KAR Auction Services Inc.
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Unidentified Participant: With us today from the company we have Eric Loughmiller, Executive VP and CFO. In the audience also, Mike Eliason, Treasurer and Vice President of Investor Relations. We have an intimate crowd here, so just please ask questions. The management team will be around all day. They're very busy with one-on-ones and small group meetings, so now's our chance. Without further ado, I'll kick it over to Eric.

Eric Loughmiller: Thanks, Doug, and thank you, everybody, for coming out bright and early this morning. It's always great to be first. Hang on--there we go. Thanks, Ariel, it's on now.

Let me first introduce KAR to those that may not be familiar with the name yet. KAR Auction Services actually is made up of three primary businesses. We have a used car auction business, Adesa, which operates in the US, Canada, Mexico, and the UK currently. And last week we announced a transaction. In Europe, we bought a Belgian based company, or we're going to buying, closing after regulatory approvals, on a European-based CarsOnTheWeb, so it's obviously an Internet-based auction that's throughout continental Europe and eastern Europe. So that's our business there. We're the number-two player in this marketplace behind Cox Automotive, which owns Manheim Auctions, and our market share is roughly 30% in North America, and we're an up-and-coming player in other parts of the world.

The second leg of our three-legged stool of this business is Insurance Auto Auctions. Insurance Auto Auctions is a salvage auction business, so they're selling primarily total-loss vehicles for the insurance companies. So when there's an accident, the damage is such that they decide to total the car instead of repair it, those cars, in the US and Canada in particular, also in the UK, are going to end up at an auto auction where they're sold. In that business, about, call it 65% to 70% of the vehicles will be dismantled, and the remainder will be either recycled, meaning crushed car bodies, or they'll be rebuilt and actually put back on the road. That's an up-and-coming retail segment that we all want to be aware of. Make sure you know if you're buying a repaired total-loss vehicle. It will say it on the title.

Here we are co-leader in the industry in North America, with Copart, a public company. We have approximately 40% market share in North America. In the UK, where we have a salvage operation, we're a distant number-two player to Copart, with just under 10% market share in the UK.

The third leg of our stool is AFC. This is a floor plan financing business that supports both the used car and the salvage business, with the majority of its lending into the used car space. This is floor plan lending, so it's not your traditional long-term consumer lending. The average loan is about 65 days long in duration. It's a fee-based business. We generate over half of our revenue from fees and the remainder from interest rate charges to the dealer. It's a very high-quality, fast-turning floor plan receivable line. And we have a securitization in place to finance--well, those used to be off balance sheet; they're now on balance sheet. But it's a securitization that provides quite a bit of liquidity, about $1.5 billion of liquidity to us in addition to the balance sheet that we use our cash from.

To sum it all up, our three legs of our stool generated $3.5 billion in revenue last year in 2017, $838 million of adjusted EBITDA with a 24% adjusted EBITDA margin. So it's a very strong business, generates a lot of free cash flow, and I have a cheat sheet. Maybe I have the number that, the free cash flow number that we generated in 2017 was nearly $400 million, just under $400 million. So we generate a lot of cash.

As you look at it, we like to highlight the reasons that you would lend or invest into our enterprise. First, we have unique fundamentals that generate a consistent free cash flow year over year, a growing free cash flow year over year. We have strong and visible organic growth. We actually can see--we have pretty good visibility out to 2 to 3 years in the used car space. And then in the salvage space, there's a very, very consistent, steady trend based upon miles driven of accident rates as well as total-loss rates.

And in fact, the total-loss rates have been growing over the last few years, so actually, more cars are being totaled as a percent of accident claims, and accident claims are increasing, so it's a very good backdrop. And our expectation is that will continue for quite a bit of the future. It's really the nature of the average age of a vehicle on the road today is 11.5 years old in the US and Canada, so these cars that have an accident are, with labor rates and collision repair costs going up, parts suppliers getting more expensive to supply the parts because we just--again, we've had disruption in the auto industry in '08 and '09 that caused a lot of parts suppliers to go out of business. It's been a perfect storm for total-loss vehicles.

