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KAR Auction Services Inc Financial Update Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the KAR Global Update Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker for today, Mike Eliason, you may begin.

Michael Eliason ***KAR Auction Services, Inc. - VP of IR & Treasurer***

Thanks, Tawanda. Good evening, and thank you for joining us for the KAR Global Business Update Conference Call. After concluding our commentary, we'll take questions from participants.

Before Peter kicks off our discussion, I would like to remind you that this presentation 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 could cause actual results to differ materially from what we present today, and such risks are described in our SEC filings. In providing forward-looking statements, the company expressly disclaims any obligation to update these statements.

Let me also mention that throughout this presentation, we'll be referencing both GAAP and non-GAAP financial measures. Required reconciliations can be found in the press release that we issued this afternoon, which is also available in the Investor Relations section of our website.

Now I'd like to turn this call over to KAR Global's CEO, Peter Kelly. Peter?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Thank you, Michael. Good evening, everybody. As many of you probably know, we are holding -- hosting an Analyst Day tomorrow, where we will provide a significant amount of information about our business and our expectations for 2025, and we're very much looking forward to that.

On this evening's call, I'm going to preview some of the content that we plan to present tomorrow, specifically relating to our current year performance. The materials that I'm going to be referring to are also -- can also be found in our 8-K filing that we issued this afternoon. And those materials relate to our guidance for 2021.

So you will have seen that following the close of market, we removed our guidance for this year. The principal reason for that is the semiconductor shortage affecting new vehicle sales and the related impacts on used vehicle prices and used vehicle volumes within our marketplaces.

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Specifically, we announced the following: We are removing our guidance for the remainder of this year. We are providing guidance that we expect adjusted EBITDA of between $95 million and $100 million in the current quarter. And we're also expecting full year sales of approximately 2.6 million vehicles sold this year.

So I'd like to spend a few moments to connect the dots from a semiconductor shortage affecting new vehicle production to reduced volumes of used vehicles in our marketplaces.

So I'm sure you've all been following the news and seeing reports about the global shortage in semiconductors. This is an item that first came on to our radar screen in the first quarter of this year, and its impacts have increased and worsened since then. These supply chain impacts have resulted in significantly increased lead times for semiconductors across all industries, with the automotive industry being particularly badly affected. Currently, average lead times for semiconductor supply in the automotive industry have increased to an all-time high of 26 weeks -- of over 26 weeks. This in turn has resulted in fewer new vehicles being built globally. There were 1.4 fewer new vehicles produced globally in Q1 and 2.6 million fewer new vehicles produced globally in the second quarter.

We've been keeping in contact with our OEM customers over the past weeks and months and taking stock of their updates, including notices of increased plant shutdowns. We've also been having some discussions with semiconductor experts and reading industry reports. Based on those discussions, we expect that these production impacts will persist through the rest of this year and into 2022.

We do expect to see some small improvements in production in the first half of 2022 and more substantial improvement in the second half of 2022. However, we expect that despite these improvements, global automotive manufacturing will remain below normal levels even in the second half of next year.

This decline in new vehicle production has been showing up in terms of reduced new vehicle sales in the U.S., with the SAAR dropping from over 18 million units in April to 13 million units in August. This is a significant decline despite a relatively strong economic environment and significant customer demand. It is a decline that is purely based upon supply.

We've seen average days supply metrics of vehicle inventory at dealerships dropping to the lowest levels for many, many years. And we've seen, reported today, a reduction in new car inventory at dealerships to below 1 million units compared to a pre-pandemic level of 3.6 million units. And again, that's new vehicle inventory at U.S. franchise dealers.

This shortage of new vehicles has driven a significant depreciation in used vehicle values. This increase is evident at the retail level where we saw prices peak in June time frame start to fall back in July. But again, that trend reversed in August and used vehicle prices started on an upward trajectory again in August. The exact same trend is evident to the wholesale level where prices peaked in May, and we saw 2 months of price declines into July. But used vehicle prices at the wholesale level started to trend back upwards again in August.

So these dynamics impact KAR in a number of different ways. For one, fewer new car sales results in fewer used vehicles traded in the dealerships. This reduces the volumes of vehicles available within our dealer-to-dealer marketplaces. So this represents a headwind.

Despite this headwind, our dealers' dealer volumes have been performing quite well, and we expect to grow our total volume in the dealer-to-dealer marketplace this year. However, the bigger impact to our business is in the off-lease space. Higher used vehicle values mean that consumers with leased vehicles have more equity in their vehicle and they are less likely to return them at the end of the lease.

