KAR Auction Services, Inc. (UPDATE)
September 08, 2020

Corporate Speakers:

- Eric Loughmiller; KAR Auction Services, Inc.; CFO
- Jim Hallett; KAR Auction Services, Inc.; CEO

Participants:

- Stephanie Benjamin; Truist Securities, Inc.; Associate
- Ryan Brinkman; JPMorgan Chase & Co.; Senior Equity Research Analyst
- Gary Prestopino; Barrington Research Associates, Inc.; MD
- Craig Kennison; Robert W. Baird & Co.; Senior Research Analyst
- Bob Labick; CJS Securities, Inc.; President & Director of Research
- Daniel Imbro; Stephens Inc.; Research Analyst

PRESENTATION

Operator^ Good morning, ladies and gentlemen, and welcome to the KAR Global Investor Update Call.

(Operator Instructions)

As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Mr. Eric Loughmiller, Chief Financial Officer. You may begin.

Eric Loughmiller^ Thanks, Jerome, and good morning, and thank you for joining us today for our call. Before Jim kicks off our discussion, I would like to remind you that this conference call contains forward-looking statements within the meaning of the safe harbor provision of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties that may affect KAR's business, prospects and results of operations, and such risks are fully detailed in our SEC filings. In providing forward-looking statements, the company expressly disclaims any obligation to update these statements.

Now I'd like to turn this call over to KAR Global's CEO, Jim Hallett.

Jim Hallett^ Thank you, Eric, and good morning, ladies and gentlemen, and welcome to our call. Today, we have only one topic that we would like to talk briefly about, our announcement that we have reached agreement to acquire BacklotCars. We have agreed to pay $425 million in cash to acquire BacklotCars. We expect to close the transaction prior to year-end following required regulatory filings and approvals.

A lot has happened in our industry over the past 6 months. KAR Global has accelerated the transformation of its businesses from legacy physical auctions to a leader in digital

wholesale marketplaces. We have experienced unprecedented declines in our business in March and April, followed by an unexpected recovery in volumes, record-high wholesale prices and record conversion rates, and we have pivoted our business model following COVID-19 disruption to be less labor intense in all of our marketplaces. So let me talk a little bit about BacklotCars.

Backlot is an app and web-based dealer-to-dealer wholesale auction platform. BacklotCars is similar to TradeRev, but it uses a slightly different auction format. As opposed to a timed-auction format, BacklotCars uses a 24/7 bid-ask marketplace. Their listings include a comprehensive vehicle inspection performed by automobile mechanics, and the company has demonstrated extraordinary growth over the past couple of years. BacklotCars currently operates in 46 states across the United States and in several markets where KAR does not have a presence today. The business is currently operating at a modest loss, but is very close to breakeven, and the path to profitability is clear. In addition to an outstanding business, we are also acquiring a talented management team with the acquisition of BacklotCars. The 4 founders have demonstrated a deep knowledge of dealers in the wholesale marketplace. Justin Davis, Josh Parsons, Ryan Davis and Fabricio Solanes will be great additions to the KAR management team. We have tied $20 million of the purchase price to retention of these key employees.

Let me conclude with an explanation of why BacklotCars and why now. First, our strategy is clearly directed at being a leader in the digital transformation of the wholesale auction business. We have also recently articulated our goal of increasing our market share to become more competitive in the dealer consignment segment of our business. We have made many changes at TradeRev and have proven the business model can be profitable, and we believe we'll be even more profitable at scale. And finally, the recent disruption of the wholesale auction industry has accelerated the adoption of digital transactions by both sellers and buyers. I am confident that the combination of BacklotCars with ADESA and TradeRev will accelerate our growth in the dealer consignment space. I know you would like to hear more about our plans for putting our businesses together, but we are not allowed to take steps towards integrating BacklotCars until the deal closes. Once we receive the necessary regulatory approvals, we will develop our plans, and I look forward to sharing those details when it is appropriate. I hope you understand that we are very limited on what we can discuss about the combination of BacklotCars, TradeRev and ADESA on today's call.