We also leverage technology and data analytics. This is an important part of our business. We're not just running an auction; we're doing a lot more, providing value-added services, increasing our revenue per unit on all the transactions across our spectrum, and able to provide additional long-term growth that goes beyond just the supply of vehicles. And then we have a clear, shareholder-friendly capital allocation framework that allows us, when needed, to pay down debt as well. So again, a capital-driven business where we can invest the capital. We have multiple choices to use our capital for the greatest return.

It's a unique industry, and you say, "Okay, Eric, why would you look at this industry?" Well, the main thing is there's 295 million cars on the road. And when you have--297

million, if I don't round it to the nearest number. 297 million cars in North America and not quite that number, but close to it in Europe, a new market for us. So there's 42 million of those cars that change hands in a year. So think about that: 42 million used car transactions, and that all provides an opportunity for us. 297 million cars on the road operating on infrastructure that was primarily built in the 1950s and '60s when there was half or less of that number on the road.

So clearly, with our infrastructure, the number of cars, it's impossible for cars not to wreck. It just is. We drive faster today than we did when the infrastructure was built. We have much more safety features in the vehicle to give us that false confidence that we're going to be immortal forever if we drive these cars because they're going to protect us. And again, but the cars are going to be damaged and the damage is going to result in total losses.

So on the top right in the red, you see the salvage industry. There are about 13 million cars every year that go out of service. Of those, only about 5 million are going to our salvage auctions and our competitors through the industry. So there's a lot of opportunity for growth there. These cars are end of life, accident-prone, whatever they may be. But about 5 million will be processed, most of which are processed through insurance companies. Those are the cars that come to the salvage auctions.

Then we go to the bottom part of this slide. How do the 42 million cars that change hands--where do those cars come to? How are they sold? Well, on the left, you've got 12 million that are C2C. That's Craigslist. I guess you could use eBay Motors or Auto Trader as an individual; most of those are dealers. But Craigslist. Other sources--go to any Walmart parking lot, for sale's right there on some of the cars as you pull in. Whatever it is, it's two consumers getting together without a dealer.

Then you have 30 million units that are through a dealer network. In the US, there are 35,000 to 38,000 independent used car dealers and 17,000 franchise dealers. So that gives you a dealership group, US and Canada, 55,000 to maybe even 60,000, depending on the day of the week, because a used car dealer can go in and out of business very quickly. It's a low barrier to entry.

So of those dealers, they sell 30 million used cars a year. Here's an interesting statistic: the top 100 used car dealers in the United States make up substantially less than 10% of the volume. The top. It is not a concentrated industry, notwithstanding all of our strong and positive impressions of companies like Carmax or Penske or Sonic or Asbury, Lithia, all having emphasis on used car transactions.

Of the 30 million transactions, about 11 million, they are buying directly from our auctions, whether it be Adesa, Manheim, other competitors, online, whatever--11 million units. That leaves 19 million units that they are getting from the public, trading amongst other channels, however they can get the cars, including buying directly from the public as opposed to trade-ins.

Of that 19 million, we estimate 5 million to 7 million change hands from the original dealer that has a transaction before it's retailed. And that 5 million to 7 million of the 19

million is an additional addressable market for us, and we've introduced a product called TradeRev, which is a dealer-to-dealer mobile application that allows dealers to exchange inventory prior to retailing the vehicle. I'll probably get into that in a little bit, assuming I have time and you have interest.

In terms of visibility, here you see the industry statistics. It's been a very steady industry. If you look back to 2008 at 9.5 million units, roughly, we were 15 consecutive years in 9.5 million units, plus or minus 100,000 or 200,000. A couple of blips. There's one that rounded up to 10 million units; there's one that was down to like 9.3 million early on and 9.0 million in 2009. A highly structured industry, and that is because used car transactions can vary more than that, but our part of the market, the wholesale trading of vehicles at auction, has remained fairly consistent.

And on the far right of this chart, what you can see is we're growing to a new plateau. We are growing up to about 11.5 million units now, and that is a function of the cyclical recovery of the auto industry and the resultant increase in leasing that is creating a strong supply of vehicles.

