Daniel Imbro:

Good morning, everyone, and thanks for joining us for the KAR Auction Services presentation. My name's Daniel Imbro, I'm the retail/broadlines analyst and after-market auto analyst here at Stephens.

Daniel Imbro:

As a reminder, the fireside chat this morning will be Q&A. I've already received some questions via email, but there should be a button in the top-left of your user interface where you can submit questions directly to me, or just email me at daniel.imbro@stephens.com. From the company, happy to be joined by Eric Loughmiller, CFO. Eric, thanks for joining us today.

Eric Loughmiller:

Thank you, Daniel.

Daniel Imbro:

Yeah. So, I think most people on the call today have a pretty good understanding of the business, but maybe, can you provide a brief refresher of a few different segments, and then just broadly how you're viewing the wholesale market today, given the disruption you talked about in your 4Q call?

Eric Loughmiller:

Sure, Daniel. Well, KAR Global operates used car auctions around North America and in Europe, both in the UK and continental Europe, through our operations there. We are focused on being a digital marketplace business. In addition, we offer floor plan financing for independent used car dealers in the US, Canada, and we have begun offering some floor plan facilities in Europe as well, on a more limited basis.

Eric Loughmiller:

So, those are the two segments of our business. We've been very focused, Daniel, on simplifying our business, and we changed our disclosure somewhat at year end, hopefully to make it more simple.

Eric Loughmiller:

Our costs are all aligned with revenues within ADESA or AFC. We previously had a holding company element of our segment reporting. That no longer is necessary, as our businesses are more streamlined after the spin of Insurance Auto Auctions in 2019.

Eric Loughmiller:

We also want to simplify the metrics, and looking at on-premise versus off-premise. So, as we look at it, we are clearly in a constrained supply environment in our industry, but with plenty of demand, plenty of

opportunity for us to have transactions, we just need more vehicles coming into the wholesale channel, and that will happen with time.

Eric Loughmiller:

This is a cyclical change that occurred with the disruption of 2020. It will take some, maybe a quarter or two is our opinion, for the balance of supply and demand. What comes with limited supply is very high used car prices, both wholesale and ultimately retail. Or at a minimum, it squeezes gross profit for the retailers, but they generally are able to raise the retail price.

Eric Loughmiller:

So, it's an interesting and challenging environment, but one that we're ready for. Our focus in 2020 was to right-size the cost structure for what we think is the new wholesale economy around used cars, and we've accomplished a lot there.

Eric Loughmiller:

We're not ever done. We will always look at our cost structure, making sure it matches up to the way we generate revenue, but I think that's enough of an intro, and I'll let you lead me down the questions you think most interesting to our attendees.

Daniel Imbro:

Yeah, well, you mentioned it there, we're in a short supply environment, but you expect that to improve. I'd love to hear your outlook on the different segments, between dealer consignment, repo, off-lease, which of these segments do you expect to recover faster? Repo was the big surprise last year, maybe not coming back sooner. But can you maybe talk about what your outlook is for each of those, and which one recovers soonest?

Eric Loughmiller:

As we look at it, we would segment the market, first it's commercial and dealer-to-dealer. Commercial would be off-lease vehicles, repossessed vehicles, rental cars, private fleets, any non-dealer who is wholesaling a vehicle as part of their business model.

Eric Loughmiller:

Then the dealer is dealer-to-dealer, it would involve dealer trades, aged inventory, cars purchased from consumers that they don't intend to retail. That's a new component, that it's C2D. But we do not get involved in the D2C, the dealer to the consumer retail transaction.

Eric Loughmiller:

As I look at the commercial segments, the hardest-hit remains the repossessions. Repossession activity was growing. It bottomed out probably in 2012, at about 1.2 million repossessed vehicles processed through our industry, through our entire industry, the used car wholesale industry.

Eric Loughmiller:

That number had grown to 1.9 million in 2019. It was expected to be 2 to 2.1 million in 2020, and it ended the year estimated to be 1.2 million cars were repossessed, down about 40%. And that was with

a very strong first quarter in repossessions, and has been much lower through the summer months. There's been a little bit of a rebound, but not back.

Eric Loughmiller:

We're still running... We run a network through a digital platform that assists lenders, both captive finance companies and banks, in identifying service providers who can assist in the repossession activities, all the way from skip tracing to issuing default letters. It's a whole series. It's not just the taking of the car. And our transaction volumes there are 40% below previous levels, so we're not seeing the recovery quite yet.

Eric Loughmiller:

Off-lease, interestingly enough, the source of off-lease remains strong, and as expected. But the number of those cars making it into our formal wholesale channel is significantly reduced because of the high used car values.

Eric Loughmiller:

Consumers are buying a higher percent of the vehicles at turn-in. They're buying it out, creating equity in the car that they can use in a trade, or perhaps just buy the car at residual, which is a better economic transaction than going out and replacing the car.

