

KAR Auction Services, Inc.

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Ryan Brinkman: Hi, I am Ryan Brinkman, the Automotive Equity Research Analyst at JPMorgan. Thanks for joining us for the 2020 JPMorgan Automotive Conference held virtually this year.

Before we get going with our next presentation, which is KAR Global, I just wanted to remind the investors that you can ask a question, and I'll pose your question to management, by typing it on the conference website. I'll ask it without your name or firm affiliation.

With that, I want to welcome to the call Jim Hallett, Chief Executive Officer and Eric Loughmiller, CFO of KAR Global. Thanks, guys, for joining us. We really appreciate it.

Jim Hallett: Thank you, Ryan. Good to be here.

Ryan: We're going to launch right into fireside chat here, and then I'll ask the investor questions. First thing, could you provide us with a high level of summary of the sources of supply, whole KAR Auctions, off-lease, dealer consignment, repossession, rental, fleet, government, other, etc. What's going on with them and what is the outlook going forward?

I think rental is less important for you but just curious what's going on there too, given as they tried to adjust to lower demand environment. Then on repossessions, I was personally struck on the Ford call to hear that they're talking about near record low delinquencies in this environment.

Just curious if maybe it's the calm before the storm. What your take is there? Then when you add it all up, all the various different sources, what do you think that means for overall volumes, the back half of this year, and in '21?

Jim: I'll start Ryan and say that our business is driven by the off-lease cars and the repossessions primarily. Those have been huge drivers of our business over in the past several

years and continue to be. Right now, used-car prices are high and conversion rates, they're very high. There's very strong demand for used-cars.

As you know, a number of the manufacturers shut down production and those [inaudible] newer car inventory, thus making the used-car inventory that much more attractive. These cars are usually young cars, as we say. Three, four years old, 40, 50,000 miles on them, very, very attractive. They continue to be a strong source cars for us.

We're selling a lot of those vehicles in our online platforms. The other cars, the other area, trade-ins, that supply has gotten a little bit tighter. There's less trade-ins being taken in and of those trade-ins that are being taken in, the franchise dealers and the independent dealers are holding on to more of those vehicles just for their own retail purposes.

As you said, the rental cars is a small segment for us, but we have seen increased business on the rental fleets. A lot of that has to do with what's going on with the Hertz situation. We've been selling more cars for Hertz than what we normally would. As we turn to...What segment am I leaving out here? [laughs] I'm going blank.

Ryan: Off-lease is strong, rental, you've pretty much got, the repos is really what you want to talk about.

Jim: That's what I want to talk about, I'm sorry.

Ryan: You want to go to repos.

Jim: The repos have not showed up yet. Quite frankly, we've been expecting them to show up. There were some restrictions on repossessing cars, and I think a lot of the financial institutions were holding back on repossessing cars and trying to keep their clients in the car rather than repossess them.

Now, the delinquencies have built up to a point where repossessing activity is going to start to take place. We thought we would start to see more activity in July. Haven't quite seen that, but we do feel that it's going to have an impact on the second half of the year.

As we go into the second half of the year, we think supply will be steady, and with an increase from repossessions, we should see volumes perhaps tick up a little bit in the second half of the year. Eric?

Eric Loughmiller: The only thing I've got to add, Ryan, is we had a glut of repo cars on our lots in March when we had to shut down temporarily. We've worked through that inventory, and we haven't replenished it yet, as Jim mentioned, but we expect it to come.

A lot of repos that were ready to be sold were delayed, and that really helped our May and June volumes, and now off-lease is carrying it. As you know, in our business, it's always one segment or another. They're never all going in one direction, up or down.

Ryan: Thanks. Maybe on [inaudible] margin, I was hoping you could maybe dimension a little bit more the discussion on the 2-Q call about the permanent changes to your cost structure that should lead to improved gross and EBITDA margin, going forward. You permanently eliminated 3,000 positions, I believe, with another 2,000 on furlough. First, can you talk about the 3,000?

That was like 20 percent of your workforce at the end of 1-Q. It was just a really big number, and I think you ran a decently tight ship previously, right? How confident are you in the permanence of those reductions? Is there a danger in cutting too deep?

On the 2,000 that was discussed to remain on furlough, is the reason why they are on furlough and not permanently separated because these positions are thought to move more in relation with volume and would then need to be added back should volumes return to pre-COVID levels, or are there some opportunities for reduction there also?