With that said, we will take a few questions before we sign off today. Eric is available to answer any questions about the financial aspects of the transaction. So I'll now turn it back to our operator, Jerome, for Q&A.

QUESTIONS AND ANSWERS

Operator^ (Operator Instructions)

Your first question comes from the line of Stephanie Benjamin with Truist Securities.

Stephanie Benjamin^ I was hoping maybe, Eric, if you could just provide a little bit more details on the size of the BacklotCars business from just a volume standpoint, number of annual units, growth rates, just anything so we can kind of gauge the scale as it compares to TradeRev and some of your competitors.

Eric Loughmiller^ Stephanie, we'd like to share more details specifically, so what we'll tell you is very similar in size to TradeRev at this time, so it's comparable in size. As we get through HSR, hopefully, over the next 30 days or so, we'll provide more details following that clearance, but it's similar in size to TradeRev.

Stephanie Benjamin^ Got it. And then just trying to think about how this compares to TradeRev and even your own rollout strategy. As we recall, it was definitely having -- for TradeRev, a lot of boots on the ground to expand the presence with dealers that now you're under a kind of united front under the entire ADESA sales force. How has, to the best of your knowledge, Backlot expanded across the U.S., increased their presence with the dealers? Maybe if you could walk through what you found that made it so attractive for you guys to look to bring it under your own umbrella?

Eric Loughmiller^ Jim, do you want me to start with that one?

Jim Hallett^ Yes, sure. Go ahead, Eric.

Eric Loughmiller^ So Stephanie, the first thing we noticed is that they've had a very efficient capital model. They've incurred minimal losses. They have invested in their inspection unit using mechanics to do the inspections, which serves the need of the buyer having an expert, shall we say, available to do those inspections. And they've used a combination of inside and outside sales, which, again, has been very efficiently deployed. So as we look at it, it's very interesting to look at this bid-ask marketplace. It takes the pressure off of a buyer having to be on his phone at the right time to make sure he gets the car. Their listings will be up for anywhere from 1 to 3 days. They will execute the transaction very efficiently with a lot of information, and there's actually a lot of interaction available between the buyer and seller as part of that process within their construct. So it's a very attractive model. It's, I would call it, complementary to the offerings of KAR, and we're excited about adding them to our business. Jim, do you have anything to add?

Jim Hallett^ I think, Eric, you've got it covered.

Operator^ Your next question comes from the line of Ryan Brinkman with JPMorgan.

Ryan Brinkman^ Great. And I apologize if I missed this earlier, but can you share with us again what the gross margin profile of the businesses? And then how should we think about the profitability of the business going forward? Is it the case that like TradeRev, it's a business that requires people in the field, calling on dealers in order to grow such that growth near-term might limit profitability? Or will you be able to better sort of cycle past costs as revenue rises?

Eric Loughmiller^ So Ryan, we are not at this point talking about the financial profile of BacklotCars because we have to clear HSR. And again, that information is confidential. We'll share more after we get that clearance and prior to closing. But I will tell you that the business operates very efficiently, as I mentioned to Stephanie, and we're very pleased with how they've performed. They've maintained modest losses throughout their history. They are growing very fast and have a very efficient business model. We look forward -- there will be, we think, an opportunity for some synergies on the operations side, combining BacklotCars with the various offerings of KAR, and -- but on the operations side, and we're looking forward to getting those -- that planning started as soon as we can, but not until we receive clearance and are able to work more closely with the Backlot team on how the businesses will look like together.

Ryan Brinkman^ Okay. Great. And I imagine this is -- apologies if I missed again, sorry, I just hopped from another call, being funded out of the plentiful cash on hand you have after the recent capital raise?

Jim Hallett^ Yes. We -- Ryan, thanks for that. As I mentioned on our earnings call, we have about $1 billion in cash available, and that number is growing, and we will be using cash on our balance sheet to complete this acquisition. There will not be any draws on the revolver or any debt incurred.

Operator^ Your next question comes from the line of John Murphy with Bank of America.

John Murphy^ Just a first question. Given there's kind of some overlap sort of dovetailing with TradeRev, should we assume that TradeRev spending slows down or potentially stops? And this $425 million that's being spent on this is -- it takes the place of that, these things get woven together? Or would there be continued investment spending in TradeRev?