Eric Loughmiller:

We're also seeing grounding dealers buy a much higher percent, because they can acquire... A grounding dealer is the dealer for which a consumer returns the vehicle at the end of the lease, and that dealer has the right, as part of his rights by taking that car back, and it doesn't have to be the dealer that sold you the car. It could be any dealer of that brand. That dealer has the right to buy the car at residual value, which I've just described as below market. So, being below market, that tells you that they would buy a lot of those cars, and we would lose the opportunity.

Eric Loughmiller:

We're not only losing the opportunity for a little more revenue on our Openlane private-label platforms, but we're seeing a lot fewer cars make it to physical auction, where we can provide those valuable services that increase our revenue at KAR Global.

Eric Loughmiller:

And then the rental cars, they deflated pretty aggressively early last year. They've been the smallest component of our commercial and consignment base for us. In the industry, they're a little larger than they are for KAR, for ADESA.

Eric Loughmiller:

But we don't expect, to be honest, for that to recover back to previous levels, probably well into '22, and it might even be '23. That's evidence that the business traveler is not renting cars like they used to, and so the fleets seem to be smaller. On a leisure traveler, they're likely to run the cars longer, higher mileage, and have more time between acquisition and disposal through the wholesale channel.

Eric Loughmiller:

So, we're seeing that as a segment of the market that's likely impacted through '21, and at least part of '22. We would have to see the reflating before we see the deflating, and that's why we're saying it's a little longer-term. They're not increasing the fleet size significantly yet.

Eric Loughmiller:

Dealer-to-dealer, huge opportunity for us. It's not that there will be more dealer transactions. We don't think so. It's just that we believe our offerings through the digital marketplaces that we develop will be able to serve a greater number of the transactions where a dealer takes a car in trade or buys from a consumer, and decides not to retail the vehicle, or tries to retail it, is unsuccessful, and decides to wholesale it, to turn over the inventory on his lot.

Eric Loughmiller:

We really think that's the greatest growth opportunity right now, it's our focus with the acquisition of BacklotCars in the fourth quarter of 2020. Our current integration activities, which I'm sure you'll get into the questions on that, that's all geared towards what we think will be a segment that, while it doesn't grow in terms of the number of cars coming back into the marketplace, the number of cars handled by the formal wholesale auction networks, both physical and digital, we think will be a growing volume for us.

Daniel Imbro:

That's great, and I've got a question from the audience that came in related to that. So, as you transition to more digital auctions, how are you able to keep your vehicle condition reports as consistent and reliable? I'd imagine that's a huge focus for you guys, and for your online buyers, but how have you guys invested in that, and are there any challenges there?

Eric Loughmiller:

Yes, and Dan, that's a really good question I don't get very often. Number one, it requires tools, and they involve technology. We need to make it where there's a consistency in what the inspection is reviewing, how that inspection is presented to potential buyers, a common language, a common format to it. So, we're investing in the development of a better report that has more consistency.

Eric Loughmiller:

An off-lease car gets the highest value, without question. It's sold between captive finance companies and banks to the franchise dealers. It comes with a comprehensive inspection report, typically performed by a third party, and signed by the consumer in agreement as to the condition of the vehicle. That is probably the most consistent, most thorough inspection report.

Eric Loughmiller:

Unfortunately, on anything other than the end-of-lease transaction, economically, we do not have the financial resources given to us to do that level. So the key is, how can we provide an inspection with all the pertinent information, but not as detailed as that?

Eric Loughmiller:

We think the use of technology, we're investing more into technology, trying to let the technology identify potential issues on the car, using machine learning and artificial intelligence. I'm not going to say much more today about that, but we're looking at that as a key component.

Eric Loughmiller:

We're also looking at the images, you've got to have great pictures, and the industry has depended upon enhanced imaging, so that you can pinch and zoom, and you can look at different parts of the car to see if you're comfortable.

Eric Loughmiller:

Then last, a consistency in nomenclature. Our competitor, Manheim, Cox Automotive, contributed to the industry its auto grading system, and we use it, as well as all the independent auctions, so there's a consistent grade.

Eric Loughmiller:

Unfortunately, it's based upon a subjective condition report, so there can be variations. But based upon what you write in the report, it grades it consistently. So, I think if we get a more consistent subjective review of the car, you'll get a more objective score, which can then directly correlate to the value paid for the car. So, we'll be investing in that.

Eric Loughmiller:

We have the right number of people. It's not a big increase in our capex. It's actually a prioritization. We've been spending a lot of money on the customer experience, and one component of that is enhancing the inspection process, across all of our platforms.

Daniel Imbro:

That's great. Maybe taking a step back before we dive into the different pieces, so you have a lot of moving parts this year, the industry obviously in flux, you have a CEO transition occurring this year. What are your biggest strategic focuses for '21, and if we fast-forward 12 months, how are you going to grade '21 a success? What are, if you hit these metrics, you're going to call this a successful year, given everything going on? Would love to hear your thoughts on that.

Eric Loughmiller:

Well, let's start with the CEO transition, it doesn't change our strategy. In fact, Peter Kelly's been the president of KAR Global for over a year. He was leading our digital efforts prior to that, so obviously it's a natural step for a person with his digital background in the auction industry coming into the role and expanding his responsibilities to the CEO from the president.