In 2008 and 2009, the last peak of lease transactions, lease returns, we were returning in the United States about 2.6 million leased cars per year. In 2018 and 2019, we will have 4.5 million leases terminate, and those cars will be returned to the marketplace. An additional 2 million units coming back wholesale because those leases terminate. While the consumer has the ability to buy that at residual value, typically right now residual values are above wholesale value, and therefore it's unlikely that a high percentage of those vehicles will be bought out by the consumer. And there will also be the ability for the grounding dealer, they call it, the dealer you return the car to, can buy at residual value. Well, they have the ability to buy at wholesale value, because--I'll get into the private label sites that we run for the OEMs. They can buy it wholesale if it's below residual. They do not have to buy that car at the contract value. In many cases, they're incented to do that.

So 11.5 million units is going to be, in my opinion, the new norm, something again, 11--it could vary. It will settle in as we get past the cyclical recovery. There is no evidence, based on the SAAR that was released this past week, the expectations for the November SAAR being at 17.5 million, 17.6 million units for the month of November. We have a strong 17-million-unit new car sales. And those new car sales include 30% of all transactions being lease originations. And that is continuing, and that's how they're going to sell cars as we continue to see increasing interest rates done that I'm sure everybody's forecasting.

We are in an increasing interest rate environment. It's highly likely that the consumer's going to want to use a lease because he only has to pay for half the car, and he gets a new car every 3 years, and roughly half the car is all he pays for, and he's only using his credit on half the value of the vehicle, and the captive finance company's balance sheet is supporting the remaining value of the vehicle and taking the risk of what will happen to that value over the ensuing 3 years. So it's a transaction that will probably be very attractive economically to the consumer in an increasing interest rate environment.

How do we make money? Okay, we make money in all of our businesses by charging for everything we do in the transaction. So if you look on this chart, you're looking at Adesa, which is making about $600 per transaction across all of our marketplaces. And we're getting that money from a buyer, a fee from the buyer, a fee from the seller, fees for ancillary services and other related services. Other related services are services we provide off of our sites, meaning end-of-lease inspections. We are the largest end-of-lease inspection company in North America, probably in the world, because they don't do them in the rest of the world. But in the world.

We have a repo company. In fact, we have multiple repo companies now because that's such an active marketplace for us. We do paintless dent repair, transportation onsite. We do transportation for vehicles that aren't even sold through our network of auctions. We are the largest automobile transport company in North America. Let me change that--one of the largest. I believe we're the largest, but I really can't prove that, so let me go with one of the largest so I don't have a problem with my attorneys. But I don't know of anybody that moves. And the reason being, well, you might say, "Well, the OEMs move a lot of cars." Yes, but we move then two ways, and we're moving--we sold 5.5 million cars in 2017. 5.5 million cars, and many of them we moved into the auction and then moved them out with transport. And we don't own the trucks. We do that through a platform, technology, that takes people that need a car moved and people that move cars and put them together, using CarsArrive network, into a technology that matches them up for the most efficient pricing and the most efficient routing of vehicles when you're moving, especially across long distances.

Think of that truck that passes you on the highway. Anywhere that you're traveling, you'll see these 10-car haulers. Well, what are they doing? Are they taking 10 cars from Point A to Point B? No, they're taking 10 cars from Point A, B, C, D, E to G, E, E, F, G, E, F, G, Y, X, Z--all the other letters. They're moving them across, and the key is as they're moving and dropping a car, can they pick up another vehicle that is going on their route? That's how they can make the most money as truck drivers. And when they do this--and CarsArrive network allows them to log in, in the middle of their route, and say, "Can I pick up a car driving from Chicago to Dallas?" And look, if I go 20 miles off the highway, there's a wholesale transaction that occurred, and that car needs to get to Dallas. It's a very active market, especially with technology allowing the buyers and sellers to be from broader geographies to exchange the vehicles.

So we make money on everything we do. In the salvage front, it's a little simpler. We get a buy fee and a sell fee. We have total-loss solutions. We have a number of administrative services we're now providing where we might draw a small amount of fees. But I'd say the vast majority, well over 90% of these fees, are from the buyer and the seller, and that's the transaction, because it's a wrecked car, it's a total-loss vehicle. There isn't--we don't do anything to the vehicle. We're not going to pop a dent; we're not going to pull the fender out so you can drive it. It's sold as-is. There we get about actually $500 per car sold. And it's a high-margin business. It's lower gross margin but higher EBITDA margin than the used car business. So it's a very strong business.

