses or conditions (including, without limitation, changes in applicable laws and regulations) will not result in material environmental liability to the Company. Furthermore, compliance with legislative or regulatory changes may cause future increases in the Company's operating costs or otherwise adversely affect operations. Certain of the Company's products, such as paints and solvents, are highly flammable. Accordingly, the storage and transportation of these materials expose the Company to the inherent risk of fire.

The Company acquired North Star's bumper plating operations in March 1997 and Midwest Bumper's plating operations in March 1999. The Company previously conducted similar operations at 12 sites, 11 of which were closed between 1983 and 1993 and one of which was closed in 2000. The Company's bumper plating operations, which use a number of hazardous materials, are subject to a variety of federal and state laws and regulations relating to environmental matters, including the release of hazardous materials into the air, water and soil. The Company endeavors to ensure that its bumper plating operations comply with applicable environmental laws and regulations. To date, compliance with such laws and regulations has not had a material effect on the Company's capital expenditures, earnings or competitive position. While the Company is currently doing remediation at the site of its former Newark, New Jersey plating facility (closed in 2000), the Company does not anticipate material expenditures in completing that operation. No material capital expenditures with respect to the Company's bumper plating operations are anticipated during the next 12 months. Although the Company believes it is in substantial compliance with all applicable environmental laws and regulations relating to its bumper plating operations, there can be no assurance that the Company's current or former operations have not, or will not in the future, violate such laws and regulations or that compliance with such laws and regulations will not have a material adverse effect on the Company's operations. Any inadvertent mishandling of hazardous materials or similar incident could result in costly remediation efforts and administrative and legal proceedings, which could materially and adversely affect the Company's business and results of operations. In addition, future environmental regulations could add to overall costs of the Company's bumper plating business or otherwise materially and adversely affect these operations.

Decline in the Number of Collision Repairs. While the number of collision repairs has declined in recent years, and may continue to do so in the future, the cost to repair a vehicle has continued to increase. The decline in the number of vehicles being repaired is due to, among other things, automotive safety improvements, more rigorous enforcement of stricter drunk driving laws resulting in fewer accidents and the increase in unit body construction and higher collision repair costs resulting in a larger number of automobiles being declared a total loss in lieu of being repaired. Recent innovations such as impact detection devices available on certain vehicles could also result in less collisions. The continuation of such decline may have a material adverse effect on the Company.

Volatility of Stock Price. The trading price of the Company's Common Stock may be subject to significant fluctuations as a result of variations in the Company's actual or anticipated operating results, changes in general market conditions and other factors. In recent years, the stock market generally has experienced significant price and volume fluctuations which often have been unrelated or disproportionate to the operating performance of a specific company or industry. There can be no assurance that the market price of the Company's Common Stock will not decline below the current market price. It is possible that in some future quarter, the Company's operating results will be below the expectations of public market analysts or investors. In such event, the price of the Company Common Stock may be materially and adversely affected.

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ITEM 2. PROPERTIES

The Company's principal executive offices are located in Pomona, California, on premises owned by the Company, which contain approximately 20,000 square feet. The Company also leases approximately 7,500 square feet of space contiguous to the owned property. In addition, the Company owns facilities used as distribution centers in Chicago, Illinois; Quincy, Illinois; Bethlehem, Pennsylvania; Denver, Colorado; New Albany, Indiana and Palmyra, New Jersey, of which two of the facilities also serve as regional hubs and three serve as wheel remanufacturing facilities. The Company leases its remaining facilities.

The Company's regional hub facilities range from approximately 30,000 square feet to 238,000 square feet. Its distribution facilities range from approximately 1,500 square feet to 129,000 square feet. In addition, the Company has a nationwide distribution and storage facility located in Greenville, Michigan which has approximately 212,000 square feet. All of its leased properties are leased for terms expiring on dates ranging from on or about the date hereof to the year 2015, many with options to extend the lease term. The Company believes that no single lease is material to its operations, its facilities are adequate for the foreseeable future and alternative sites presently are available at market rates.

Of the Company's distribution centers, 10 are leased from parties in whom current officers or directors of the Company have an interest. The Company believes that the terms and conditions of leases with affiliated parties are no less favorable to the Company than could have been obtained from unaffiliated parties in arm's-length transactions at the time of the execution of such leases.