Eric Loughmiller:

So, it's a natural transition. To many it sounds like it was sudden. This has been being worked on for a couple of years, as to identify the right person to lead. My good friend and boss, Jim Hallett, will turn over the reins on April 1st. That just happens to be his 68th birthday. He's agreed to stay on as executive chairman for two years. He'll remain chairman of the board, and he may remain on the board longer, but there's a two-year transition where he'll be available to assist Peter and the rest of the executive

team as needed. So, it's not a clean break for Jim. It'll be a gradual move towards his ultimate retirement at the end of a couple of years after he turns it over.

Eric Loughmiller:

So, with that, what are we measuring? Peter's goals are very simple. We want to grow our dealer consignment position and establish ourselves as the leader in the digital dealer-to-dealer marketplace.

Eric Loughmiller:

We are already a leader in the digital commercial business, especially with the off-lease vehicles, but in other tools, with the likes of our Openlane platforms, the private labels that run on that, adesa.com, where we operate Simulcast, Simulcast+, ADESA DealerBlock. So, in addition to growing that, we want to increase our share, which is already at a very respectable number, in the commercial segment of our business.

Eric Loughmiller:

We've begun, and we'll continue to focus on simplifying the business, and with simplification, we want it easier to understand what we do, easier to understand the metrics that demonstrate the level of our performance and the success we're having in the marketplace.

Eric Loughmiller:

And you saw the beginning of that in our 10-K, where we simplified the presentation, we eliminated the holding company portion of our segment reporting, and everything is aligned with the revenue that we generate in ADESA or AFC. And we'll reduce the overhead around the business.

Eric Loughmiller:

Simplifying also means that we want to reduce the cost structure to a level that's supported by the digital marketplace business that we have embarked upon becoming. We do not intend to run vehicles across the lane in 2021, but we have not said that we will never do it again.

Eric Loughmiller:

At this point, we don't think we should ever have to do it again, but we want to look at the data. We want to be driven by the results. We want to see that our marketplaces can generate the same or better results for both the buyer and the seller of vehicles in the wholesale, where... We operate on both sides of the marketplace. We create the market. I need the buyers to be able to get the inventory that they're looking for, and the sellers to be able to get the outcomes, when they wholesale a vehicle, that they're expecting.

Eric Loughmiller:

So, simplifying the business will lower our cost structure, allow us to remain competitive on pricing of our services, and hopefully allow us to increase our share as the digital marketplace gives the platform greater reach to a broader audience. And if we are successful, we will become the most liquid marketplace.

Eric Loughmiller:

And then last, all of this actually overlays our international operations. We do believe that we are uniquely positioned to be the digital leader in Europe, which includes the UK. The UK is somewhat of a separate market, due to the right-hand drive.

Eric Loughmiller:

We have ADESA UK and ADESA Europe, two separate platforms that operate on our ADESA Global footprint. It's a technology footprint. We have efficiency, and we have the opportunity... The growth there has been tremendous in 2020, because they shut down the physical operations, and we think we can expand that.

Eric Loughmiller:

How do we measure? The single biggest measure is our volume. Now, we think of volume as a proxy for market share. We want to grow our share of the market. Our market size is not going to get bigger. Maybe we'll take some of the informal transactions, bring them into what we call our formal networks, or our formal industry.

Eric Loughmiller:

But generally speaking, it's about growing volumes through increased share of the number of transactions that occur at the wholesale level. We have plenty of opportunities to do that. We are measuring revenue per unit for auction fees. We're measuring gross profit dollars, including both auction fees and services per car sold. We're measuring the volume on-premise and off-premise. Are we capturing our share that are on our physical location, where I actually have the opportunity to generate more than just auction fees, and am I capturing an increased share of transactions where the car is sold off-premise, from a dealer lot, an airport, rental facility, wherever it may be?

Eric Loughmiller:

So, those are the key metrics. You'll see us, gross profit, we're very focused, we believe that our business model should have an improving gross profit over the legacy business, which had 60% of the cost structure being labor. We've now reduced that to more like 50% of our cost structure, with a lower cost structure.

Eric Loughmiller:

So, Daniel, those are how we measure success. You all know we measure adjusted EBITDAs, the final financial measure, but we're also focused on operating adjusted earnings per share, and growing those numbers in the current marketplace, and having a higher efficiency in generating cash flows, which are already quite strong for us.

Eric Loughmiller:

With all the disruption of 2020, we still generated 200 million of free cash in that year. As much as we were afraid in the second quarter how much cash we were burning, we were able to recover. We raised capital outside, but we were also able to stabilize the cash we generate in the operations.

Eric Loughmiller:

With the guidance we've given, you can look in our earnings release, you will see we expect to continue, even in a year that's challenged, generating at least 200 million of free cash flow. So, the business still is a strong cash flow generator.