And what I'll be talking about in a few minutes as I get to the end of the slides is we have announced that we're going to spin off the salvage auction business to make a pure-play

salvage company that compares directly to Copart, which is a comp that we have, which trades at a significantly higher multiple than KAR has traded in terms of the equity markets. And for all of you here, that will be good news, because we would expect some time next year--we don't have a date yet; we're waiting on a Private Letter ruling--some time next year there will be a debt issuance for that company that will likely include a Term Loan B with a bond offering. And it will look--again, the corporate rating will be very similar. We've already gotten the rating advisory services. We've announced that that company will have leverage at about 3.5 times adjusted EBITDA for the SpinCo. And it will be a BB- corporate rating is the expectation at issuance. So it will be some new paper put out on the street for everybody to consider lending to.

In terms of wholesale car fundamentals, I've covered this a little bit. You have high lease originations, strong repo volumes, even though default rates remain very low. We have over $1 trillion in auto loans. There's a lot of cars to go bad. So even with a low default rate, there are a couple of million repos processed through our industry every year, and we are what we like to call the Repo Kings at Adesa. We do a lot of repos for the banks, captive finance companies, credit unions, and the various lenders into the auto market.

There's an awfully trend that's very strong for us, and while we're worried about what's happening in the auto industry, let me tell you, it's not declining; it's leveling off. And it's likely to level off, and if there is some type of recessionary economy in the foreseeable future, it's likely to be a lot softer than what we experienced in '08 and '09, where there was external forces on the auto industry as the liquidity dried up in 2008 and early 2009 for them. So we're thinking much softer. It will be a strong market. It will be back to that what I said before. We have a period of 15 years that was really the same volume in the industry. We're expecting it to level off also for an extended period of time. Don't ask me if it's 15 years this time, but for an extended period of time.

And even if there was a mild recession, perhaps as early as 2020, which some people are predicting, maybe '21, it will take 2 to 3 years after that before it impacts us. So the next 5 years are looking quite strong for KAR Auction Services.

And then on the bottom right, this is really interesting. We have not only a strong supply of vehicles, but increasing used car prices. And all the concerns about tariffs on cars being imported is actually very good for the used car industry. We have this abundance of 3-year-old off-lease cars coming back to the marketplace. Those are 3-year-old cars that have less than 40,000 miles on them. Many of them will be CPO, Certified Pre-Owned, by the manufacturers and their franchise dealers. That means they will attach a factory warranty to the used car.

And cars being manufactured today, including what's now the D3--it used be the Big Three; now they're the D3--will last 30-plus years or 250,000 to 350,000 miles on average. Of course, unless you visit an insurance auto auction site. That shortens the life when you total them. But if you can keep that car on the road, keep it in good condition, even the domestic vehicles are lasting several hundred thousand miles and up to 30 years because of unibodies and closed engines, higher technology. So that's very good for us.

And so think about it: if there's a 10% tariff on the import of a new vehicle, what is that going to do to the attractiveness of that near-new vehicle, that 3-year-old off-lease vehicle that's had one owner, that still has a sunroof, it still has leather seats, it does have front-seat heaters in the north, probably air-conditioned seats in the south. It's the type of car consumers want to buy, so it will be a very attractive market.

The salvage industry, at the same time, a lot of people say, "Well, with all these safety features, won't there be fewer accidents?" Actually, most of these safety features are about saving lives. In fact, they promote the car having less impact but still having impact. Because oftentimes, the safest way for an accident to occur is to deflect it to not be head-on and to slow the vehicle down, not stop it. At over 35 miles per hour, studies in Europe conducted by the insurance industry resulted in blunt-force trauma from seat belt and air bag contact--over 35 miles an hour, you're in trouble. Likely, it can be fatal.