ITEM 3. LEGAL PROCEEDINGS

The Company is from time to time involved in litigation incidental to the conduct of its business. Other than as set forth below, the Company currently is not a party to any material pending litigation.

In November 2002, General Motors Corporation instituted suit against Keystone and a Taiwan-based manufacturer in the Federal District Court for the Eastern District of Michigan, Southern Division. The complaint alleges that Keystone is distributing replacement grilles for General Motors vehicles with a placeholder matched exactly to the Chevrolet Bow Tie design emblem and the GMC mark emblem, which infringes on General Motors' federal, state and common law trademarks. The suit claims this violates the Lanham Act and constitutes unfair competition under Michigan law. General Motors is seeking damages in an unspecified amount as well as certain equitable relief, including an injunction. In December 2003 General Motors moved for summary judgment on two of the Company's nine affirmative defenses. On April 8 the Court granted in part and denied in part General Motors' motion. Keystone's main defenses of functionality and failure of the placeholder to act as a trademark were preserved. A portion of Keystone's implied license defense was dismissed. On May 5, 2004 General Motors moved for summary judgment on two additional affirmative defenses (laches and acquiescence). A hearing date has not yet been set.

Discovery is continuing in the case. Keystone believes that it has meritorious defenses and intends to defend its business practices. The Company believes that the products in question constitute an immaterial percentage of the Company's total sales. Consequently, Keystone believes that whatever the outcome of the case, it will not have a material adverse impact on the Company's operations or financial condition.

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

None.

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The Company's Common Stock began trading publicly on The Nasdaq Stock Market under the symbol KEYS on June 20, 1996. The following table sets forth, for the periods indicated, the range of high and low sale prices for Keystone's Common Stock as reported by The Nasdaq Stock Market.

	<u>High</u>	<u>Low</u>
Fiscal 2003		
First Quarter	\$ 21.55	\$ 17.25
Second Quarter	18.35	13.26
Third Quarter	17.05	14.55
Fourth Quarter	17.81	15.02
Fiscal 2004		
First Quarter	\$ 20.69	\$ 17.02
Second Quarter	22.15	17.80
Third Quarter	25.28	21.38
Fourth Quarter	29.31	25.26
Fiscal 2004		
First Quarter (through June 1, 2004)	\$ 27.73	\$ 25.13

On June 1, 2004, the last reported sale price for the Common Stock of the Company, as reported on The Nasdaq Stock Market, was \$27.46 per share. As of June 1, 2004, there were approximately 547 shareholders of record of the Common Stock.

The Company has never paid cash dividends on its Common Stock. The Company currently intends to retain any future earnings to provide funds to operate and expand its business and does not anticipate paying cash dividends on its Common Stock in the foreseeable future. Subject to restrictions under the Company's credit facility, the payment of dividends is within the discretion of the Company's Board of Directors, and will depend upon, among other things, the Company's earnings, financial condition and capital requirements, general business conditions and any restrictions in credit agreements.

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The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and notes thereto included in Item 8 below and Item 7, Management's Discussion and Analysis Financial Condition and Results of Operations below.

	Fiscal year ended(1)				
	March 26, 2004	March 28, 2003	March 29, 2002	March 30, 2001	March 31, 2000
	(In thousands, except per share amounts)				
Consolidated Statement of Operations Data:					
Net sales	\$ 501,108	\$ 439,139	\$ 382,274	\$ 351,845	\$ 372,466
Cost of sales	282,079	247,913	218,475	204,073	211,840
Gross profit	219,029	191,226	163,799	147,772	160,626
Selling and distribution expenses	148,371	129,822	114,276	110,170	110,976
General and administrative expenses	43,333	38,424	32,816	30,155	30,800
Non-recurring expenses			6,796	7,104	3,881
Operating income	27,325	22,980	9,911	343	14,969
Other income	2,235	1,782	1,895	2,037	2,613
Interest expense	(671)	(553)	(698)	(1,456)	(954)
Income before income taxes and cumulative effect of a change in accounting principle	28,889	24,209	11,108	924	16,628
Income taxes	11,167	9,462	4,450	1,401	6,819
Net income (loss) before cumulative effect of a change in accounting principle	17,722	14,747	6,658	(477)	9,809
Cumulative effect of change in accounting principle (net of tax)					