We included a chart in our 8-K, and we will present this tomorrow on our Analyst Day that shows this very clearly. And by the way, our OPENLANE platform represents we estimate 80% of all North American off-lease volume. So we think the trends that we included on that chart are very indicative of the industry overall.

In this chart, we see that off-lease vehicles returned by consumers have -- are down by 57% in the current quarter. And again, we're estimating the full volumes for this full quarter down by 57% compared to Q4 of last year. Not only are there fewer vehicles being returned, but those vehicles being returned are all being purchased upstream by the franchise dealer who, in many cases, has the same right as the lessee to purchase the vehicle at residual value.

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And based on that trend, you'll see in the graph that the upstream conversion rate has increased from 58% late last year to an all-time high at 86% in the current quarter. And this has resulted in a significant reduction of over 85% in the volume of off-lease vehicles flowing downstream into physical auction channels versus Q4 of last year. And by that, I mean the volume of off-lease vehicles flowing to all physical auctions, not just ADESA physical auctions.

So as you might imagine, this set of circumstances has represented a significant headwind to our commercial seller volumes in 2021 in a way that was not expected at the start of this year. Now -- and there's a chart shown in our 8-K that summarizes this.

If you look at that chart, which compares our expected volumes for the current year with our 2029 volumes, you will see, first of all, that we're showing a modest growth in our dealer consignment business. However, our commercial seller volumes have declined by approximately 1.2 million vehicles versus 2019. So the volume challenge that we face at KAR is clearly tied to the commercial seller volumes, and this category represented 70% of our volume in 2019.

I want to be very clear that this decline in commercial volume is not a loss of market share. It is an industry-wide situation. And again, there's a slide contained in our 8-K that demonstrates that.

That slide compares average weekly volumes sold by all commercial sellers at all U.S. physical auctions and compares that to our volume for those sellers at ADESA's U.S. auctions. We compare each week sales, for us and for the industry, with the same week in 2019.

And you will see a number of things evident from that graph. First of all, ADESA's trend line mirrors the industry very closely. In fact, over the past 4 months, ADESA's decline has been slightly less than the industry overall.

Secondly, there has been a steady decline from the post lockdown bump of June to August of last year, June to August 2020; a steady decline through to May of this year, albeit with a slight bump in the first quarter. And finally, if you look at the last 8 to 10 weeks, the decline appears to have bottomed out at approximately a 55% reduction in commercial vehicles supplied to our industry.

So ultimately, it is this set of circumstances affecting volumes of vehicles being made available for sale by our commercial seller customers that is negatively impacting our volume and our performance. These semiconductor supply chain issues disruptive but we had hoped and expected would be the start of a volume recovery in our industry in the second half of this year.

We have been encouraged to see used vehicle prices peaking and starting to decline in June. However, more recent announcements of further production cutbacks by OEMs and a renewed uptick in used vehicle prices, evidenced both in the retail and wholesale markets, have shown otherwise, and this has led to our announcement today.

Finally, in our press release this afternoon, we also provided a short summary of what we plan to discuss in more detail tomorrow, our targets for the business in 2025 and specific details on how we intend to deliver on those targets.

We look forward to presenting all of that in more detail tomorrow. But for now, I'm happy to take your questions relating to 2021.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ryan Brinkman with JPMorgan.

Ryan J. Brinkman ***JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst***

We saw last week that wholesale prices rose 3.5% in the first half of September. Inventory units, you mentioned, under $1 million at the end of August. We also had last week, IHS significantly lowering their expectations for 3Q and 4Q global light vehicle and North America light vehicle production. And obviously, the 3Q reduction probably already reflected in the current prices.

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But I'm just wondering if you could look ahead to 4Q. I know you're not guiding to 4Q given the market uncertainty, but how do you think it plays out in the fourth quarter with inventories as low as they are, with them not being replenished like we thought that they probably would be maybe being further depleted.

Will used car prices do you think just continue to go higher? And if they did go materially higher, how would that impact the bottoming out that we've started to see in commercial consignment volumes and how 4Q might potentially track relative to 3Q in the event that the prices did keep going higher?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Thank you, Ryan. So first of all, thank you for those data sources you're referencing. The types of data sources that, obviously, we've been paying attention to there and summarizing that very well. I think the way I'd characterize it is there's obviously high demand versus the supply available of used vehicles.