Jim: Ryan, I'll start and I'll let Eric weigh in as well. First and foremost, a lot of these positions are part-time positions. A lot of these part-time positions have to do with our commitment to going through this digital transformation. As we announced on our call, we've sold over a million cars this year. In the last million cars we've sold, none of those vehicles have crossed an auction block.

None of those cars have had to be driven. We've been able to eliminate the drivers. When you're not driving all those cars across the block, not only do you eliminate the drivers but you eliminate a lot of the people that are in the safety lanes, a lot of people that are working in the yard, people that are working in terms of moving these vehicles.

A lot of that cost structure has gone away as a result of us going 100 percent digital. The other 2,000 people that are on furlough, we've told those folks on furlough that if they're not called back by October, those positions will be eliminated. Again, a lot of those positions will be part-time

positions.

As well, we had to give notice with those furloughed employees that it would take us through October. There's a possibility that some of those people could be called back out of the 2,000. That will depend upon demand in terms of do we grow our volumes, do we have a need for those people to come back.

Overall, I would say that we feel that we've rightsized the company for the business that we're running today and the business that we foresee here in the coming months and as we go into 2021. We always have the opportunity to call more people back if, indeed, we need them. Eric?

Eric: The only thing I'll add, Ryan, to clarify. Furloughed about 11,000 employees. We've called back 5,000, eliminated 3,000 positions, have 2,000 left. There's also 1,000 positions that have been eliminated because of natural attrition. One of the ways that we'll call back a portion of those 2,000 is as people leave our organization, we back-fill those positions.

We're trying to call people back who have experience with our business. If they're not laid off between now and October, it is likely they're coming back to fill a role that might actually already exist. We think the cost savings is permanent. The one issue is, will we be able to continue not running cars in the future? At this point, we're committed to that. That would be the major change.

Most of these people, though, if they come back, it will be for services revenue, Ryan. The question is, if people are asking for certain services, then we need more people. It will not be as much tied to volume in my opinion. We have enough people to handle the volume for the foreseeable future. If we need more for those services we deliver, we would call them back.

Ryan: That dovetails pretty nicely into my next question, which is whether you might consider transitioning to selling vehicles exclusively online even after the pandemic subsides. We were talking earlier, when IAA was part of KAR, I asked them if they'd ever consider selling vehicles only online and they're like, "No, absolutely not."

Now, they've changed their tune and they've used coronavirus as an opportunity to accelerate that transition toward purely digital. Perhaps there are fundamental differences between salvage cars and whole cars that would prevent you from making such a move. Feel free to educate me about that. The biggest difference between a salvage car and a whole car is that a whole car runs.

Even there, Jim, a lot of the work that you've been discussing, doing around making auctions safer could possibly lead to the vehicles never even being driven in an auction lane anyway. Curious to hear your thoughts there.

Jim: Ryan, thank you. That's where I was going to start my answer, is we were talking about transforming this industry long before COVID came along. Quite frankly, we were thinking about a transition, the transformation that would happen over the course of the next two to three years. What COVID did is, COVID accelerated that.

This started out as a safety discussion that I started a number of years ago, I would say, over the last two or three years, I've been a voice for the industry, saying that there's a lot of danger in driving 3,000-pound vehicles among crowds of people, and every year, our industry has some severe accidents including fatalities from time to time.

I was of the opinion that there's no need to run a vehicle. Today, with the information that we can get on cars with the technology we have, the data we have, the condition reports we have, you don't need to see, and touch, and feel the car to be able to buy the car, as demonstrated on our platforms. Those cars we sell on our platforms, often the customer never sees or touches those vehicles.

It started out as safety, then COVID comes along and we weren't permitted to operate our auctions in many cases. It was deemed nonessential business, and we basically converted all of our auctions to a simulcast product within the space of 7 to 10 days. We went 100 percent simulcast, and what we proved is, number one, we can sell cars on simulcast without running them.

We proved that we can get equal or better returns on those cars. We proved that we can even use an automated auctioneer, and an automated auctioneer can get the same results as a live auctioneer.

One of the biggest accomplishments that I mentioned last week is, during this period of time, we signed up 12,000 dealers who had never, ever bought a vehicle online, and trained them how to use our online platforms. With that background, and maybe more to add from Eric, is, I believe that we've demonstrated to our sellers that the way of the future is online.

