KAR Auction Services Inc.

DOUG KARSON: Hi, good afternoon. Doug Karson here, the Auto Analysts at Bank America. I'm grateful to those that are participating. Looks we have a pretty good list of attendees that have dialed in. So please remember to ask questions.

We will be able to get those questions to management. With us today we have KAR Auction Services. They've participated for many years at our Ohio conference and we're so happy to have them on a virtual basis. With us today, we have Eric Loughmiller, the executive VP and CFO of KAR.

So we're going to kick off about 28 minutes of like a fireside chat format and I'll start with the first topic. Eric, thanks again for joining us. I was just looking through your deck and I saw slide four.

It always kind of impresses me the size of use of vehicle market. So if you could just talk a little bit about the addressable market that you guys compete in. Just to give us some framework for this discussion.

ERIC LOUGHMILLER: Sure. And thanks, Doug, for having us. We always enjoy being here in sunny Florida. Although, I think I'm missing Florida this year. Aren't I?

DOUG KARSON: Yeah.

ERIC LOUGHMILLER: But the addressable market on slide four really lays it out. This is the North American market. And I'll talk a little bit about Europe in a minute. But there are 300 million vehicles on the road. And we're really talking about the US and Canada.

Of those, 42 million vehicles change hands in any given year, and even in 2020, that number is going to be $40 million plus with COVID and the impacts you have. So while you have new cars that come in, you have cars that lead the marketplace, either through the salvage industry or just taken out of service due to age. We're dealing with an addressable market of 42 million units.

Of those, how did they transact? On page four you can see it. 30 million are through dealers and historically, 12 million are consumer-to-consumer transactions. Now in 2020, COVID is impacting the number of consumer-to-consumer transactions and we're seeing the likes of CarMax, Carvana, Vroom and Shipt get very aggressive in online buying.

Partly because of very high used vehicle wholesale prices, but also they're sourcing vehicles because of a shortage, as the number of transactions has been disrupted due to limitations created by COVID, and traffic and lower new car sales. It's actually lower new car sales that are causing them to have fewer, lower supply. So at the bottom you'll see, what part of the market do we address?

It's a subset of that 30 million retail transactions executed by dealers. We are a B2B business. We operate at wholesale only. We do not have any transactions directly with consumers. Well, I shouldn't say that. We have a couple of options that law in the state.

One is Washington, the other Michigan, where we sell public vehicles on behalf of county and city municipalities. They do mandate that we allow public participation. Very few consumers participate. It's still a dealer to dealer auction, but they have the right to buy. And it's just literally zero.

It's almost zero transactions. So of the 30 million, about 10 million or about 1/3 of those transactions go through a wholesale transaction that involves a formal network, that includes our businesses in the auction industry. And then you have another 20 million transactions where the dealer source is directly from the consumer and sells it retail without changing hands.

Or there's another six million transactions where they're buying them through other wholesale channels, other than the physical auctions. A million of those, or a million and 1/2 now are coming from our OPENLANE channel, which is the private label sale of off lease vehicles. So we see it as a very big market. Currently, we're selling below 2019 levels.

Which in 2019 we sold 3.8 million vehicles. And we'll be below that. I'm not giving a number yet, but that's due to COVID. It's been down since March. And we do expect the market to rebound over time, Doug. And we have a huge amount of opportunity to really expand from the 10 million units, plus OPENLANES' one, to a much bigger number through the digital marketplaces that we've invested in and have had been adopted through COVID.

DOUG KARSON: That's great. Always enlightening to go through that chart. So the first question he had was on the EBITDA margin. So you were able to deliver at 8% year over year increase in adjusted EBITDA, on a 15% lower revenue and a 9% fewer vehicles sold. This is all in the third quarter.

So if you could talk a bit about the execution. What it means for the margin profile going forward, and what actions did you take to be able to make that increase happen?

ERIC LOUGHMILLER: Sure. And Doug, there's very little good that could be said about a pandemic, and we know that. However, it did provide an opportunity for us to accelerate strategic plans we had in two areas. First, to go to a completely digital marketplace. We believe that would take another probably five to seven years for a transformation of our industry to occur. And it ended up, we had five to seven weeks with the shutdowns and the like.