Now does that mean used vehicle prices will go up and up from here? I'm not sure they will, but I think it does mean there's a lot of support for used vehicle values, so I don't expect them to go down materially, okay?

So that would be my expectation, although, we've got to continue to watch the market carefully. I would say from a sort of week-to-week basis, there's a pretty strong level of consistency from 1 week to the next in terms of what we're seeing. Our dealer-to-dealer volumes are relatively stable 1 week to the next. Our commercial seller volumes are also relatively stable 1 week to the next.

And I referenced in my remarks and the slide will be presented tomorrow within the 8-K how there seems to have been a bottoming out of supply on the commercial seller segment.

And I guess, to be honest, Ryan, that makes sense to me because if I go segment by segment through commercial seller volumes, to all intents and purposes, we are not selling any rental vehicles today. So rental cannot go below 0 in our marketplaces.

To all intents and purposes, almost no off-lease cars are making their way downstream today. I mentioned how it's an 85% decline. So off-lease vehicles cannot conceivably drop much more than they have, at least in our higher revenue-generating marketplaces, the open sale and the downstream marketplace. So I can't really see that dropping much more.

And repossession volumes are stable. They're well below normal. I actually think there's some maybe -- if there's 1 segment that has some nearer-term upside potential, I'd say it is repossession segment.

So I think there is a level of stability, both in terms of dealer-to-dealer supply and commercial supply. Now Ryan, I will say one more thing. There's often some seasonality in our business, so I've got to factor that in as well. But I don't see the commercial supply dramatically worsening from its current level. I just don't see it coming off the bottom. It's going to take a while longer for it to come off the bottom than perhaps I had hoped.

Ryan J. Brinkman ***JPMorgan Chase & Co, Research Division - Senior Equity Research Analyst***

Okay. That's helpful. And then just my other question is in relation to some of the investment gains that were previously expected for the full year. With the decline in CarLotz share price since the last time that you guided or spoke, I'm not sure if you're still interested in monetizing the investment at these prices, I'd be happy to get your thoughts on that. But also if you were to, would it still result in investment gains? I'm not sure I ever understood what your cost basis was for some of the investments that you made.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Ryan, I'm going to let Eric, who's here with me, speak to that question, but thank you for the question.

Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

So Ryan, you're absolutely right. We would expect that with what's happening in the market relative to all retailer stocks, and CarLotz being one of them that we may not sell as many shares as we had originally anticipated. However, I will also assure you that our basis in

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that is well below the $3 to $4 price it's trading at today.

And again, you'll see that we have an unrealized appreciation from the original investment. It is declining, but we are still in a net gain position across that even at today's values. And we'll see the pace at which we want to sell them or is this kind of a temporary market condition. We'll get our advisers involved in that, and may slow down our monetization of that between now and year-end.

Operator

Our next question comes from the line of John Murphy with Bank of America.

John Joseph Murphy ***BofA Securities, Research Division - MD and Lead United States Auto Analyst***

Just a first quick question when you went through rental off-lease and repos. I mean the idea that rental can't go lower is interesting because on a net basis, what our understanding is that some of the rental car companies are not actually sources of supply but actually demand at the moment. So on a net basis, you're almost kind of a net negative to supply.

I'm just curious, as we see volumes recover on new vehicle production, if those rental car company -- when those rental car companies could potentially flip from the abnormal demand side of the equation back to the more traditional supply side. I mean it's kind of a wacky time, as you know, as well as anybody in the market. I mean that's -- and that's probably one of the weirder moments is that somebody who is traditionally a big part of the supply is actually now part of demand.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Yes, John. Good observation. We obviously observed the same. And we've seen the rental car companies buying significant volumes of vehicles in our marketplaces, particularly in the earlier summer period as they were probably building up for summer demand.

My expectation is that as vehicle production starts to ramp up with manufacturers, they will tend to prioritize selling those cars in the areas where they can maximize profits, which is probably not fleet sales, it's probably to consumer sales and consumer retail sales. So I think it will be quite a while before rental companies are getting their orders filled at the level they would like them to be filled from the motor manufacturers.

Now I fully expect they're going to get some vehicles and they'll get some level of supply, but I would expect that they may not get all the vehicles they'd like until well into next year and maybe beyond.

