

KAR Auction Services, Inc.

KAR Auction Services, Inc. presentation delivered at the J.P. Morgan 2019 Auto Conference on Tuesday, August 13, 2019 at 5:10 PM

Jim: KAR auction services. We really had two major divisions, which was ADESA, which is what we call our whole car business, like the call of the of the straight cars, the ones you and I drive up and down the road every day.

We also had a business called Insurance Auto Auctions, which was primarily focused on in-selling cars for insurance companies that had been declared total losses.

Recently, we've just completed the spin-off of Insurance Auto Auctions, and we've been trading separately for about the last 30, 40, 50 days. The spin-off has been very successful, created tremendous amount of shareholder value.

I think the stock has appreciated somewhere on a combined basis in the order of $2.5 billion since we did the spin-off, so it was a successful spin. I think our investors are happy with the spin.

Now we're two standalone companies. Eric and I stayed with the whole KAR portion of the company. Eric's our CFO. We'll continue to manage that company, smaller business.

Going from a company that was somewhere in the order of $950 million of EBITDA, now currently going to be looking at a company that's projected to do $530 million to $550 million of EBITDA here in 2019.

We're getting focused on being a smaller company, right-sizing the business, being much more innovative through the use of technology and changing much more of our processes in the field to be much more innovative in the way that we operate things going forward here in the future.

Eric, can you add to that?

Eric: No. The industry we're in, though, has been through a cyclical change and now we're facing plateauing volumes in the off lease space, which I think everybody's expecting.

As we look at our industry, it's actually the time for us to look for innovation to grow the marketplace and Jim will talk about that in a few minutes when Ryan asks questions about trade rev and the opportunity there.

But we're really pleased with where we're positioned. We think we have some competitive advantages and we're in a strong position to perform and continue growing. We put out some long-term guidance of 6 to 9 percent revenue growth, our current adjusted EBITDA margin of 20 percent. We believe we can grow to 25 percent over the next five years.

We have some real opportunity, not only to grow the company, but also, I think, expand the multiple and great value for our shareholders as KAR stands alone.

Ryan: Thanks so much. The first area I'd like to really delve into is your outlook for industry whole car auction volumes. Around the time of the split from IAA, you were looking for very slight increases in total industry auction volumes through 2021.

At the same time, it looked like the increase would be driven maybe more than entirely by the growth in dealer to dealer, that is outside of traditional auction channel.

What do you think will be the direction over the next couple of years of overall auction volumes, and also for the markets that you've more traditionally served, including maybe your most profitable physical auctions?

Jim: With that, I think where we're focused is, the industry has been driven in the past several years by the heavy volumes in off-lease volumes. These are vehicles that have been out on lease for three to four years, coming back to be resold. Those vehicles have been on a steady climb over the course of the last six, seven years.

Those volumes are going to peak here in 2019, and as those volumes peak, I don't suggest that there's going to be a tremendous drop-off, but they're going to plateau. For the foreseeable future, for the next two or three years, we're going to see those lease cars be at that steady...As a matter of fact, there's been about 30 percent of the total new car sales are leased vehicles for consumers.

I just read an article today that's saying that leasing is actually jumping up above the 30 percent mark, and it's at an all-time high. As we think about it, the cars that are being leased today are the used cars that we will be selling in three or four years from now, so, those volumes will be steady.

Also, as we look at the dealer-to-dealer business, these are the used car and the franchise dealers. These are the dealer trade-ins that they want to remarket.

We see these vehicles. We've seen an opportunity to actually grow this segment, and not necessarily all our physical auction sites, but we see an opportunity to grow this segment through the use of our technology.

We have a relatively new product that many of you have heard about if you've followed our industry, where we have developed a online network where we sell vehicles. As well, we've developed a mobile network where we're selling dealers and transacting for dealers, dealer to dealer, over this technology.