Daniel Imbro:

Yeah, that's great. I want to dig in on, you mentioned gaining share, and not bringing back running physical cars. That's obviously somewhere you've differed from a lot of your independent competitors, as well as some of the bigger competitors, as we all know, they've chosen to return to running physical cars.

Daniel Imbro:

Can you maybe explain the feedback you're hearing from dealers, what are they saying about your decision, and how do you think that plays out over the coming year and what are the scenarios where you would start to re-run cars again? You mentioned it's depended on the data, but what are the specific things you're looking for to make that decision and potentially bring back some of that labor you cut?

Eric Loughmiller:

Well, Daniel, it's fairly straightforward and simple. We measure the outcomes for our customers, and if we can make our customers more successful, we want them to be more successful, we're going to do whatever that takes. So, if running cars across the block made our customers more successful, we will obviously consider doing that.

Eric Loughmiller:

At this point, though, we believe there's evidence that we can make our customers more successful by creating a larger marketplace than being tethered to a physical location. It doesn't mean the cars aren't centrally located, there's value to that. But having the auction process be less dependent on the person standing in front of the car, and more on the reach technology gives us, we think is an important move.

Eric Loughmiller:

The feedback from our customers is very supportive on the commercial side, and on the dealer side, many see the value of an expanded market reach. They see the value of the increased liquidity, on not just relying on 20 or 30 individuals who are standing in the lane bidding on the car. I've got a really dynamic marketplace bidding on it.

Eric Loughmiller:

There are also some customers, primarily dealers, and many of them independent dealers, who assert that "That's not how I do business, and I am going to do it the way I've always done it." All we ask in that situation is the opportunity to show them how we can perform and make their business more successful, have a as-good or better outcome. That's a challenge in some markets.

Eric Loughmiller:

We typically are finding the competition who's running cars that is taking a little bit of share from us right now is the independent auction in a local market. It's typically not to our large competitor. It's typically to the independents with a local presence.

Eric Loughmiller:

We have gained some of those customers back after a few months, but we really think as we develop our digital tools and platforms, that the cars will come back to the market that gets them the best outcome with the least amount of cost.

Eric Loughmiller:

One of the things we're very focused on is reducing the cost to our customers to get to the marketplace. Tools like BacklotCars, TradeRev, Simulcast+, don't require the car to be on our site. We can run auctions through Simulcast+ on days that are not normally scheduled for an auction, because we don't need an auctioneer. It runs with an automated auction process.

Eric Loughmiller:

So, we're developing these tools that allow us to sell cars any time, anywhere, at the highest possible price, with the greatest exposure to the entire marketplace, and that's our focus. Our competition doesn't have the resources to invest, or the technology platforms already developed that we do.

Eric Loughmiller:

So, we need to play to our strengths, not move to the lowest common denominator in the industry, and we have conviction on the path we're taking. We believe it's the right answer. We have the evidence that it's getting the same or better results, in many cases better.

Eric Loughmiller:

And now it's our job to communicate that with data, with analysis. We will take on all challengers to that process, but we ask that they give us a chance, not that they just dismiss the process. Give us a chance to prove that we can get those results.

Eric Loughmiller:

Part of the savings here comes in what I call the fees and friction of the transaction costs, moving of vehicle, having it sit for a week or two waiting for its spot in line at the auction. Our tools eliminate some of what I call the friction.

Eric Loughmiller:

So, you've got to look at the net economics, but you can also look at the gross economics, what did the car sell for? All of that's important, but that's what we're focused on, Daniel, and we are committed to staying this path. We are not head-in-the-sand, ignore what the market tells us.

Eric Loughmiller:

If we found that running cars had a better outcome for our customers and made them more successful, we still have the capability to return to that type of business, but we have announced that we will not do that in 2021, and it is our goal not to run cars again. We think it's unsafe. We think there's real

reasons not to do that. We have a lower cost structure. We think over time it's a more efficient transaction, so that's our position.

Daniel Imbro:

Yeah, that's great, and a question came in from the audience during that, when you mentioned Simulcast+. You mentioned, it doesn't need to be on your premises to sell the car. Does that increase the risk that other digital-only competitors could go after that same volume, and at least to the dealer, pitch that they can offer a similar proposition of, "Don't move the car off your lot, we can sell it online"? Whereas historically, you guys had the benefit of saying, "On our lot, we can do X, Y, Z, to help facilitate the sale."

Eric Loughmiller:

Well, the first thing is, when we run these sales on Simulcast+, the inspections are completed by our company. So, even if it's off-premise, this is not inspecting one car at a time. We're typically going to a... Like in the case of the Hertz announcement we made publicly, we went to the Hertz lots, and we were able to inspect a series of vehicles that were going to be offered, and send our people from our auction site to the airport facility, inspect the cars, get the images that are needed to be a successful transaction.

Eric Loughmiller:

Second, you can have a platform that lists all those cars, but are the buyers logged into it? Simulcast+ gets access to all of the users of adesa.com that are on Simulcast, the physical auction marketplace. Simulcast+ has the same buyer base, has this access to the same people. They see the same process, with the expectation of, the live auctioneer is replaced with an automated auction process, Daniel.

