KAR Auction Services

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Hamzah Mazari: Next up, we have KAR Auction Services. We have Eric Loughmiller, CFO, and Jon Peisner, Treasurer.

Thank you for joining us.

Eric Loughmiller: Thank you, Hamzah.

Welcome, everyone. We have 25 minutes. So, I'm going to give everybody an abbreviated introduction to the company and get right into a couple of majors topics that investors are talking to us about. And then, Jon will cover the financials.

But to introduce our company, KAR Auction Services operates, really, in three lines of business, three business segments.

ADESA is the used car auction business. This is wholesale, used car auctions. It's business-to-business. The buyers are licensed dealers in the various locations that we have. We don't do any auctions, really, to the consumer, unless required by law in certain states or provinces of Canada.

We had just over $1.1 billion of revenue, and adjusted EBITDA margin of 22.9%.

This operates in a duopoly, with about almost 80% market share shared between us and our largest competitor. We have 24% market share as of 12/31/13, and our largest competitor would have something between 40% and 45%. That would be Manheim, which is a subsidiary of Cox Media. Again, they're not public. So, we have to estimate. But it's about that, based on industry data.

We then also operate...

One more thing. And they operate in 64 locations in the US, Canada, and Mexico. So, they have 64 auction locations.

Insurance Auto Auctions is a salvage auction business. This is auctioning predominantly total-loss vehicles for the insurance companies. So, these are damaged cars.

And, again, it's B2B. We sell to licensed dealers, dismantlers, rebuilders, and scrap yards, where they're going to scrap the car body.

They had just over $800 million of revenue, with a 26.4% adjusted EBITDA margin.

And they operate -- the number keeps changing. I think it's 166 locations right...? 164. We move up and down depending on demand and locations and market share in certain regions. So, 164 locations.

And, again, it's a duopoly situation. There's a public company called Copart, which has a comparable market share. We estimate that we are just under 40% market share in the business. So, again, two players make up about 80% of the market in the US and Canada. Here, we are not in Mexico. We operate in the US and Canada.

And then, there's Automotive Finance Corporation, AFC, which is a floor plan financing business which provides floor plan financing to independent automobile dealers, as well as some of the dealers that buy cars at the salvage auctions.

It has about $225 million in revenue and a very high EBITDA margin percent, at almost 60% EBITDA margin, on this business.

And something unique about it, about two-thirds of the revenue are generated from fees, not from interest rate spread. So, this is a fee-based business. It has very consistent performance.

And currently, operates 104 loan origination offices in the US and Canada.

And has a portfolio with just over $1 billion outstanding on the floor plan loans, all to independent used car dealers.

The marketplace we serve is really made up of the cars on the road, the "vehicle park" as we call it. There's 275 million vehicles on the road in North America, which is really US and Canada. It's not Mexico, where it's probably a little different marketplace.

And within that, 45 million transactions occur in the used car marketplace. So, 45 million vehicles on the road will change hands annually.

About 16 million right now, 15 million to 17 million, new car sales enter the marketplace.

And about 13 million units a year are taken out of service, where they do not renew their registration. So, that's how we measure this, is through the DMVs.

So, you end up with a modest growth in this number.

Of the 13 million that go out of service, almost 4 million end up in the salvage auctions, predominantly total-loss vehicles, but also some end-of-life vehicles and even some vehicles that are the $500 trade-in value you get for the car that the dealer doesn't really want. They will take that car to a salvage auction to move it into a different part of the marketplace, for parts.

So, in the bottom-right of this chart, you will see the used car transactions. Of the 45 million, 13 million are going to be C2C, a consumer to a consumer. That would be...think of eBay, Motors, Craigslist. You're going and listing a car, trying to get a consumer to buy that car at a retail value.

And 32 million of the units change hands through the dealers, or in a wholesale-to-retail world. Of those, 8 million to 10 million occur in our marketplace, which is ADESA, and another 20 million to 22 million are occurring from other transactions: trade-ins, dealer trades amongst themselves, buying directly from a wholesaler, not using the auction format.