The way of the future for many, many businesses is transforming to digital, and it's no different for our business. My hope is that we've demonstrated and been able to convince our customers of

the value, the convenience, the economics, just the time factor, it's all good. My hope would be to never run a car again. That would be my hope.

Now, I won't go as far as IACE did a couple of years ago and say, "I'll never run a car again," but I would hope that we don't get put in that position. We've demonstrated over time, and we've now been doing this for four months. Whoever they are, people say that if you can do something for 90 days, you can create a habit. I hope we've created a habit that sticks. Eric?

Eric: Ryan, my grandparents had a saying, necessity is the mother of invention, and that's what happened here. We had an invention, and necessity has created it to be front and center and an important solution. Our competition was at certain stages of development. We've all moved faster.

The question is, will there be a competitive marketplace in a local market where that is not the solution that the local market selects? If that's the case, we'll have to evaluate, is that a market we should participate in? We do believe we can demonstrate the results. It's hard to argue with our competitor's index that you often quote, the Manheim Index.

It's interesting, it's record highs when all cars are being sold predominantly or most are online. There's a few independent selling physically. Most cars are online. That is the best evidence. This has allowed us to collect more data in a controlled environment to show our customers the value proposition is not altered through an online marketplace.

At that point, I am waiting to give them greater flexibility, right, Jim? There's things we can do on simulcast plus that have been a huge hit with our customers.

Jim: Ryan, I would say, if you think about it, I believe that the commercial customers are really liking this a lot. It makes a lot of sense to the point where they don't even need to show up at the auction to represent their vehicles. They used to fly someone in, fly somebody to the auction, have hotel expenses, travel expenses, and everything associated with moving people around.

Now, they can basically sit in their office and interact with the auctioneer at the auction in terms of whether they want to sell the car or not sell the car. You think about that cost, it's been taken out. The harder will be bringing some of those independent, smaller dealers across the line.

The independents that have been going to the local auction for the last 25 years, dealing with the same people for the last 25 years, they have their favorite auctioneer that sells their cars. You get

the point here is, they believe, and there's this belief, and I understand it, that a live auctioneer running the car across the block will get you better results.

I understand why a dealer could believe that, but I think we've disproved that theory or that myth with the results that we've demonstrated.

Ryan: Thanks. I'm seeing several questions coming across here from clients asking about TradeRev. Apart from a [inaudible] margin, probably the only thing that people truly latched onto post 2-Q, the peak of the profitability there at least in May and June. Can you talk about the drivers of that?

I think it also was driven by the lower workforce to the extent that that's permanent or not, and the extent to which we should think about TradeRev remaining profitable, going forward.

Jim: Again, the first thing that we did is, we took action on TradeRev, we reorganized TradeRev, we reorganized the leadership, and we reorganized the sales team and the go-to-market strategy. With that said, we eliminated the incentives. We were putting several incentives on for the buyer in terms of transporting vehicles across the country. It was very expensive.

As you know, we spent a lot of money on it. TradeRev lost a lot of money in the past couple of years. We wanted to prove to ourselves that we could operate the TradeRev platform and we could do it in a profitable manner. We did bring those sales forces together. There were some reductions in terms of the overall headcount, but we focused on value proposition.

We focused on some enhancements to the technology. We focused on that go-to-market strategy that I talked about, and the results speak for themselves. We were quoted as saying that we are profitable, and not just break-even, but we are profitable. The margins were 60 percent plus on the TradeRev cars we sold. We think it's sustainable.

We think we can continue to grow the business from there. Eric?

Eric: The only thing I'll add, Ryan, is our target in the short-term now that we've proven we can be profitable is not to maintain break-even or profit. We want to invest, though, in a way that gets us a higher share of that marketplace. I would not expect us to be profitable the remainder of the year.

I would expect us to have a high gross profit, maintain a high conversion rate, and then spend

more in the marketing area to try to capture a greater share. That would be what I would look for the second half of the year.

Ryan: That relates a little bit here to some of the other investor questions. They're asking why ACV did, they say, multiples of your volume during the quarter. Maybe the answer is that you could have pursued that volume, but you couldn't have done so without the personnel reductions.