Eric Loughmiller:

So, the key to this is, while technology is important, we are the only company, to my knowledge, and I'm pretty aware of the marketplace, providing a Simulcast+ in the used car auction business. There are similar processes in the salvage business, but they're not selling the same type of car.

Eric Loughmiller:

So, we are very optimistic that this is going to be a difference-maker for us. It's a small component of our business right now. It was put into production as a response to the COVID-19 restrictions, where we had to have a way to do this, and in some parts of the country we couldn't even have the cars delivered to our lot. It wasn't permitted that we could have interaction with anybody.

Eric Loughmiller:

So, we were able to go out and inspect the cars and you have protocols around touching the vehicle, and how you had to sanitize it. It didn't make sense to bring them onto our lot. So, out of necessity, as we said, necessity is the mother of invention. This was in the works, was planned to be piloted at the end of 2020, and got accelerated into full production in April of '20, and has been an important tool that we've used for our consigners.

Eric Loughmiller:

I think it's a difference-maker. It's more than just the technology, though, Daniel. You've got to have the buyer base already using it, and that's the advantage we have. We call it Simulcast+. You would log into it like you're logging into Simulcast. You would see an event sale. So, the fact that it's off-premise is a distinction we're making. Our customer doesn't even know.

Daniel Imbro:

That's great, and that's a good dovetail into maybe some of your more direct online business. Let's start with the recent the decision to consolidate BacklotCars and TradeRev, you guys have run the TradeRev brand in the US for, call it three years now. Obviously you bought BacklotCars in the back half of 2020. Can you maybe just talk about the strategic decision? Why did it make more sense to fld everything under the BacklotCars brand? Was it a brand perception of TradeRev that you wanted to change, or can you walk through that decision before we get into different parts of that industry?

Eric Loughmiller:

Well, the first thing I'll say is, COVID had one positive impact. It accelerated the pace of adoption of digital marketplaces. It just did. Now, maybe everyone wants to go back to the old way, but a lot of people are buying cars, and in fact on TradeRev, we had registered over 20,000 dealers to buy on the TradeRev platform who had never bought online before. So, the adoption of that market, while it was forced, was pretty impressive.

Eric Loughmiller:

Second, with that result, we saw that the natural development of the marketplace with our TradeRev product, that was still evolving, we found BacklotCars was a faster-growing digital dealer-to-dealer marketplace that was differentiated from the other competitors that were running timed auctions like TradeRev.

Eric Loughmiller:

TradeRev was just another version of a timed auction. It had things that we would argue were differentiation, but the process wasn't differentiated. We measured the data through diligence, after we owned it, we went in and scrubbed all the data, and determined, no, the BacklotCars platform gets higher net retention or value for the vehicle than TradeRev, or even a similar-priced car at ADESA, or independent auctions where we were able to [inaudible 00:30:01].

Eric Loughmiller:

We had several sources and said, "Okay, this is a top-performing marketplace." So, when I see that, it was natural, the thing we had to do was pick one platform. Why? I can't have my buyer base split looking at two different platforms for the same type of inventory.

Eric Loughmiller:

So we made the decision to migrate the US customers, because the US customers were buying on the US TradeRev app. The Canadian customers buy on the Canadian TradeRev app, and they were separate instances.

Eric Loughmiller:

So, we're going to keep the Canadian customers on TradeRev, and the US customers have now been all migrated onto BacklotCars. We have shut down the TradeRev platform, and consolidated the digital dealer-to-dealer buyer base onto one platform. And it's going well for us.

Eric Loughmiller:

As we mentioned on the call, we were seeing a little bit of a lag when you moved them from TradeRev, they had to get used to it. A five to seven day period of coming up to speed. And now that we've migrated all the customers, we're seeing very good adoption rates, high success, high conversion rates. When they list the cars, there's a higher conversion rate on BacklotCars than there was on TradeRev, and a lot of those customers are saying, "I'm getting more money," because the 24/7 bid-ask marketplace gives me the opportunity to have more buyers see the vehicle and bid on the vehicle."

Eric Loughmiller:

So, all of that's important to us, and it's something that I think we'll differentiate in the marketplace. And we believe it's a strategy that can create the winning platform, and that's what we're after, is the winning platform.

Daniel Imbro:

Yeah, and that's a great dovetail into my next question. On the 4Q call, Jim was very clear, you guys want to be number one, and there seems to be more of a focus on growth, and maybe, not at the expense of profitability, but I feel like in the back half of '19, you guys got very vocal, you were focusing on profitability, maybe not as much on growth. The focus now seems like it's on growth, so can you talk about what drove that shift back to the focus on growth? Was it a competitive response? Obviously one of your peers is out there in the market, is it anything [inaudible 00:32:22] that, or what drove that decision from your seat?