When does -- at this point, I am not expecting any significant rental volume supply into our marketplaces this year. But I do think as we look into 2022, there is an aging that takes place in those fleets. I think there is a certain age and mileage of vehicle that a rental customer is not prepared to pay for. So I would expect some rental de-fleeting in the context of 2022, and obviously, that would be upside versus current year performance.

John Joseph Murphy ***BofA Securities, Research Division - MD and Lead United States Auto Analyst***

Okay. Then the second question on cost response or business structure response. I mean you're seeing sort of this dearth of flow because vehicles are not being created or produced, if you will. Is there any incremental response that you need to take on the cost side or business structure side in the near term that may actually make the business stronger in the long term?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Yes, John, that's another good question. We're going to speak tomorrow to our cost agenda, which there is a robust cost agenda here. And obviously, that is something that is on my mind, and we are continuing to look at ways to be more cost effective and to match our operating cost structure to the volumes available to us, et cetera. So we will touch on that in more detail tomorrow. There's nothing I want to report on tonight's call in that regard.

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Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

But Peter, let me add. John, our outlook for the third quarter does contemplate continuing the strength that we've experienced year-to-date on gross profit and the strong control over SG&A. That's -- and we'll talk more about it tomorrow, but I wanted you to know there's nothing in the third quarter that's changing those trends.

John Joseph Murphy ***BofA Securities, Research Division - MD and Lead United States Auto Analyst***

No. Yes, I was just...

Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

It's all volume. It's purely a -- it's very much a volume in the supply side issue we're facing, yes.

John Joseph Murphy ***BofA Securities, Research Division - MD and Lead United States Auto Analyst***

Okay. And then lastly -- and I'm sure you'll probably talk about this more tomorrow, and I don't want this to get lost in the shuffle tonight. When we look at just 2025 outlook of 4.25 million vehicles, $3.4 billion, $3.5 billion in revenue, $750 million to $800 million in EBITDA, I mean that's higher than what we have. I think we're probably at the higher end of the range in the out years.

I mean that's a normalization plus. We can talk about it more tomorrow. But I mean what gives you that confidence to talk about that in 2025 versus what we're seeing right now? I mean it just seems like an indication of what we're seeing right now is an interim disruption that you think normalizes over time. But just -- I don't know if you can give us a quick-and-dirty there what we talk about tomorrow.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Yes. I think -- certainly, we'd like to hold our remarks on that until tomorrow, but we have a high level of confidence in that. We're going to talk in more detail tomorrow. And I think 2025, we expect to be well past these production disruptions affecting new cars well before that date, even though we recognize they're going to go on longer than we had originally hoped.

We hoped that the industry will be recovering out of that in the second half of this year. And clearly, it's going to take longer than that. But we do -- and we'll talk in more detail tomorrow about the drivers behind the performance that we expect for 2025.

Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

And John, Peter's information tomorrow goes to a level of granularity beyond just the KAR level. It is a lot of information that builds it up so that you are not left guessing where does that improvement come from? So I think it will be a good discussion tomorrow.

Operator

Our next question comes from the line of Craig Kennison with Baird.

Craig R. Kennison ***Robert W. Baird & Co. Incorporated, Research Division - Director of Research Operations and Senior Research Analyst***

Thanks for hosting this call. I think I understand the catalyst you're looking for in terms of an end to the chip shortage and a normalization of maybe inventory in the channel. I guess I'm wondering, is there a lag that you anticipate with respect to your business and some of those catalysts? Do you expect to be on maybe a delay relative to when you see a recovery in those key drivers?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Craig, thank you. Good question. I'd say it's a little bit of a mixed bag. I'd say there are some areas where our volume recovery should be tied sort of lockstep with the industry. So if I think of trade-in volumes, the dealer-to-dealer marketplaces, those would tie directly to new car sales. So as new car sales, new car production ramps up, trade-in volume should also pick up exactly with that.

I'd say there are some areas that are probably somewhat independent. I would say, for example, in the repossession vehicle space, the volume shortage is sort of independent of the production issue. It's, I think, been more tied to government stimulus and consumer protections. So I think that has a chance to abate sooner.

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I'd say in sort of the off-lease space, it's possible, there is a little bit of a lag. It's possible. I don't want to -- I can't say for sure. But if I think through it sort of logically, I would say we've got to see production ramping up. That will then start to impact used vehicle values, and that will then change the calculus that a lessee has at the end of their lease in terms of is this car worth more to me kept or turn it in for the residual value.