Now, you're talking about [inaudible] back toward the middle, investing a little bit more for growth. How do you balance the growth and the profitability there is really the question, I guess?

Eric: Let me start and let Jim follow on. First, we did not think it was a good use of capital to spend money to protect it in a market that was highly, highly risky, very risky. Granted, it came back faster. At the end of the day, we were conserving capital in order to be able to grow this business into a healthy market over the next several years.

I don't want to speak about what my competitors do. What I'll say is I felt we were prudent. Anything that was done in May and June relative to the relative market, I don't think impacts the opportunity that we see over the next two or three years, notwithstanding the numbers.

Yes, I did see some numbers that were quite strong. Again, our numbers were also quite strong across the whole business. We were focused on the whole of the business, not just one channel.

Ryan: Great. Thanks. Maybe a question on CarsOnTheWeb. There are a couple from clients here as well. Maybe just talk a little bit about the opportunity over there, how that market works differently or similar in the US. Also, given that it is a capital-light platform, are there any limitations on your ability to expand that into other geographies?

Jim: Ryan, I'll start with saying that Europe was a little bit slower in terms of its rebound. In coming back to the market, I'd say it was probably somewhere in the neighborhood of 30 to 45 days behind what took place in North America in terms of coming back. The volumes are back. We would expect that we'll be back to 100 percent of those volumes in the third quarter and continue to grow.

If you take a look at the size of the car park in Europe, it's similar to the size of the car park here in North America. There aren't a lot of digital platforms. Digital platforms are going to play a much greater role, maybe even more so in Europe. CarsOnTheWeb has the unique ability to cross-border transact. They're selling cars from Western Europe and Eastern Europe.

They're selling cars in 50 different countries. I guess there's a lot of more complex dealings with cross-border transactions in terms of collecting VAT taxes and logistics. Sometimes a vehicle has to make several stops before it gets to its final destination across several borders. We think there's a real opportunity.

We've had a number of commercial customers inquire about our platforms and how we could service them going forward, because there really is no platform quite like CarsOnTheWeb. I know that this is a business that Eric was very much involved in acquiring. Eric, you're the master on it.

Eric: Listen, I agree with Jim. The opportunity is tremendous because of what's happened in that marketplace. Again, it will accelerate the growth, not into the next few months, but in the next year or two. It's brought attention to the need to be able to transact without a physical presence. That's what we thought would happen. They're behind us, and now they're going to catch us.

The other thing is these cross-border transactions are so important to moving a big fleet of cars that are in service, where they're trying to replace those cars with new cars and not redistribute the used cars in the same market. Right, Jim? That's what they're doing.

They're trying to get it out of their new car market, especially if you're talking about the UK, Germany, France, Spain, Italy to an extent, even Portugal.

Jim: Ryan, when we gave you our growth targets earlier in the year, we spoke about international being a third of that growth target that we'd laid out. We're still very much committed to that. We certainly feel that that's very achievable going forward.

Ryan: Great. Thanks for that. Maybe just some questions here around capital allocation. You've got a lot of cash on the balance sheet now compared to history. Would you maybe look to rein in a little of the dilution from the recent transaction by repurchasing shares? Or, do you think the current environment, despite the better 2-Q and intra-quarter trends, warrants more conservatism?

Or, even if you are more reassured by the industry backdrop, would you just prefer maintaining dry powder for acquisition, expansion etc.?

Eric: As I mentioned on the earnings call, what we want to do is protect the balance sheet for a few more months to make sure we have great visibility of what's coming. We did, Ryan, as you

know, amend the revolving credit facility that puts some restrictions. The most restrictive covenants that are in that amendment are through the end of the calendar year.

I would not view those as limiting, given that we didn't expect to have a billion dollars of cash on the balance sheet right now that we felt it could get worse and our covenant calculations would have been more difficult than it turns out they're going to be. I want you to know those are not inhibitors. We probably don't want to make final decisions on capital allocation.

We would appear to have adequate capital to support our growth initiatives for the foreseeable future. If the markets look like that they are much healthier than what we thought might be the case in April and early May, we would consider all options of capital allocation, including some that you typically described as shareholder-friendly actions. Those would be on the table.