Eric Loughmiller:

Well, our focus has always been, become the leader, and grow the business. During the COVID period, though, that became an irresponsible singular focus. We said, "At this point, we need to protect the company. We need to be there when the market recovers, and to do that, we need to reduce the losses. We need to have a more focused view on financial dependency," and what we learned in that process is that we have the ability to both make money and grow the business.

Eric Loughmiller:

So, when we said we're going to focus, invest more, we're investing profits, not losses. We believe that we can operate the business... We sold 316,000 cars on the combined platforms in 2020, and we have a very aggressive growth target for that platform, BacklotCars in particular, for 2021.

Eric Loughmiller:

And in doing that, we also have said, and we will exercise financial discipline. It's not that we're going to lose money now. That's not what we said when we said invest. We plan to break even or better.

Eric Loughmiller:

So, at a minimum, we want to be at break-even, and we're on target to do that, but we're doing that while we're growing, entering new markets where there's an investment and cost, with the profits to follow. So, we want to be balanced but do that.

Eric Loughmiller:

Interestingly enough, when we look at that competitor of ours that filed an S-1, I'll just comment, they lost less money in 2020 than they did in 2019, by a significant margin. So, I don't think our focus was any different than the large competitors we have in the digital dealer-to-dealer marketplace. Everyone was in protect-the-business mode, conserve cash to the extent you can.

Eric Loughmiller:

So, what'll be interesting is, going forward, will there be a focus on some financial discipline in the competitive landscape, or will there be a focus just on market share growth at all costs, and the capital is provided by the marketplace for us to do that without focused on earnings?

Eric Loughmiller:

We will remain one eye on market share, one eye on earnings, because we think that's what our investors expect of us. We do believe you keep your customers the way you get them, and if the only way to get them is to give your services away and lose money doing it, it'll be very hard to make money in the long run.

Eric Loughmiller:

And you know we made that shift really beginning in 2019 where we made major changes to the leadership, to the go-to-market strategy. We combined the ADESA dealer-to-dealer salesforce with the TradeRev dealer-to-dealer salesforce. We're very pleased with the results of that, those decisions, and now it's time for them to bear fruit when the market gets back to a more normal level for wholesale transactions.

Daniel Imbro:

Got it, and when you look at that BacklotCars entity now that has TradeRev in there, what investments are needed from here? Is it a variable cost model, where you'll need to add inspectors, and I think that's contracted. So, what is the incremental investment you need in BacklotCars to support your ambitious volume growth targets, or is all of the cost structure in place to where now it should be more fixed?

Eric Loughmiller:

You'll need to add people as you expand marketplaces. It's probably not linear to the number of cars you sell. It's probably more focused on supporting a marketplace, and I can get efficiency once I hire those people in that marketplace.

Eric Loughmiller:

But the bottom line is, we've got the platform. We'll continue to improve the platform. We'll continue to listen to the customer. But the platform, the heavy lifting is behind us. We have a combined organization that can service the dealer, so we're well-positioned.

Eric Loughmiller:

However, if we hit our growth targets, and if we pursue that goal that we laid out, an incremental $100 million within four years of EBITDA contribution, we will have to add people to support that, but those people will be, like you say, a variable cost model. They'll be being added to support the field transaction. We'll be able to leverage the technology and the infrastructure of KAR relative to the back office.

Daniel Imbro:

Great. Maybe shifting over to margins a bit here in the last 10 minutes. I think in the fourth quarter [inaudible 00:36:56] headcount reductions stayed low, but obviously we saw a little bit more year-on-year contraction in underlying margins. Can you just maybe remind us what happened? Were there any other one-time items that we didn't talk about on the call that would help explain those moves, and then how you're viewing the outlook for your cost structure at ADESA today?

Eric Loughmiller:

Yeah, we think we have the cost structure properly aligned. The volume dropped in Q4 to 75% of the prior year throughout the quarter, and it's pretty consistent month-to-month. And at that level, there's a little bit of [inaudible 00:37:30] margin performance on our business, even with the lower cost structure.

Eric Loughmiller:

So, as I look at it, we've improved the cost structure. We probably need to get growth back to be at least 80% of 2019 levels, instead of 75%. At that level, I think we perform as well or better than the prior year.

Eric Loughmiller:

And I did have, I don't want to call them one-time items, because you're in business, and what's one-time? One-time means you'll never do it again, and I'm not sure that market conditions didn't create this.

Eric Loughmiller:

First and foremost, we had losses in gross profit related to purchased vehicles. Purchased vehicles were relatively flat Q3 to Q4, down slightly, but relatively flat. And yet the losses on that nearly 90 million of revenue in the greater were significantly greater in Q4 than they had been in Q3. And the losses are created by the ADESA Assurance program.

Eric Loughmiller:

As a reminder to your audience, used car prices continuously rose from April until August and even into September. And then in September, we actually saw them reverse. So, with that backdrop, the losses are... We do not bet on the values of cars. We don't hold inventory [inaudible 00:38:54] the market's going to recover.