Second, as a result of the shutdowns, we furloughed 11,000 of our 15,000 employees on April 3rd. And then as the markets started to recover, we're calling them back, recognizing that we were a public company and we had to make changes in our processes. There were a number of things we had to do in order to stay in business, but with a fraction of the number of employees that we normally had operating our business.

Because we made those changes in processes, as we began to see the volumes rebound, we realized we did not have to call all of those people back. So we are operating with just under 10,000 employees today, and have been at that level pretty consistently since June. And we think that's compared to 15,400 employees immediately prior to the furloughs and the impact of COVID.

So reducing our headcount by 1/3, and labor is our single largest component of direct costs and of SG&A each. So individually, that's the biggest cost lever I have to pull. But we focused not just on reducing the number of people that are needed to do the same thing, we started by adjusting processes.

How can we run this business? We did benefit from the fact that 100% of our transactions are now digital. And a big component of this was eliminating sales day labor, because we're not running vehicles on sale day through the Lanes. And I won't get into the jargon that sounds like. But essentially, the cars sit idle on our property and the sale is done using images that are shown on our simulcast or simulcast plus product.

Our other product offerings, OPENLANE, TradeRev, and now BackLot Cars, the car is not on our property. And they've always used images, and then a completely digital marketplace. So the leverage we're getting is we're getting higher gross profit, even though we have lower revenue. Gross profit increased, gross profit dollars per car sold are also positive.

And then lower SG&A, we were able to eliminate. And if you look at the third quarter results, we were able to reduce SG&A to 131 million from the quarter down from about 155 million or so. I should be more precise than that, Doug. I've got the number right here.

But that reduction is what we believe is a sustainable, permanent reduction in our cost structure on the SG&A front. Yeah. We went from 158.9 down to 131.0 in the quarter. So that $28 million reduction is a very real reduction. Most of it coming out of the headcount reductions on the SG&A front.

DOUG KARSON: If we do see a pick up in volume, do you think you can do the same volume with the current head count? Or maybe would you need to add a few back?

ERIC LOUGHMILLER: Good question. And I can answer that actually with confidence. Because in June, our volume was 108% of 2019 levels and that's when I got to this headcount. In July, we were 100% and then the market, as the supply situation tightened and we've been below that since.

We were able to operate the business very efficiently, very effectively and meet the needs of all of our customers as well as reporting requirements with this headcount. So we're pretty confident that this is a headcount that-- and a cost structure that we can sustain going forward, getting back to 2019 levels and even beyond that. Even growing from that level without significant changes in the cost structure and adding more heads.

It's easy to talk about moving to a digital format and selling vehicles. What we've had to do is move to more of a technology based support structure, which is less labor dependent. And so that's why I'm pretty confident that we can maintain this lower cost structure, even in an environment where volumes were to grow, perhaps even beyond the 2019 levels at some point in time.

DOUG KARSON: So you adapted to a different market. Now, it looks like your customers also have adapted too. So, they would typically come on site, and kick the tires and walk through an auction. And now, they are doing that digitally. Right?

ERIC LOUGHMILLER: Well, yes and no. So one of the things we learned going through-- what we've eliminated is the auction process requiring the car to move. There is an interest, and buyer feedback told us, they want to be able to preview the vehicles. So the cars, the on-site vehicles are lined up as if they're going to run through the lane. It makes it more efficient on the day before or even the day of the sale, someone coming in and making sure the car is what they think it is.

So there is still the ability to physically inspect if it's running on simulcast or simulcast plus at one of our locations. However, you are correct, on the other hand, most dealers are getting enough information from the inspection report and the pictures that they're not even seeing that necessary. It probably becomes a little more useful on that older car that still has a fair amount of value.

You probably don't need it on the off leased car that's worth 19,000 plus. If you look at the channels that we're selling, on page eight, we walk you through. And it's the physical lanes, where we're selling a car that's approximately $11,000 in 2019. That's the car, Doug, that you want to kick the tires on.