Eric Loughmiller^ So John, let me start. Again, we can't say much, and we actually can't finalize our plans. At this point, both businesses will continue operating until we receive clearance on antitrust and close the transaction. However, when that's completed, I think what you would expect is we will continue investing in the dealer-to-dealer space, the capital needed to be competitive in that marketplace. So I think you'll see some synergies from the combined operations, and you'll see the investment continue. The good news is, as I've mentioned -- as Jim mentioned in his comments, they're very close to breakeven. In fact, the path to profitability is very clear and apparent to us for all of these businesses, and we think this strengthens the financial power of the organization, but by having, again, reaching scale at a much quicker pace by combining the 2 businesses if we receive clearance -- when we receive clearance.

John Murphy^ Okay, Eric. And then just a second question on net debt-to-EBITDA at the end of the second quarter, I think you were at 2.5x. Just without having the benefit of all the information here, it looks like this may add as much as a turn, plus or minus, so

you're about 3.5 turns net debt-to-EBITDA. But obviously, profitability here sounds like it improves. I'm just curious, as you think about leverage, where are you comfortable? I mean, I guess, maybe you can't give as a pro forma for this deal, but where are you comfortable on net debt-to-EBITDA sort of through cycle? And what's the current target?

Eric Loughmiller^ Again, John, you know our history. We've occasionally gone above 3x and then quickly bring it back. But we're generating a lot of cash in our business in the core KAR business. So going to 3.5x, as you've described in your analysis, getting back to 3x or below is our goal. And as you know, about half of our debt is bonds, which don't mature until 2025, and the net -- the senior debt is significantly less than what our target is. So we're very comfortable with the capital structure and the ability for our cash from operations to delever the company back to its target of 3x or less.

John Murphy^ And just one last quick one. I just ran through the slides on your website. And Jim, it looks like you have 4 auction service brands and 15 ancillary service brands. This would take that ancillary service brands up to 16. A lot of moving parts, a lot of offerings for your customers. Sometimes in the financial community, we get lost in that bevy of offerings. I'm just curious at any point, would there be sort of a move to kind of consolidate brands over time to streamline the offering and really kind of -- you're adding -- you're building a one-stop shop and have one, but just to maybe eliminate a little bit of confusion, just say, listen, we do everything. Here, a car, we don't need the sub-brands to support them. We can do whatever you need, full stop, and let's consolidate this and maybe save some cost on all these branding efforts and some of the confusion.

Jim Hallett^ Yes. At this point in time, John, I would say there's nothing definitive. But certainly, we do hear about our brands from time to time. We think about our brands from time to time to think about how we best present ourselves as a one-stop shop that you talk about. And I think we will stand by, and we'll see how this all shakes out at the end of the day. But at this point in time, nothing that I would speak to.

Operator^ Your next question comes from the line of Gary Prestopino with Barrington Research.

Gary Prestopino^ Yes. Tell me about where are they in markets that you're not in right now. You said it added markets.

Eric Loughmiller^ Gary, again, for HSR, we try to -- we don't want to talk too much about it, but their focus has been in the middle of the country, the Midwest. And so those types of markets where we may not have an auction operation would be what we're referring to.

Gary Prestopino^ Okay. Can you tell me is there a lot of dealer overlap? And because one's a timed auction, one's 24/7, is it possible for a dealer to have both apps now, both TradeRev and BacklotCars?

Jim Hallett^ Yes. They could be operating on multiple apps right now, and they will continue to operate on individual apps until we get the closing.

Gary Prestopino^ Okay.

Jim Hallett^ And then we'll have to decide how we go forward.

Operator^ Your next question comes from the line of Craig Kennison with Baird.

Craig Kennison^ I wanted to ask about whether you've been working with BacklotCars in the past through your other operations, whether it's AFC, CarsArrive, AutoVIN, any of those other portfolio companies? Do you have, I guess, an operational history with this company?