Eric Loughmiller:

Under the ADESA Assurance program, we were selling the cars as soon as they were returned, and we had increased losses relative to the prior year, and relative to the prior quarter, and we think that's

transitory. We think the market has rebounded. Used car prices are going up, mitigating the situation that resulted in fourth quarter having a bigger [inaudible 00:39:14].

Eric Loughmiller:

Second, we have cost of occupancy that affected Q4. Again, it's one time that I did this, but it isn't. Our cost for the year didn't change. In Q2, I deferred 50% of the rent on about 75% of our operating properties that go to direct costs. These are the auction facilities. I deferred 50% of the May rent and 50% of the June rent, and agreed to pay that rent in December, when we would expect our financial performance to have improved.

Eric Loughmiller:

I negotiated these arrangements in April, when I was burning 150 million cash in a month. So, that resulted, while we straight-lined most of it, the costs actually came in Q4 higher as a result of many of those deferrals. Also the CAMs hit in Q4, and a number of other occupancy things that were greater impact than they had been in prior years and prior quarters.

Eric Loughmiller:

So, that hit Q4. That was about the same impact on margins as the increase in purchased vehicles. Around my other businesses, the margin degradation was minor. Auction services down about 20 bips, or... Let me get the number right. I may get these backwards. I've got a schedule here for May.

Eric Loughmiller:

Auction services were down 60 bips. Other services, meaning the ancillary work and other things, were down 20 bips is all. That wasn't bad... And that was sequentially. And compared to the prior year, they were down modestly, but most of this was due to the purchased vehicles and the occupancy that did not hit Q4 in the prior year.

Eric Loughmiller:

So, I think our cost structure's where we need it to be. I think our performance will improve as, even at the same volumes, but it's a situation where we just need a little more volume. We don't need to get back to previous levels. A little more volume will go a long way in improving the financial metrics of the business.

Daniel Imbro:

Yeah, that's great, and then I wanted to follow up, I got one from the audience that came in on the headcount reductions related to margins. Obviously that's been consistent, you've taken some more out. But are you seeing any inefficiencies or signs you've cut too deep? You mentioned earlier that some of the dealers are shifting volume around the industry. Any evidence that's coming from expense cuts or labor cuts, or do you expect that these labor cuts can be permanent?

Eric Loughmiller:

So, Daniel, to their point about the industry, a lot of these cuts were eliminating sale day activities around moving the vehicles. So, the cuts didn't cause it, but not running the cars has caused some of the dealers to try other alternatives, I'll admit that.

Eric Loughmiller:

But we cut the cost because we're not going to run cars, not... We cut the costs, and the only way to make the numbers work. They're one and the same decision, that we're not going to run vehicles. So, it's directly related. If we were to run vehicles, we'd need more staff on sale day, and we don't intend to do that, we will not do that this year, and we don't intend to do it going forward. But we will watch the data and the evidence as to whether that's the right decision.

Eric Loughmiller:

So, the cost cuts, they're permanent. We are working on improving the customer experience unrelated to the cost cuts. We have a customer experience team. It goes to checkout processes. We want a centralized checkout function, as opposed to a local checkout.

Eric Loughmiller:

When you go to an auction, historically, you check out at the auction where you're buying the vehicles. Well, that shouldn't be the case. We should have a global checkout process, where you can buy cars across all of our... And digital does this, buy across all the platforms, there's a single checkout process. It's very efficient, very quick.

Eric Loughmiller:

When you want to make payment, you don't have to make payment and identify where did you buy the car, what auction, where does this get posted, which is historically how the operations have worked.

Eric Loughmiller:

It's now the VIN number, you have the VIN number, it's posted, it's all an improved checkout process. We're looking at our title processing. We handle millions of titles a year, and I handle them in the AFC business, we handle them in the ADESA business. We're handling them in the repossession services businesses that we operate. Can we centralize those functions? AFC uses title as collateral. How can we get efficient as a company to do that?

Eric Loughmiller:

So, there are some things where we're identifying efficiency opportunity. I don't think the cuts we made created inefficiency. Again, it may have changed a change in process on sale day. I used to run the cars through the lane, if it sold it went to a sold lot, and if it didn't sell, it went back to its spot, which they always got wrong, and we'd lose cars doing that.

Eric Loughmiller:

Now the cars don't move. I don't have to run the car for 30 or 45 seconds through the lane and then have that driver know, does it go left or does it go right? Does it go to the sold lot or back to its spot?

Eric Loughmiller:

So, those types of things have actually increased the efficiency, and now, even though I'm selling digitally, I still move the car to a sold lot, but I don't do it in 45 seconds. I have drivers planned, and I don't have to bring in extra staff because I'm moving so many cars on sale day. I can do it over the next day or two, because I'm going to set the sale for the next week, and I'm going to probably begin setting that two or three days before the sale, so I have more time to be more efficient in how I move vehicles.

Eric Loughmiller:

I can move them fewer times. That's the goal, can we move the car fewer times? That incurs less labor, reduces the risk that we can't find the car when we go to look for it because it's not where it's supposed to be, those types of things, Daniel.