Because it's a high enough value, it's more than basic transportation to the retail consumer. They're buying features and functions, and the quality and how it looks. And when you're at the top of the market, you've got the three-year-old off lease car, not much risk. You probably can live with pictures.

And at the bottom of the market, that dealer to dealer, online only, where you're $7,000 or less. BackLot Cars is even a little less than that. It's basic transportation and how the car looks is probably less important. And you're looking for input on the mechanical functionality of the car. And we can do that through vehicle inspection reports.

DOUG KARSON: That's perfect. I guess that leads me into, why don't we talk a bit about trade rev. Your volume is over 21% and you close a transaction of BackLot Cars. Maybe tell us a little about the rationale, strategically for that acquisition.

ERIC LOUGHMILLER: We have been committed to the transformation of the industry, because we've seen this as something that is going to happen whether we like it or not. And so we've embraced it for a couple of years, actually three or four years that we've owned TradeRev. And we had to make some adjustments, go to market strategy and the business model beginning '19.

Because the results weren't matching up to the results that we desired. We were losing too much money in order to grow the business and we just felt, it's a mature marketplace. We don't need to do that. Let's look at it. And we've pivoted the TradeRev business over the course of the last 15 months.

And in doing that, we've gotten to break even at a run rate of just over a couple hundred thousand cars a year sold, where we thought that number would be 300,000 to 400,000 in previous discussions with investors. So we've lowered the break even point to a point where we feel very good about it. And what we've learned is in the third quarter as the result of that, we've been able to get to the growth rate on the TradeRev marketplace.

And by the way, since the end of the third quarter, that growth rate has accelerated. We have the right go to market strategy, we've focused on service levels and now we're able to grow. And then you mentioned BackLot Cars. I'm just going to go on to that. BackLot Cars is the fastest growing dealer to dealer digital marketplace in the United States right now.

Faster growing than TradeRev and its primary competitors. And it's now about the same size as TradeRev and growing very fast. And they also are a solution, again, that the marketplace is accepting. And this isn't cannibalization of the physical market. The physical market ebbs and flows.

And these cars come in and they go out based upon pricing and all of that. If you can get the maximum value without moving the car to a physical market, the co-signers, including dealers, have always done that. And that would be happening with or without these types of digital offerings. The fact that we have the digital offerings is allowing us to increase the portion of that TAM that we talked about earlier that's available for our marketplaces to serve.

There's 5-10 million, what I call, informal transactions in the wholesale marketplace. Where a dealer gets a car, isn't going to retail, and doesn't use our formal auction processes to exchange with another dealer and get that into a different location. Well, with these tools, we're able to participate in that without significant cost around the transaction. The fees aren't lower.

The fees aren't the issue. It's moving the vehicle. It's the transaction related costs. It's a more efficient transaction with less movement of the vehicle and that's what's driving the fact. And then there's no sell fee when you go on TradeRev or BackLot Cars. We have a high enough conversion rate that we can live off the buy fee. So we've eliminated the friction to try the marketplace.

We expect a higher conversion rate, 50% or better, and the economics of this business model are working very well. And so we're excited about the opportunity. We think this is going to be a primary driver of our growth.

I've been asked that over the past two years. We've been talking about very strong growth rates in a mature market, Doug. But this is the reason why, is we're capturing the informal marketplace that did not use auctions through these tools. And that's a big plus for us.

DOUG KARSON: That's helpful. I had a question kind of broadly. You're in a good position to see a lot has happened with these used car prices. I think they got to an all time high, I think, over the summer.

And they're unpredictable in nature. So can you give us a little KAR of like what you're hearing from dealers about their used car pricing? Now that we're getting more inventory coming in, on the new side. The SAAR is at 16 million now, it's not at nine.

ERIC LOUGHMILLER: Yeah. So, Doug, an interesting point. Number one, used car values remain at all time highs or very close to it, and it's because of a lack of supply. It's a combination of fewer trades on new car. Even with that SAAR number, it's coming back to that. Inventories are still at 20 year lows on the lots of a new car.

And ATPs are at all time high or at very high levels. I don't know if they're all time highs, but at unusually high levels. And what that's doing, is if the new car prices are high and there's a lack of inventory, the dealers are going to be trying to make up some of that activity on their lots with more used car transactions. And with high new car prices, used car prices rise up.