We can get into the weeds here a little bit later if you want, on how the technology works and some of the things that we're doing, but this is really expanding our adjustable market. If you think about the number of dealer vehicles that are sold on an annual basis, there's about 9-10 million dealer trade-ins that are sold on an annual basis.

Currently, there's about five million of those vehicles that come to a physical auction, so there's somewhere in the neighborhood of four to five million that are not coming to a physical auction. The way that we're addressing that market is through this technology. It's called TradeRev.

It's a dealer-to-dealer application where we're able to stand in the middle of those transactions on a mobile application, much the same as we would at a physical auction or at an online auction.

We're seeing growth in the dealer-to-dealer market, and I think the other thing that I would mention is we're doing a lot of work with data and analytics. We're helping many of our major OEMs, captive finance companies, understand how to price their cars based on the data that we receive.

I like to say most of our customers have data on their own vehicles, but we have data on the entire industry. We're able to take this data, and we're able to turn into actionable intelligence, build pricing models that help our sellers understand what's the best channel to sell their vehicle in, market-by-market what the expectation on price is going to be.

Even down to on the buyer's side, recommending to buyers what cars they should be buying and how much they should be paying for those cars based on their history of several metrics that we

look at.

Overall, we think it's a growth market.

Ryan: I appreciate that, and I think that sets us up to get into the weeds on TradeRev then. Maybe just before we do, for those a little bit less familiar in the audience, if you could describe exactly what TradeRev is, maybe give an example of a use case, how the transaction works, and how this differs from what was available even a few years ago.

Jim: Sure. Historically, when dealers take in a vehicle on trade that they're not going to keep it to retail it for their own purposes, they just want to liquidate the inventory and monetize it. For the last 50, 60, 70 years, they've sent these vehicles to physical auctions. They transport them to physical auctions, and they get sold at a physical auction.

The other alternative that they had was if they didn't want to send it to a physical auction, they would sell it to a wholesaler.

A wholesaler was the middle man, would show up, and whatever vehicles the dealer didn't want, the wholesaler would negotiate with the dealer, and he would buy the trades, and then the wholesaler would take it to a physical auction, or he would find another channel to dispose the vehicle of. That's history.

Going forward, we still have physical auctions, and physical auctions aren't going away any time soon, but there is a transformation that's taken place. The transformation that's taken place is a digital transformation whereby we're now created another channel to kind of displace that wholesaler.

We're going to be able to put TradeRev on a mobile application and be able to allow the dealers to transact dealer to dealer. We're going to stand in the middle of that transaction.

When I say "stand in the middle of the transaction," that means we're going to guarantee price, we're going to guarantee check, we're going to guarantee title, and we're going to guarantee any arbitration or any problems with the vehicle.

What will happen now is when the dealer wants to get a bid on that vehicle, basically, he'll go out, he'll take a few shots, a few pictures of the vehicle, download some information, and he'll immediately launch that vehicle to a network of buyers.

It's a 45-minute auction. Within a 45-minute auction, that physical car will get 25, 35, 40 bids in the space of 45 minutes, and in the space of 45 minutes, he will have a guaranteed price on which he can sell that vehicle for.

As you think about that, now you no longer have to wait for a certain day of the week to take your car to the auction, have an auction one day a week. You can basically have an auction every 45 minutes on this.

The minute the car arrives, you can immediately upload it and launch it, and be selling vehicles. We think this is a way to not so much cannibalize our existing auction.

There will be a little bit of cannibalization there but the bigger opportunity will be going after this expanded adjustable market that I talk about, where we'll be able to get more of those cars that were not coming to a physical auction.

Maybe they were going to a wholesaler, and we're able to grow our market and our dealer segment through TradeRev.

Ryan: Thank you for that explanation. Toward the end of the remarks there, you talked a little bit about addressable market and cannibalization. Let's hash out everything there is to discuss there.

For example, how are you thinking about the addressable market for TradeRev in unit terms or in dollar terms? How are you thinking about your potential piece of that market relative to the portion of your more traditional business that could potentially be disintermediated?