Eric Loughmiller^ Craig, what I'll answer is they initiated a process, and we expressed our interest early on in that process, so this has moved fairly quickly. But like all operators in the used cars -- wholesale used car space, almost all of the operators will have a relationship with AFC as an independent funding source, and they may use other services of ours throughout their business, whether it be transportation or other things. But again, our relationship would have been within those business offerings, and that's probably where it would have occurred. And all of our competitors actually use AFC as funding sources as well as we use all of the various AFC funding sources that might even compete with AFC. So it's a pretty wide open industry relative to offering those things to the buyers, in particular.

Craig Kennison^ And then there's a lot of investor interest in some of the digitally-native auto retailers, like you know the names, Carvana, Vroom, Shift, names like that. To what extent does BacklotCars bring any of those relationships to the equation? And then maybe stepping back more broadly, just to what extent does KAR Global serve those kind of fast-growing digitally-native auto retailers?

Jim Hallett^ Yes. So Craig, I'll start, and Eric can add to it. Those auto retailers are very, very large customers for KAR, and they continue to be very good customers for KAR. And we've provided a lot of supply -- and a lot of supply to those large customers that you're speaking of, certainly on our OPENLANE platform and through our physical auctions as well as now, some of these more digital platforms.

Craig Kennison^ And then just finally, how would you -- if you were to combine these 2 organizations from a volume standpoint, where do you think this organization would rank in terms of volume in the dealer-to-dealer channel?

Eric Loughmiller^ Addressing the combination of the 2 is a little premature until we get through antitrust, but it's comparable in size to TradeRev. And again -- and TradeRev did, what, 157,000, 158,000 units last year and is growing from there. And I'll let you do the math, Craig, and you can analyze who you think the competitors are and decide where we

shape up against them. But we're very excited about putting these companies together and growing our dealer consignment business in total.

Operator^ Your next question comes from the line of Bob Labick with CJS Securities.

Bob Labick^ Just from looking at this guy's website and stuff, it appears that inspections are a really big selling point for their process. And Eric, I think you mentioned it a little bit before with mechanics. Can you talk a little more about their process, maybe the number of inspectors they have? And how it is similar and/or different from TradeRev's process and ADESA's and if there's any potential synergies with your AutoVIN inspection, 700 people, or how that can all fit together?

Jim Hallett^ Yes. So Bob, it's Jim. Again, I'll start. I think that's the kind of the thing that we probably need to give you more clarity on as we go forward. I think there's -- as we get through HSR, there's a number of things that we need to think about in terms of what those synergies are and what that could possibly look like. The one thing that we can tell you for sure, and we mentioned in our commentary, is they have a much different inspection system where their inspectors are mechanics that actually do these inspections, and that would be different from what we're currently doing. And then the other thing is ours is a timed action, and theirs is a bid-ask auction, and it's actually over a period of days rather than minutes.

Eric Loughmiller^ Yes. And Bob, let me add, the AutoVIN business model is addressing a different inspection than what you have for any of these auctions. So even TradeRev is not using the AutoVIN inspectors as part of the TradeRev inspection process. AutoVIN is primarily doing end-of-lease inspections and lot audits, and that's a different process than what you have in during inspections for these. And the other thing I'll point out is BacklotCars uses a combination of employees and independent contractors to complete inspections and have a very efficient cost model around doing those inspections, and that's very attractive to us.

Bob Labick^ Okay. Great. And then I think you addressed this, but I'll just try asking one more time in terms of how will you think about balancing out the growth and investment in BacklotCars and TradeRev together to reaching breakeven versus pushing forward for market share gains? Just what are the factors that you'll weigh? And when will you potentially give us more information on that?

Eric Loughmiller^ Well, again, both TradeRev and BacklotCars are essentially near the breakeven point to the point where I don't think it's an issue of whether it'll breakeven or not going forward, and so we will be focused on, again, improving our position within the dealer consignment space where our current market share is less than 20% as an entity. So I'm really excited about focusing on growing our share of that market, like has been our strategy for the last couple of years.

Bob Labick^ Okay. Great. And then just one last one, just a clarification. You mentioned they're similar in size in terms of volume. Is BacklotCars all U.S.-based? And is TradeRev still kind of 50-50 U.S.-Canada in terms of volume?