Because they're basically a discount to a new car, especially on the late model. And if the late models are higher, it pulls up the values, all the way up and down the age stratification of used cars. So we have a unique position where there's an imbalance. There's a lot of demand for used cars, and even lower end used cars, as COVID has caused people not to be interested in using public transportation.

They're looking for basic transportation, inexpensive transportation. Combine that with a relatively high unemployment rate and an underemployment rate. Less need for long term driving, miles driven is down. So basic transportation is high in demand. New car inventory is low.

All of that's contributed to a situation that will not be permanent. But it's temporarily high prices. And then I have my franchise dealers and my used car dealers all competing for a share of wallet that isn't growing. But there seems to be a fair amount of demand. And demand from the consumer is supplemented by federal subsidies.

We've got these stimulus programs that have put money in people's pockets that allows them to buy a used car, and maybe even a slightly better used car than they had before. So all of that's contributed to higher pricing. We think, as you go into '21, we expect some of these factors to stabilize.

We expect used car pricing to come down at the wholesale level. We expect used car pricing to come down at the retail level. And we expect, actually, new car inventories to go up and then incentives to enter the game, giving a reduction in the ATP, the average transaction price.

So I think we just have to be patient enough to get to that point of stability. And in my business, it's actually more important to have transactions than a high value. In fact, a high value is a deterrent to using the wholesale marketplace. They try to discern or mediate it and work around

it. So lower prices will actually create increased volume levels for us and we look forward to that day.

DOUG KARSON: That's a good point. Maybe we'll talk a little about the balance sheet. I mean, it's a pretty good shape. Maybe this gives a little color about your leverage and your view on the [INAUDIBLE], your current readings, and where you feel comfortable taking leverage up if you saw something interesting. Just a little KAR on the balance sheet.

ERIC LOUGHMILLER: Yeah. We don't think we're past the COVID disruption in the marketplace, Doug. And so our balance sheet, while we did the BackLot Cars acquisition and close November 12th using some of our cash, our balance sheet, we want to be defensive. We want to maintain a relatively high cash balance.

Because when our markets recover-- not because I'm worried about not being profitable. It's because when our markets recover, I will need to invest working capital into that recovery for two or three months, maybe four, and then it converts to a lot of cash. And it's a temporary need, but it's one that I would prefer to satisfy off my balance sheet than use my revolver or increased leverage to do it.

So I'm running at about a 1.6 times net leverage right now. My senior net leverage is zero or slightly negative, because again, I have a good capital structure right now. So I'm looking at that as being a strength. So that when the markets begin to recover, I have the ammunition to attack that market and not be worried about managing working capital because of any stress on the cash in the business.

Which is exactly why we raised capital in a PIPE transaction last spring and closed it in June. So it's there for that purpose. It remains there for that purpose and we'll wait until our EBITDA recovered back. I've still got that April loss in my last 12 months. And I really want-- if I were to look at any transactions, I really want to be at a more stable position on my last 12 months performance.

So that's important. And as I look at it, I'm disappointed that we have a split rating on our bonds right now. And I think it's not my job to rate debt instruments, but I can't imagine. I understand the reaction of the Moody's downgrade, but I don't understand the lack of reaction when we made changes to our balance sheet without touching leverage.

We increased the cash balance. Our performance was-- even in my discussions with them, was well beyond expectations, very quickly in the summer. And we've continued to perform with a higher margin business, higher profitability on lower revenue. The businesses is stronger.

So my suspicion is that at some point in the hopefully the very near future, they'll be reconsidering as they see the discipline that we're exercising around our capital structure, and the consistency and performance in our business, and the stronger profitability of the business, even with slightly lower revenues. Also, we are proving to them the moats around our business. This is a very, very strong cash flow generating business with significant moats around the business. It is hard to compete in these marketplaces with the mature business model.

I think they give the benefit of the doubt on this to the salvage industry, of which we used to own a big piece up and now they're on their own.

DOUG KARSON: IEA.