Obviously, you're so enthusiastic, you must think that the TradeRev opportunities significantly outweighs what could be disintermediated, but how can you dimension that, put some numbers on it, help us understand?

Jim: I like the two-part questions because usually, I forget the second part. Anyway, starting with the first part. [laughs] I'm sorry, just the TAMs, excuse me, the total addressable market. I forgot the first part. When you think about it, today, we say the total addressable market of dealer trades is 9 to 10 million cars.

About 5 million of those cars are being sold at physical auctions today. Our company has 20 percent share of what's coming to the auction today, so we really believe there's 20 percent there,

and there's another 80 percent that we are not touching today. That's really the share that we're going after.

Not only the four to five million cars that don't come to auction, but the other cars that do come to auction, so there's an 80 percent opportunity.

People will ask me often, "Are you not concerned about cannibalizing yourself?" In fact, no, I'm not, because this transformation is going to take place, just like we see transformation in every business. It's going to take place, and it's only a matter of time.

I've learned through history that it's better to disrupt yourself than to wait for somebody else to disrupt you, and that's exactly what we're doing here.

With that said, I do believe that it's not winner-take-all. I do believe there's an opportunity for there to be two winners in this space, two dominant players, and I believe that we can be one of those players. I'd like to be the winner that takes most.

With that said, currently, we do have two leaders in the marketplace. We have a competitor and ourselves are currently in leadership positions. I think that they are a standalone technology offering. They have a platform and they have a buyer base.

I think what gives us what I call the unfair advantage or the right to win is, we not only have a platform, we have a much stronger buyer base. We have a buyer base of 90,000 unique buyers that buy off of our platform throughout North America.

We also have a collection of assets that we can put around our TradeRev platform. We can attach transportation. We have a transportation company that we own. We can attach financing. We have a finance company that we own. We can attach inspections. We have an inspection company that we own. I don't think any other company has a similar offering to what we have.

Other than the two, ourselves and the other major player in the industry, there are other smaller players, but I do think as we continue to penetrate the market and deploy into new markets, I think that we have the opportunity to be the leader in the space.

Ryan: I would absolutely agree that you are a much more natural owner, which leads to some interesting questions like, for example, is Manheim working on capabilities? Shouldn't they also be natural owner? What do their efforts look like?

How has this unnamed competitor, ACV, owned by private equity, how have they been able to be as relevant as they are, given that they're not a natural owner, given they don't have cars arrive? Are they just competing on price? What do you think their profitability looks like?

Jim: Let's just start with what we consider our biggest competitor in the entire auction environment to be, and that is a company called Manheim. Manheim is owned by Cox Communications.

They're a direct competitor with us. They have physical auctions. They have online auctions. They have similar assets to what we have, and I believe the two companies that should win in this space are Manheim and KAR. We should be the natural winners. We should be the natural owners of this entire market.

You mentioned a competitor by name, so we'll talk about ACV. ACV is a venture fund, venture capital. Currently, right now, I would say in terms of just pure volume that's being sold in the United States, they are the leader. We would be in second place.

We're absolutely the leader in Canada. We have a very strong leadership position in Canada. This is a Canadian company that we acquired back in 2013, and so with the venture capital folks, I think that they got to jump on their go-to-market strategy.

I think we were more focused on our technology, building the technology, and less focused on the go-to-market strategy.

What I say I've learned over the course of time is, with start-up technologies, and many that may be in that space, I think you have to have good technology. You don't have to have great technology. You don't need every bell and whistle that you can possibly put together. You just need to have good stand-up technology.

I think we focused on the technology a little bit too much. I think our venture capital folks focused on their go-to-market strategy, and quite frankly, they got a lead. When I say got a lead, it's not a sizable lead, but there's probably a gap of 4,000 or 5,000 cars a month.