Daniel Imbro:

Got it, that's great. I wanted to wrap up at the end here with a few more questions, but touching on [inaudible 00:45:20] competition, off-lease has been a strength for you guys for years, with Openlane and the consistency you guys have had there.

Daniel Imbro:

Can you talk about the difficulties of breaking into that? Obviously a peer that filed an S-1, sounds like they intend to move towards that business. You guys have always had a moat there. Can you talk about that moat is, expand on that a little bit, and then talk about any recent developments on the off-lease OEM front?

Eric Loughmiller:

Yeah, Daniel, I find it interesting that the platforms have segmented the market based upon who are the sellers, who are the buyers. When you go to the off-lease channel, it's predominantly our private-label sites on Openlane, and then it goes to adesa.com.

Eric Loughmiller:

Those are sites for which franchise dealers are acquiring inventory, as well as the CarMax, Carvana, Vroom, Shifts of the world, and other large... Penske, Sonic, AutoNation, Group 1, all of them have large retail used car operations, and they are doing... They generally are not looking for inventory on BacklotCars or TradeRev.

Eric Loughmiller:

So, we think, while the TAM is properly addressed when we look at the whole marketplace, maybe 22 to 25 million transactions for which you're competing, we aren't convinced that every platform competes for every segment of that addressable market.

Eric Loughmiller:

We do not believe, and by the way, we have the information to support this, it is not the appropriate marketplace to try to sell dealer cars worth less than $10,000 to dealers through the Openlane platform.

Eric Loughmiller:

It is also not the most efficient and highest-performing outcome for the dealers to take high-end off-lease cars and sell them on TradeRev or BacklotCars, where the buyers are predominantly independent used car dealers looking for cars that range from several thousand dollars to $10,000.

Eric Loughmiller:

You can sell any car on these. It's not that it's limited, but that's not where your most liquid marketplace is, based upon the value of the vehicle. If I have customers who run car lots where their consumer is buying cars with an average retail value of five to $10,000, they are not looking on Openlane to see what

cars they can buy at $19,000 or greater, because they won't have the foot traffic, they might sell it, but they won't have the foot traffic to make that the right inventory selection.

Eric Loughmiller:

So, the same would apply when I'm looking at Openlane, I've got franchise dealers who sell higher-end used cars and new cars. So, I think the marketplace will settle in. It's not that you can't sell the cars, but we think we can continue to make our offer differentiated to serve the markets, to have the highest... The goal here is to have the highest liquidity, the most active unique buyer base on each of our platforms, and have the inventory matched up to what that buyer base is looking for. It's all about successful outcomes, high conversion rates, get the cars in front of the right people, they will buy it at the right price.

Daniel Imbro:

That makes sense, and I know we're butting up on time here, so I'll leave it with this. Eric, it's tumultuous out there. You guys are leading some of this disruption, but when you look forward, what excites you most about the car story, but also just this year, and where you guys are at in the life cycle right now going forward?

Eric Loughmiller:

Well, when we spun off Insurance Auto Auction, Jim Hallett and I were asked, "Why'd you choose to stay at KAR?" This is exactly why. We knew we had an opportunity to transform our business. It's exciting to revisit the cost structure permanently, to look at how we can be more profitable, operating on hopefully more transactions, but even if there weren't more transactions, have a more profitable business that drives cash generation at the highest possible level in the industry.

Eric Loughmiller:

We continue to believe that the moats around the businesses remain wide and deep, and the fact that competitors are stepping their toe in the water, they don't know how wide and deep that water is. They really just don't know, and it's going to be hard, and we have to stay the course.

Eric Loughmiller:

We are committed to being a digital marketplace business. We are committed to being the leader in the digital marketplaces that serve the wholesale remarketing industry for used cars. We have a breadth of services, including AFC, that support these transactions.

Eric Loughmiller:

So, that's our focus, and we remain committed, and you know what? We have dealt with disruptors forever. I've been in this business now 15 years. There's always somebody saying, "That's too profitable for me to ignore." And we have been successful. We have fought off the competition, and proven that we are able to transform our business to meet the needs, and we have an advantage with the buyer base and the knowledge. We have the ability to process... I mean, listen, are you going to give some upstart technology business $30 billion of your cash? We sold over $30 billion of cars in 2020, a depressed year.

Eric Loughmiller:

This is more than just, "Hey, I've got a mobile app." This isn't a video game that everybody'll learn to use. Behind it is a very serious transaction with a lot of economic support required to service the transaction, and we're prepared to do that.

Eric Loughmiller:

And we'll never take our competition lightly. We respect our competitors, we learn from our competitors, and they set the target for us to exceed the competition's performance. So, it's all good. Without competition, there's mediocrity. We are not focused on mediocrity.

Daniel Imbro:

Well, that's great. I'm sure we could go on all day here, but I'll keep everyone on schedule. Eric, thank you for the time, and thank you everyone for sending in your questions. Sorry for the ones we didn't get to. And yeah, with that, thanks everyone for your time, and we'll end the meeting. Thanks.

Eric Loughmiller:

Thank you, Daniel.