ERIC LOUGHMILLER: IEA. I think they're discounting the moats that remain around the two big players, ADESA and Manheim, in the used car auction business. I really do. But, they have a job to do. They do it and I have to live with the result. But I assure you, we're taking it head on with Moody's and others.

I think our company is well positioned. I think our leverage target of three times or less remains relevant. Even though I am well below that now, I want the flexibility to increase that net leverage when the markets are recovering, not before. And so, Doug, that's kind of the position we're taking. But we have plenty of ammunition if something comes up, like BackLot Cars. We're able to act on it and not miss opportunities as well.

DOUG KARSON: Yeah. You got a little flexibility there. It's good. Maybe working on slide 17. We were thinking about what the allocation for capital would be in 2021. And we kind of think about CapEx and dividends as strategic investment, share repurchases. I know you can't give me guidance in '21, but how should we think about how '20 looked versus '19?

And there's some, obviously, big changes made given the environment. But as the environment softens up, can we think more like a 2019, '18 type number for '21?

ERIC LOUGHMILLER: You know, again, the ifs and buts we have to be careful of. But, it's clear to me that we're on our path back to a more normal level of performance. And let's define normal as 2019 or better. Right?

It's not just '19, it's or better. And so I think what you'll see, number one, the CapEx will be a bigger commitment in '21, because I cut it back. I'm not giving you the final your number, but it will be-- I've already indicated, it will be less than the guidance we gave at the beginning of the year of 135 million, which is down.

And with this commitment to digital, Doug, I want everybody to understand, it won't require that CapEx number to balloon up higher. There's only so much you can do and these technologies are going to mature. They're not continuous investment. There's continuous investment, but at the level we're putting into it now. So I'm comfortable with that.

We have not reinstated a dividend and we've not made a decision on the long term of what our dividend policy will be. We have made a strategic investment at the end of '20, but we want to integrate that investment and let the markets recover before we pursue putting further capital into strategic growth. At some point though, that will be the priority again.

And the markets that I'm most interested in would be, again, continuing to develop the digital marketplaces in North America, as well as expanding perhaps in the European market or globally. We think that's a real opportunity, because they also-- I haven't talked about it, but their

TAM is almost as big as the North American US and Canada TAM. Europe, for example, is about $250 million cars in operation, and 30 million or so change hands every year.

So it's a very similar market. And we're a very small asset light business over there. That's huge opportunity and that would be a target for potentially future allocation of capital. And then, again, we have some dilution coming from the preferred stock. At some point, if it made sense, if we think it's the right transaction, we would of course use share repurchases.

I did announce in the last quarter that we do intend to buy back stock this quarter, if it makes sense, subject to certain limits that the board has approved. So I think all the levers are available to us, including return to shareholder in the long term. But in the near term, in the next couple of quarters, we're probably being very defensive in protecting the balance sheet and the cash on the balance sheet.

DOUG KARSON: That's perfect. That's a good color. I could put in investors, it's like 12. Gives you a little bit of the demographics in this European market.

ERIC LOUGHMILLER: Yeah. And it's on page 12. It's an exciting market, Doug. And we are doing very well over there with our cars on the web purchased. We have ADESA UK. And with the shutdowns in many of those countries, we have customers trying to get on our platform.

So we're getting growth at a pace that might be a little ahead of where we thought we would be with the businesses we bought that were relatively small. So it's increasing my interest in those markets and it's also very profitable. It's not asset investment, it's more technology. What we would be doing going forward, Doug, is trying to expand the buyer base more rapidly.

And that's what we've done in the US and Canada. Is our acquisitions have been, it's not about physical locations, even though they involve locations. It's about building a buyer base up to create the dynamic market that you really need.

DOUG KARSON: That's perfect. Perfect, perfect. So we're actually at the top of our time limit. This was really helpful. There's some investors that you came in with some questions that we can't get to, but we'll try to answer those on the follow.

And thank you for sharing time with us, Eric. And this was really a nice overview. And that concludes our fireside chat for today. Thank you.

ERIC LOUGHMILLER: Thank you, Doug, and thank you for hosting us.

DOUG KARSON: Thanks.