So there is possible a little bit of a lag there. But I'd say, overall, it's a bit of a mixed bag. And if I was to sort of average it all out, I'd say we trend -- I'd say we match fairly closely with the industry.

Craig R. Kennison ***Robert W. Baird & Co. Incorporated, Research Division - Director of Research Operations and Senior Research Analyst***

And I think you had mentioned that you feel like you're holding market share. But I'm curious if there are maybe competitors without the digital footprint that you have that could be struggling more in a market like this.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Well, Craig, the volume constraints -- and again, the material is in the 8-K, and we'll talk about it tomorrow. It's very much focused in the commercial seller space, okay? And a lot of, I'll say, independent auctions that are purely more physical in nature without the digital presence. They tend to cater more to a dealer-to-dealer transaction. So they haven't been as negatively impacted. But anybody who's got exposure to the commercial seller segment, I'm sure, is seeing a very similar experience to ours.

Operator

Our next question comes from the line of Daniel Imbro with Stephens.

Daniel Robert Imbro ***Stephens Inc., Research Division - Research Analyst***

Peter, I actually wanted to start there actually on the dealer side of the business. I think we understand the commercial challenges. You guys have presented that. But during the quarter, I think you mentioned a few times in interviews that you guys had brought back physical auctions and some capacity because of maybe negative share shifts from the dealer side. I'm curious how your customers responded to those incremental OpEx investments? I mean did you gain share back on the dealer side as you brought back those physical locations, I think it was 11 locations. Any color there you can share on how that share is going?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Daniel, thank you. And again, that's going to be a topic for tomorrow. We're going to share a more detailed update on what our experience has been. And it certainly has been interesting. So we have seen -- I'll just preview to say we have certainly seen some positive impacts, particularly on lower-value vehicles and in that dealer and reposition segment. And it has enabled us to increase our volumes at those 11 pilot locations, okay? So if it's okay, Daniel, I'll leave it there because I'd like to share a more detailed update, if you like, tomorrow in the presentation that we're presenting.

Daniel Robert Imbro ***Stephens Inc., Research Division - Research Analyst***

Got it. No, that's helpful. And I have a feeling I may get a similar answer to this one, but I think in your prepared remarks and in the slides, you mentioned commercial is a challenge today. And I think in the release, you said you expected commercial to improve by 2025, obviously, to get to those numbers.

Can you maybe talk about how we should contemplate that with the fact that off-lease, the biggest part of commercial, is going to fall pretty meaningfully in '24 and '25 just due to less new vehicle sales this year and the average lease term being 3 years. So I guess, are we just going to make up enough rental and repo cars to make up for that? Or how should we think about the different pieces of commercial as they improve?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Yes. Again, I'll talk in considerably more detail about that. But I will say you are correct, Daniel, that fewer new vehicles produced in 2021 means fewer 3-year-old vehicles in 2024 and similarly 2022 to '25. So those linkages, obviously, we're well aware of and are reflected.

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The bigger question affecting off-lease volume is not the total number of leases written, although that does matter. The variance there is probably 10% or 15% one way or the other, okay? So it's not a massive, massive impact.

The biggest driver will be what is the market value -- the prevailing market value for used vehicles, how does that compare with the residual values that are written on those lease contracts. And that's the issue we have right now. There's a lot of vehicles maturing out of lease.

The problem is almost all of those vehicles, the current market value is well, well higher than the residual value, so the consumer is not returning the car. So I think that's the situation we expect to normalize by 2025. That's what will help drive a return to more normal off-lease volumes in our industry. And I expect that to happen by then.

Daniel Robert Imbro ***Stephens Inc., Research Division - Research Analyst***

That's great. And then, Eric, just to squeak in a clarifier. Does the 2025 guidance include the acquisition of CARWAVE or not yet?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

We'll discuss it tomorrow, but that range does include the CARWAVE acquisition we would expect to close. But the range is such that if for some reason it didn't get to the finish line, we would not be changing that range.

Operator

Our next question comes from the line of Stephanie Moore with Truist.

Stephanie Lynn Moore ***Truist Securities, Inc., Research Division - VP***

I was hoping maybe you could walk through a little bit your second half '21 implied volume guidance. I'm just doing kind of some quick math. And I'd love to hear the thoughts kind of breaking out the on-premise and off-premise because it sounds like -- if you look at just the off-premise, I would think -- and correct me if I'm wrong, so that's probably the first part of it, is that the performance in 2Q is probably similar, just given you said you're seeing the continued strength backlog.