So the car is not going to stop to avoid an accident on a highway, but what it's going to do--and by the way, my vehicles do this; it drives me crazy. If I forget to use the blinker, it won't let me cross a lane. But it's to keep you from hitting head-on, you know, try to reduce the contact. So this is actually very good, because all of those features--rear cameras so that we can back up without turning over our shoulder because apparently, we've gotten lazy--all of that will be good because that damage is expensive.

And the insurance industry is all about math. If the repair costs exceed a certain percent of the value of the vehicle, the car will get totaled. And they get totaled because the remaining parts are more valuable dismantled than they are to repair the vehicle, and they need those parts because John Murphy, an equity analyst for Merrill Lynch, so I can use his name at this conference, does Car Wars every other year. He's currently estimating to take a $30,000, roughly $30,000 new vehicle and to build it with aftermarket parts, which is what you would do in a collision, is over $170,000 of labor and parts. That is why those parts are so valuable.

So for $30,000, I can get that part and extract it. That's why the salvage industry is so strong, is those parts are extremely valuable in the aftermarket, and they've been proven to be more reliable than a manufactured aftermarket part in terms of staying within specifications of the OEM. So it's a very strong industry.

And then last, the AFC short-term financing, very strong credit. By the time I issue my financial statements 40 days after quarter end, I'm basically through two-thirds of those loans being repaid. So I kind of know the credit. It's a very just strong, visible portfolio with very--we charge basically a prime plus 350- to 450-basis-point spread. My cost of funds is now just a little bit over 2%, so I have a very strong interest rate spread. And the only reason I don't have Bank of America with me is this is hand-to-hand combat. Every car is an individual loan. This is asset-based lending like you haven't heard.

Banks can't do this. They can't file the title fast enough to get it back to the dealer. Because if the dealer retails the car 3 days after they buy it, I have to provide the title, because the title serves as collateral. The title has to be returned to the dealer so the consumer can finance the vehicle. This is a very strong business for us. We see that dealer every week at auction. Our target is to make loans for cars bought in the wholesale

marketplace at our auctions or our competitors' auctions. Why? Because then we know the fair value of the car. We do 100% loan to value on wholesale, meaning the retail spread is our protection. And we will finance fees. And again, we average about $175 per loan transaction. That means when they take out a loan, we only get $175 and we turn that into a very strong operating income relative to the total loan portfolio. The return on equity in that--don't quote me on this--it's like a credit card portfolio, which is typically in the high teens to low 20s in terms of those transactions because they turn so quickly and the losses are so low.

In terms of leveraging technology and data, I talked about that as one of our attributes. We've done a number of acquisitions and then we've expanded the capabilities of these organizations, whether it be Openlane in 2011, which brought us CarsArrive and RDN, which is one of the repo networks. We then added some what I would call smaller technology-based products and data science as we got into the 2013-2014 timeframe. And then in 2016, we completed the acquisition of TradeRev and DRIVIN, which completed our data analytics capabilities. The bottom line is, it's more than just running an auction.

And someone says, "Well, how would you describe an auction." In fact, our CEO was on a program last Friday afternoon, Cramer, Mad Money--kind of scary, but he made it without saying too much. He described us as the New York Stock Exchange for used cars. So think about that: the New York Stock Exchange is where you go to buy and sell stock. But the New York Stock Exchange doesn't own any of that stock. That's our used car network, and so what do we need in order to be smarter investors? Well, smarter used car dealers, we need better data. We need to know more about the value of the vehicles, what they're retailing for, what's low in supply in a marketplace, what's high in supply in a marketplace that will drive prices down. All of that will help the dealer make a better wholesale transaction and guarantee that they can run their business profitably. All of that is data that we have more information than just about anybody in our industry in particular has all the information, whether it be our competitor or us. But we have this information and we can leverage that information into better decision-making by the dealers, which results in a high-value transaction, which is how we can make the kind of money we make, a little bit at a time, with each of these transactions.

Here's kind of our--this is our growth chart. This is where we're growing, and this is why we're a strong credit. Again, we have growth in the off-lease volumes, we have the ability to generate strong, strong cash flows in all of our businesses, and we allocate capital to dividends, acquisitions, and in an increasing interest rate environment, from 2007 when we completed an LBO to put these together, until 2009 when we did our IPO, we paid back $1 billion of debt using cash. That wasn't reduction of our leverage through ratios and growing the company. We paid back $1 billion in cash.