I think that we've seen that we were closing that gap. We've just come off a record month here in the month of July. We have had record days over the course of the month, and we're starting to close that gap.

I think that quite frankly, ACV has done very, very well, but going forward, I'm not sure if they have a sustainable model as a standalone, and so I see the natural winners being Manheim and ourselves. Did I get it?

Ryan: Yeah, absolutely. Thank you. My last TradeRev-oriented question is about the financial losses that you forecast this year as you invest in this business. I think you've been forced to maybe invest a little bit more because of the competitor. You've talked about $60 million of losses in 2019.

You just reported second-quarter earnings. You ran about $33 million in the first half, so you're pretty much on track but I thought to check in how you feel about that full-year figure?

Then, what are your thoughts on when these losses might turn to break even and then, with the ultimate profitability profile of TradeRev will look like when it's at scale and the competition has settled?

Jim: Three-part question.

Ryan: Sorry. [laughs]

Jim: I get it. They never give you a break, right?

[laughter]

Jim: With that said, in terms of the $60 million losses, we've outlined our operating losses would be $60 million for the year. We will not exceed $60 million. As we go forward, we expect to bring those losses down. We've told our investors in the market that we expect that we will get to break even on TradeRev sometime in 2021.

Currently, last year, we sold 117,000 cars on TradeRev. This year, we're projected to sell 200,000 cars on TradeRev. We believe that that break-even point comes at 350 to 400,000 vehicles. We project that we'll be there sometime in 2021.

In terms of profitability, there isn't really a lot of difference between what the profit will be between a physical auction and selling the vehicle on TradeRev as we go forward.

Currently, we reported last quarter that we were at $281 per car on TradeRev. We project that, in the short term here, we can probably move to $300 on a per car basis. Our competitor is actually higher than $300, so we feel we've got room there.

If you compare that $300 on TradeRev to what we would get at a physical auction, this is about a $7,000 or $8,000 car that sells on TradeRev. At a physical auction, we'd be getting $325. As we get scale and as we get rolled out to more and more markets, we feel that, then, we can adjust the price. We will be in pretty much similar to what we would get at a physical auction.

Ryan: I think that's an important point because I think the investors, they remember the difference in profitability between open lanes, online-only, closed, for an off-lease car versus if it went to physical auction, you get all the ancillary but we're just talking about when the dealer car goes to physical. There's not much [inaudible] on that.

Jim: I think that's really important for you to understand, we provide a lot of ancillary services. Matter of fact, last quarter, we reported that we were able to achieve $882?

Eric: 882.

Jim: 882. Got to check with the CFO. We were able to achieve $882 of revenue per unit sold. That is if you take all of our cars sold divided by all of our revenue, that comes up to $882.

That money is really being generated by 50 percent of the cars because the heavy users of our ancillary services -- when I talk about ancillary services, I'm talking about transportation, inspections. I'm talking about paint, bodywork, reconditioning. I'm talking about windshields, tires, and glass, all the work that we do to recondition the vehicle.

The heavy users of those services are the OEMs -- the captive finance companies, the banks, and the daily rental companies. That's where that money is generated.

The dealers don't tend to use those services. Dealers with either do the work to the cars themselves or, quite frankly, they won't do any work at all because they're just passing it through the auction. They just want to liquidate it and monetize it as quickly as they can.

I think when you think about that, it's really pretty much going to be equal in terms of the revenue that gets generated on a dealer car, whether it's sold on TradeRev or whether it's sold at the physical auction.

Ryan: Thanks. Can you talk a little bit about CarsOnTheWeb, that acquisition in Europe? What attracted you to that market? We know that the market for salvage cars works so differently in Continental Europe than in the US but how does the whole car auction market work over there relative to here?

Are there other similar type companies out there in Europe or other geographies that you might like to acquire similar to CarsOnTheWeb?