OPENLANE, obviously, has a strong positioning here of the funnel. So really just want to confirm that, again, it's not really so much the off-premise. But then kind of taking out a step further, it calls -- the guidance calls for a pretty meaningful decline in the on-premise, really volumes that we haven't even seen during the pandemic. So maybe just if you could maybe give us a little bit more color on really the background that you have in coming up with that second half guidance? And if there's any level of conservatism there? Or would just love to get a little bit more -- just given it is such a steep decline from the -- on the on-premise side, in particular.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Thanks, Stephanie. We didn't provide any detail, I think, in the 8-K on on-premise versus off-premise split. I would just caution a little bit some of the analysis. I think it's -- yes, I think it is true that our off-premise dealer-to-dealer continues to be very strong, okay? We're pleased with those results.

OPENLANE, on the other hand, again, is off-lease vehicles and off-premise. The OPENLANE volumes have been negatively affected to a significant degree by the trends that I referenced and the decline in lessees returning off-lease volumes. So that affects our off-premise volumes as well.

So if -- I'm going a little bit from memory here now Stephanie, but in the first half of the year, -- Our off-premise volumes were, I think, 53-ish percent of our total, okay? And I believe that in our current quarter, they're trending a little bit below that, okay, closer to the 50% level.

I don't have that precisely, but that's what I understand the case to be. So I don't think the decline is skewing solely to the on-premise, as your comment kind of implied. I think, if anything, the decline has been a little bit more off-premise, and it's been tied to the OPENLANE off-lease channel, if that's helpful to you.

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Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

And Stephanie, tomorrow, Peter will give some details commercial versus dealer that might clarify. We do not go into off-premise versus on-premise, but that will be enough information for you to kind of look at your bridges and see where you think the difference is. It is predominantly commercial.

Michael Eliason ***KAR Auction Services, Inc. - VP of IR & Treasurer***

We have time for 1 more question, if we could, and then we'll save everything else for tomorrow afternoon.

Operator

Our final question comes from the line of Gary Prestopino with Barrington Research.

Gary Frank Prestopino ***Barrington Research Associates, Inc., Research Division - MD***

Just wanted to get an idea of we're still looking at seasonality in Q4 and Q1 of next year. And you've got that outlined as a low point, but I just want to make sure I'm thinking about this the way I should in terms of how the quarters normally fall out.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Yes. The seasonal trends, I think it's fair to say, Gary, that Q4 is typically a weaker quarter in our industry, right? We don't have massive seasonality, but we have some. And Q1 -- or certainly, as Q1 straddles into Q2 is normally a strong point, right? So I think it's reasonable to expect some level of seasonality as well this year, but I do think there could be some offsetting trends that might make it different this year to others.

So it's sort of difficult for me to predict it precisely, and that's part of the reason we're not guiding to a Q4 at this point. We just -- we've guided to a Q3.

I've said on this call that our volumes right now are sort of pretty consistent 1 week to the next. But for example, there often is a significant de-fleeting of rental cars that takes place after Labor Day, and that puts downward pressure on used vehicle values, right? That's one of the drivers of seasonality.

Well, this year, as I mentioned, there are really no rental cars entering the marketplace. So that source of downward pressure doesn't really exist this year in anything like the same magnitude. And that's probably allowing used vehicle prices to continue to rise in the manner that we've talked about.

So it's just a difficult year to predict in that regard. But I think generally, there's always a little bit of a weakness in Q4 and then a pickup in Q1, and I'd expect some reflection of that as well in our results as we look to the quarters to come.

Gary Frank Prestopino ***Barrington Research Associates, Inc., Research Division - MD***

And just the last question, just the thought. I mean given that new car prices continue to go up, do you foresee something where leasing in a year or 2 hits a high point than it had in the past, like over 30% just because that marginal new car buyer or lower income new car buyer can not afford the full price of owning a car for a 4- to 5-year basis just an outright purchase? And then would leases be shortened to maybe 2 years versus 4 years because of that?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

So a couple of responses, Gary, to that, but it's a very good question. I think the more expensive vehicles become, the more popular leasing becomes. Leasing has always had an outsized penetration on higher-value and premium vehicles. And as all vehicles move upwards in price, consumers are more likely to move into a lease financing option. So I think that drives a strength in the leased vehicle portfolio.