Now in a low-interest-rate environment, we've not focused on paying back debt. In fact, we've focused on growing the company and reducing our leverage. We're currently levered at about--I'll wait for the chart--at about 2.75, almost 2.8 times, so we're below 3 times with a significant portion, about a third of that leverage, in an 8-year, no-call 3 bond that was issued in May of 2017.

But we have a lot of opportunities, and with strategic priorities, we're not light on strategic priorities where we can go and look to grow this company. And when I talk about growing the company at this conference in particular, this is high-single-digit growth. This is not fast-flying growth, and we do not have balance sheet exposure. We do not take principal risk on the values of the vehicles we sell. Our balance sheet is very protected. In fact, most of our receivables are liquidated in 5 to7 days from the date of the transaction. It's a 5- to 7-day DSO. It looks different than that, because while I only have $3.5 billion of revenue, we sell $50 billion in cars, just under $50 billion in cars a year. And I have to process all that cash. I collect it and then I distribute it to the consigners.

I'm going to skip. I'm going to quickly go through--we have a history of profitable growth. You can do this research. What I want to get to is the capital structure, and here you can see our capital structure, with term loan B-4 and B-5 making up the senior part of our debt, and then $950 million 5 1/8% bonds that are due in 2025. And this is the structure. We will use a very similar structure after the spinoff. Proceeds from the capital raised in the spin transaction will be used to repay term loan B, whatever that number turns out to be, and the reason being that's an important element of the tax-free reorganization we're doing so we can spin this off tax-free.

I have just a couple of minutes for questions if we can, if there's any questions out there or Doug, if you have any. Yes, back in the back. We're being webcast, so they want to hear this on the webcast.

Unidentified Participant: Thanks. Just thinking far out in the future, so we've been reading a lot about autonomous vehicles, electric vehicles, and just thinking out loud about the innovations in autonomous vehicles, whether that comes about or not, whether the Phoenix and Scottsdale, those experiments work or not, how does that impact your business, and how are you thinking about it?

Eric Loughmiller: So we think a lot about it. At the end of the day, we don't care who owns the vehicles. What we care about--and we don't care. It's miles driven. If cars are driving autonomously, think about an autonomous vehicle. It's going to operate in the city, but there's a point at which that autonomous vehicle is going to age, have enough miles. It's not going to be appropriate, perhaps, to be driven driverless, if there is such a thing--driven driverless. So if you look at the Ubers of the world, they're talking about having proprietary autonomous vehicle technology that they will remove from the car, and then that car might be sold into a new market. It might be sold into an African market.

We sell cars in over 110 countries. Many of them are damaged vehicles that are repaired and put back on the road. South America, Mexico, eastern Europe--all are buying low-value cars, arbitraging repair costs, labor rates in particular, taking out the safety features or the autonomous features in some cases. So we see that as an opportunity.

We also think that's a very long-term trend in terms of car ownership. You have 297 million cars on the road with an average age of 11.5 years, and not one of us are giving up our vehicles to have a driverless car except in New York City, Seattle, San Francisco, and Chicago, where you're in a grid-based system, where you would feel safe in that vehicle. Are you going to take a vehicle from Miami to Fort Lauderdale that doesn't have

a driver? Highly unlikely. You're going to take public transportation. I saw the train as I came in last night. I drove up.

So there's alternatives. So the autonomous vehicle fits inner city, urban environment, where you can move within a grid, a lot of starting and stopping. Over time I think you'll see more autonomy. Maybe we'll see it in open-road trucking, things like that on the highways, but it's going to be point to point. It's not going to be within the city.

All right, we're out of time. Great question. We are here all day. We appear in a bar over there, and we're a stage act. But no, we have one-on-ones. Unfortunately, our schedule's full but if you can get in, make a one-on-one into a group meeting, I'd be happy to talk to you more about our business.

Thank you for attending bright and early this morning. Have a great day.

Unidentified Participant: Great job.