Ryan: Great. I'm getting a number of questions here about online-only retailers, Carvana. Let me just collate a couple of them. One investor asks, "Is there a risk that online-only retailers in need of large amounts of inventory try to strike direct deals with captives and leasing companies, disintermediating your off-lease business?"

Maybe a somewhat related question here. What are your thoughts on Carvana as a customer but also as a future competitor? Is there a risk they seek to source commercial cars directly?

Jim: We've dealt with this prior, Ryan. This is nothing new. First of all, Carvana, Vroom, and CarMax, these are big customers. They're our largest buyers, in fact. The one thing is you can't just go and pick and choose the cars that you want. We take all the cars. We dispose of all the cars. We take care of all the reconditioning and all the services that are required.

Basically, somebody looking to liquidate large fleets of cars can make a phone call to a KAR, and we can deliver any and all of those services it takes to sell that car. To allow somebody to come in, cherry-pick your fleet, and to take all of, I'll call, the nicest cars at the lowest prices, that's not going to happen.

I don't see these big resellers, these big fleets, OEMs, capped finance companies, rental companies, maybe rental companies a little bit, I don't see them selling cars direct.

Eric: Let me add. They have dealer councils with the capped finance companies that would have a lot to say about that as well. Carvana, Vroom, Shift, all of them are alternatives. We know that the dealer networks are all getting interested in the used car marketplace. There's enough

competitive tension, Ryan, to keep that from gaining a lot of traction in the discussions with the captives in particular.

Ryan: Great. Thanks. Just a couple minutes left here. A lot of your acquisitions, a lot of your focus has been on improving the margin near-term or on technology, etc. I've asked this question before. It'd be a long-term project that probably wouldn't have the best returns near-term. Any updated thoughts on China?

It seems like from left field, I was interested when I learned that Copart and other companies, they actually have employees that live there. [laughs] They're studying the market. They're looking at the market. It's gargantuan. I do a trip to China every year. Unfortunately, was canceled this year.

GM and Ford have complained to no end about how they don't have the leasing volumes they would like there because what are they going to do with the vehicles when they're returned to them? There's no remarketing. It just seems like it's right for somebody to solve that problem. I'm just curious what your appetite might be for something like that.

Jim: Ryan, we're focused on what we would consider...

Ryan: Necessity is the mother of invention. Invention is the mother of necessity. [laughs]

Jim: We're focused on mature automobile markets, where there are there are venues in place, auctions in place, businesses that we can acquire or businesses that we can build off of. There's no question, China is the biggest market in the world. It's also probably we see it as the most difficult market in the world. I would tell you that we have a lot of fish to fry before we get to China.

Ryan: Got it. Just in a couple minutes we have left here, maybe just update us on the reconditioning work and the ancillary services that were put on hold there in various different markets. I heard you say, you called they were mostly back. Just any update there and what that might mean for your results going forward in the rest of the year.

I don't know, too, with some of these potential re-closures in various different markets if everything is still looking green on that front.

Jim: As you know, we were restricted from a lot of those activities, those ancillary services. You think about body shops, mechanical shops, and reconditioning shops. Then you get into social

distancing and health of your employees and your customers. We were restricted. That was one factor.

The other factor is we're in a very hot market. In a very hot market, the dealer tends to do less reconditioning, the dealer [inaudible] seller. The seller wants to get that car to the auction as quickly as he possibly can to get the maximum price for the vehicle while that market is hot, knowing that that could change at any point in time.

During these times, and we saw this back during the Great Recession in 2009, is we saw dealers using less and less of ancillary services. Now, we have seen the ancillary services start to come back, but they're not back to the levels that we had pre-COVID. Maybe, Eric, you want to expand on that a little bit.

Eric: Ryan, what Jim mentioned, because of social distancing, while we are able to provide virtually all of our services, we can't have the throughput that we normally have because we can't let people be that close together working. The demand is off a little bit, so it matches up pretty well. We still had a strong performance on our ARPU in the quarter. Down but, again, still pretty strong.

We were 839 from our physical locations, which is not a physical auction anymore. It's from our physical locations. We were pleased with that. That's not a limitation. It will likely grow back over time.

Ryan: Great. Looks like we are out of time. Ordinarily, people would be clapping now. [laughs] Thanks for joining us, Jim and Eric. Really appreciate all this great color today.

Jim: Thank you, Ryan.

Eric: Thank you, Ryan.

Ryan: Take care.