And I can also tell you, when I think about repossessions, and I'll talk on this tomorrow as well. But I -- in discussions with customers who are in the auto finance business, one thing they have remarked to me and quite a few of them have made this remark is that they are financing vehicles today at very, very high prices. And a lot of these are financing used vehicles. And there is a risk that if used vehicle

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prices drop in a year or 2 from now, consumers will be making car payments on vehicles that are not worth the value that those vehicles are financed for. And that could also drive an increase in repossession.

So these things tend to ebb and flow. We've seen these kind of cycles before. I fully expect that over time, leasing -- I think leasing will remain very strong. And over time, we will get back to a situation where 80% of off-lease vehicles are returned by consumers and we market it in the way they always have been.

And I also think we'll see repossessions get back to normal levels. And frankly, we have a bigger portfolio of vehicles financed in this country than ever before. So I think fundamentally, the long-term prospects for commercial seller supply in our industry are very positive. We'll talk more about that tomorrow. And those underpin some of our assumptions for 2025.

Michael Eliason ***KAR Auction Services, Inc. - VP of IR & Treasurer***

And thanks, Gary. For the operator, we are going to be patient enough to take 1 more question. I think that's -- if we could limit it to 1 question, that would be great.

Operator

Our next question comes from the line of Bob Labick with CJS Securities.

Robert James Labick ***CJS Securities, Inc. - President & Director of Research***

You may punt this till tomorrow, so I'll ask a second one, too, just in case. But of the composition of the 4.25 million cars, can you give us a sense of how much of that's going to be commercial versus dealer in 2025?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Well, Bob, I want to tell you to wait until tomorrow, but seeing as you asked it so nicely I'll tell you tonight, okay? So we are projecting that our commercial volumes versus our 2021 expectation, which I believe we put in the 8-K, we're projecting our commercial volumes will increase by 1 million units versus that level. We'll talk more about that tomorrow.

Even at that level, those commercial units would be below the actual volume we sold in 2019. And that reflects a question I got a little bit earlier about fewer 3-year-old off-lease cars existing in that year. So -- but so 1 million car increase in commercial versus the 2021 expectation, okay?

And then the remaining $700,000 increase is in the dealer-to-dealer segment, okay? That's a compound annual -- that is driven principally by our digital dealer-to-dealer channel, BacklotCars and TradeRev. It's a compound annual growth rate of about 27%, 28% versus current year volumes. But if you factor in the CARWAVE acquisition, which I think is appropriate, it would represent compound annual growth rate of about 22% versus our current year volume.

So that, in essence, is what drives the 4.25 million. We're going to get into a lot more detail on that tomorrow. We're going to showcase our solutions and clearly articulate why we believe that is absolutely possible in our business.

Robert James Labick ***CJS Securities, Inc. - President & Director of Research***

Okay. Great. That's super helpful. I very much appreciate it. You don't have to answer. But if I sneak in, are there more acquisitions in the guidance? Because interest expense of$145 million is higher than the current year, $125 million despite the strong cash flow projections. So I'm wondering if the guidance includes -- contemplates more acquisitions going forward?

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

There were no acquisitions contemplated in those numbers. No more -- although, again, I do expect to close CARWAVE, and I think that's included in our range that Eric said. But no other acquisitions included. I'll let Eric comment on the interest expense.

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Eric M. Loughmiller ***KAR Auction Services, Inc. - Executive VP & CFO***

Yes. The interest expense is an assumption on interest rate increases over that period and conservatism on paying down debt that -- in our forecast, we've aggregated cash without determining how it will be utilized on our balance sheet.

Robert James Labick ***CJS Securities, Inc. - President & Director of Research***

Got it. Okay. Fair enough. Perfect. That makes sense. I just wanted to make sure there were no incremental beyond CARWAVE, of course.

Operator

Thank you. I would now like to turn the call back over to CEO, Peter Kelly, for closing remarks.

Peter J. Kelly ***KAR Auction Services, Inc. - CEO & Director***

Well, thank you, everybody, for dialing in at short notice. Obviously, not my preference to have to withdraw guidance, but I think it reflects just a reality in our broader automotive ecosystem that Ryan Brinkman alluded to in his questions on what we're seeing going on with production and new vehicle supply and all the related impacts.

I really am hoping that you can dial in tomorrow. We've got a very detailed presentation, which we're excited to deliver, and I'm very much looking forward to that and very much looking forward to delivering the types of results that we talked about here as we build this business towards 2025. So thank you all very much for your time this evening.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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