Jim Hallett^ So...

Eric Loughmiller^ Go ahead, Jim. Go ahead, Jim.

Jim Hallett^ No, I was just going to say BacklotCars is U.S.-based.

Eric Loughmiller^ And TradeRev is a combination of Canada and the U.S. We haven't given the percentage between the 2, but we have substantial performance in each country, U.S. and Canada.

Operator^ Your next question comes from the line of Daniel Imbro with Stephens, Inc.

Daniel Imbro^ Eric, I wanted to start on it historically. I think you mentioned these guys are almost as big as TradeRev. So clearly, #2 or #3 player in the market. There are new markets, but were there markets historically where you guys overlap? And so, I mean how were they as a competitor? And when they were winning share from you guys, was there any consistent feedback on things that they did well that made this an attractive takeover rather than just replicating what they do well?

Eric Loughmiller^ Well, Dan, there are markets where we both operate and operate today and again, in many markets where one or the other probably has a more share in that local market than the other. So we see a lot of synergies, and they address the middle of the country. And I would tell you they address many markets where they aren't being served by the large auction business, with the large physical auction businesses, so we see a great deal of opportunity here. So we're excited about putting them together and think that we can actually have a strong offering to the buyers and then really give them an attractive offering to keep the process of selling wholesale used vehicles very efficient and cost-effective for the buyers and sellers. That's our goal.

Daniel Imbro^ Got it. That's helpful. And then you -- a follow-up on the balance sheet. You obviously raised the preferred last quarter. Now you're using a substantial chunk of it for M&A. How should we think about M&A as a focus for you guys heading into 2021? Is this going to become more of a focus for use of cash going forward or any update there on how you're thinking about M&A?

Eric Loughmiller^ Well, I think the starting point is you don't always get to pick the timing when opportunities come to you, and this is an example of that. BacklotCars initiated the process. We got involved very early, and we're successful in reaching an agreement. And hopefully, we'll close here very -- in the very short term. Before year-end, for sure, is our plan. So -- and our priorities after that, again, we're very focused on asset-light businesses and continuing the digital transformation of our industry, and I'll let Jim speak a little more to that as to why we're focused on that. I don't think we should

decide whether it's build versus buy and things like that. We'll try to deploy capital the most efficient way we can, with a focus on return on invested capital being a key component of our analysis. And we think this transaction has an opportunity for a very nice return on invested capital over the next several years. Jim, do you want to talk a little bit more about our focus on the digital transformation?

Jim Hallett^ Yes. I think it's apparent that we've always been on a course to transform this business into a more digital business. There's certainly no question that COVID accelerated that transformation, and it caused us to be able to react much, much earlier. We continue to sell 100% of our vehicles in digital formats. And we want to make sure that we are addressing every segment of the market, that we're providing a platform for every buyer and every seller. And I don't think it's one platform takes all. I think that we've got the OPENLANE platform, and it focuses on more expensive off-lease cars. We certainly have TradeRev. We've got ADESA.com. We've now got -- we're going to be adding BacklotCars. I think it's a question of making as many vehicles available to as many buyers as we can across the entire nation, in fact, not only here in the U.S. but in Canada as well and perhaps others in the future.

Eric Loughmiller^ Thank you. Jerome, we have time for one final question, if anybody is in the queue, and then we're running out of time.

Operator^ All right. We no longer have any other question on queue. So I'll hand the call back to Jim for any closing remarks.

Jim Hallett^ Okay. Thank you, Jerome. And thank you, ladies and gentlemen, for being on this morning. Listen, we appreciate your interest and your investments in our company. I wish we could tell you more this morning. Obviously, as I said at the outset, we're very, very limited into what we can share, but we're excited to share with you once we're in a position to share. So we will look for the regulatory approvals, and we will look to keep you updated. And at some point in time, I would expect to come back to you with a much clearer strategy about many of the things that you're -- on your mind and that you're talking about and you're thinking about as we go forward. So again, thanks for being on, and we'll talk soon. Have a great day. Thank you.

Operator^ Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may all disconnect.