Jim: CarsOnTheWeb is a platform where we're able to sell vehicles. They have a very unique offering or a very unique capability, I should say. CarsOnTheWeb has the ability to transact vehicles from Western Europe into Eastern Europe. That may sound easy. It's not like going from Indiana to Ohio, I'll tell you that.

When you transact cross-border from Western Europe into Eastern Europe, there's a lot of regulations that have to be accounted for. Number one is the VAT tax. Number two is you have to take care of the logistics in how the vehicles get shipped into different countries. That's what attracted us was their unique capability to sell cars from Western Europe into Eastern Europe.

Then, we felt that not only could we buy this platform, it's much like the platforms we operate here in North America. We could buy that platform and then, we could take our relationships from around the world and we could add those relationships to the CarsOnTheWeb platform and grow that platform.

CarsOnTheWeb is a relatively small company right now. This year, it'll sell somewhere on the order of 70,000 cars into Eastern Europe. Our plan is to introduce relationships and bring new customers to that platform and not only sell cars into Eastern Europe but have cars selling into the country in Western Europe. Selling more cars for more customers but not just in Eastern Europe but to sell them within country as well.

With that said, it's a big market. When you think about the car park in Europe, it's similar to the car park here in North America. As we grow that, we believe that there are other platforms that are in the market in other countries.

We would look to acquire those platforms and tie them into what we're doing with CarsOnTheWeb as well. It's a big world out there. There's a lot of cars. As we say, we're very much attracted to mature automobile markets with strong economies, stable economies, with a

strong leasing portfolio within those countries.

Ryan: Thanks. We do an investor trip to China every year where we meet with GM and Ford and the European and the Chinese automakers. We meet with dealers, with the rental car companies over there.

One thing that we've consistently heard is that there is this tremendous opportunity for leasing in that country but it's basically entirely untapped because there's no way to remarket the vehicle. Nobody wants them coming back to them. You're talking about a 25-million-unit market that could potentially be 30 or 35 million, in which leasing can go from much less than one percent to 20, 25...The numbers boggle the mind.

It just seems like a problem that is really ripe for a solution. I've, additionally, come to learn that a lot of these auction companies, maybe even your own, have people, full time, living in Shanghai. There's no operation there but they're studying or learning the market. We haven't seen any investments yet and I'm just curious, why?

I did, via some googling and talking to people, maybe Manheim went there earlier and lost their shirt or something like that? When might this change? Is it on your priority list at all?

Jim: You said it. It's a large market. It's going to be the largest car market in the world and it's going to be the largest opportunity but it's also going to be the hardest. We've studied many, many markets. Our competitor did pull out. Our competitor went in, invested a lot of money, and then, retreated and pulled out of the market.

We've looked at China. We've had numerous conversations. We've had numerous visits. We have developed and formed a lot of relationships, but we can't put China first on our list just because it doesn't have the infrastructure. It hasn't created that used car resale market. It hasn't created the regulations within the country to be able to remarket these used cars.

As we look at China, we look at it as number one in size and opportunity but we look at it further down the list, maybe number five, six, seven, in terms of priority. What we've done is we've prioritized other markets that we would do before we would go to China.

For all those reasons, and I think many in the room may have a lot more experience in the China market than what we do, but we feel that number one, we need to learn a lot. We need to understand that culture and that economy and what the, I guess, the rules of engagement are

before we invest to any degree. We have many people on the ground, but no investments made.

Ryan: Next question is -- I don't know if I'm allowed to get the answer to this but -- if China is five, six, or seven on the list and TradeRev is up here somewhere, what's one, two, three, four? What are the things to focus on before China?

Jim: Listen, the largest market is Germany. Think about it. Think about the number of manufacturers that are based in Germany and the size of the country. Number one, you got Mercedes Benz there. You got BMW there. You got Porsche there. You got Volkswagen there. You got Audi there.

All these manufacturers are right there. There's a lot of vehicles that are not only sold within Germany but there's a lot of vehicles that are exported out of Germany. These are no secrets. We're not giving you the keys to the castle here. Germany would definitely be the highest prioritized market that we want to go to.

Then, markets after that, we would certainly want to look at France. We want to look at Spain. We want to look at Italy. Further down the road, we want to look at China, outside of Europe. Then, we start looking at, maybe other economies. Obviously, we've looked at smaller, but Australia would be attractive. South Africa would be attractive. Then, we dream a little bit further on that list.

Ryan: Very interesting. Thank you. Check to see if there are any questions in the audience? Yes, sir?

Audience Member: Can you just clarify the plans for the capital structure that was announced briefly in the call?

Eric: That's [inaudible]?

Jim: No, we're looking at increasing the term loan B. We have a B4 and B5 that mature in '20 and '21. We have a revolving credit facility that expires in '21.

What we're looking to do is, probably, amend and extend. We'll upsize I've mentioned. We haven't sized it yet. We're going to look at the markets, upsize the term loan B, looking to have available cash for these acquisitions that are in our future.

We would put the cash on the balance sheet until those things come through. We'll size it towards the end of this month, is when we plan to announce, or right after Labor Day.

Ryan: What do the discussions look like at a management or board level? You're chairman of the board. Are you? You're not on the board. Jim probably fills you in.

Just between all these opportunities, Germany, France, Italy, Spain, and share buyback, including given the recent decline in your shares, you always have to balance those somehow.

Jim: Yeah, I think we are very conscious of the balance. Our capital allocation has pretty much been the same before spend and post spend.

We've always projected, we're a dividend paying company. We've always projected to pay somewhere between 40 and 50 percent of our free cash that we generate in terms of a dividend.

We look for accretive fact positions that give good return on capital. We're very disciplined and very patient in how we acquire those, with the parameters that we acquire with.

Then third alternative is there's always the opportunity to buy back stock. When we don't have acquisitions that are imminent or in the pipeline, and we're not looking to stockpile cash, we generate a lot of cash, we're not looking to stockpile it, we'll buy back cash.

As a matter of fact, Eric announced on our earnings call last week that we have an authorization of, I think there was a remaining $119.7 million left on the authorization. They announced at this quarter we would be in the market buying stock, and we are actively in the market buying stock.

Buying back stock is always an alternative to, after the dividend, after we prioritize acquisitions, then we can always authorize buying back stock. Eric.

Eric: Yeah, let me add, our target leverage is three times. We generate a lot of cash in this business, to the extent that we're using any capital raised with this transaction I just mentioned, we would not be looking to utilize that capital to increase our net leverage.

On a net leverage basis, we're targeting 3 times, we're about 2.8 times total debt now, a little room. Again, resources we'd use for share buybacks are predominantly the cash we generate in the business. We wouldn't use significant leverage at this time to accelerate that, once we saw a real disruption in the value of our stock.

Ryan: Very helpful. Won't everybody, oh, there's a question. Got some time. Mic coming, one second.

Audience Member: I would assume there's more hybrid vehicles making its way into the ADESA system? Are you learning anything that's different about this kind of vehicle heading into the auction system?

Jim: Yeah, I couldn't quite hear that. It was a hybrid?

Audience Member: Hybrid vehicles.

Jim: Yeah. I'm not sure if I got the full question, but I'll try to answer it.

We're seeing electric vehicles, and as we're seeing those come to auction, we're also having to adapt our facilities to be able to handle these vehicles in terms of different requirements and different tools and mechanics and people that work on these cars.

We are selling vehicles for a number of manufacturers that have the hybrids. Again, it's just another transaction for us. It's another vehicle, it's another transaction. We are a transaction-based company.

As I was saying earlier today, someone was asking me about the vehicles that we get and how concerned are we about vehicles we get. Bring us your vehicle. We just want to transact. We want to collect fees.

Ryan: Great, thanks so much. Won't everybody please join me in thanking Jim and Eric for the great color.

[applause]