What's interesting about this is a lot of people say, "Well, what would happen if they disintermediate you?" We are when the car can't change hands any other way. This is aged inventory, dealer trades.

And, again, I'll use an example. If you have a Honda dealer and someone trades a Toyota in, he's not likely to want to retail a Toyota on a Honda lot, because if you love the car, what are the chances you're going back to a Honda dealer the next time you want to buy a car?

So, they're going to wholesale that car and get it into the marketplace through an auction.

Aged inventory. You might take a car in trade and you say, "Hey, it's been 60 to 90 days, and nobody's looking at this vehicle. My market isn't interested." They'll take that to our auction environment.

So, it doesn't mean the car wasn't in another part of the channel. It means that they could not retail the vehicle directly from their lot in some manner.

I'm going to go straight to, really, the story of KAR Auction Services around a cyclical recovery that is occurring in our industry at ADESA.

We've gone through a difficult time period from 2008 through 2012, in which we saw bankruptcies of OEMs. We saw a meltdown of the financial services market, where loans went away, leases disappeared for a while. We worked all the way through that, and now, as you can see from this chart, we are starting to see the recovery of the volumes back to traditional levels.

The good news is KAR as an entity was able to hold its EBITDA from 2007 to 2008, and increase its adjusted EBITDA and free cash flow every year following 2008, despite the trend you see in our largest business unit.

So, we're a very resilient company with our services that we offer across the platform of our customers. But more importantly, we're now entering a period where our largest business segment will begin growing through volumes that were predetermined by activities, in many cases, three years ago. And I'll get into what that is.

That's the off-lease sector. So, this is predictable. We at the beginning of 2013 estimated that our industry would sell 8.7 million units. And here we are at the end of the year, and it's 8.7 million units.

This is a very predictable...there's a couple of things I'd highlight. The new car sales have a direct relationship to some of the activity in the auction today. When a car is traded in for a new car transaction, there's a reasonable likelihood that a portion of those cars will end up being sold wholesale. So, that's today.

And we have a very good trend on new car sales right now. We've been steadily increasing the last two and half years, and they're predicting about 16 million, or maybe a little more, in new car sales for 2014. So, a very positive trend.

On top of that, we have new car sales through lease transactions. The average lease term is three years in the United States. Three years later, the car will have 40,000 or less miles on it, and it will be taken back to a dealer, unless it's bought by the consumer or the grounding dealer, and ultimately end up in a marketplace that I'm going to describe in a few minutes.

That is a big driver of the cyclical recovery, is the off-lease vehicles bottomed out in 2011 and 2012, and you can see on this chart where the industry volumes dropped and are now recovering, and we will have steadily growing off-lease volumes all the way through 2016.

And based on this year's predictions, it will continue beyond that, again, as more leases are being written and at the end of the lease the car gets returned to the wholesale marketplace.

In 2011, we acquired an entity called OPENLANE, to combine it with our ADESA offerings for private-label sites provided to the OEMs and the captive finance companies.

We are the clear leader. We have 90% of the OEMs and captive finance companies in the United States, and 100% in Canada.

We operate all of these sites, private label, for these dealers. And what is sold on the private-label sites? It is the off-lease vehicles, because at the end of a lease, you will have an independent inspection of the vehicle to determine how much of the security deposit will be returned. They will take pictures of the vehicle for the captive finance company.

And when you return it to the dealer, it can be uploaded onto a private-label site and sold to other franchise dealers of that brand, for two to three days. It's a chance for them to sell the vehicle before it gets into a broader marketplace.

And again, three-year-old inventory, less than 40,000 miles, very common to CPO these vehicles, which is a marketing tool for used cars. This is a very attractive car. There has been a shortage of these for the last three years.

So, that is sold in the private-label sites.

After that two to three days, through adesa.com powered by the OPENLANE technology, we get the right to sell it to the entire marketplace for another two to three days. That's the online-only open sales.

And while we get very little revenue...you can see the auction fess at the top of this funnel on the left side of this chart start at about $120. That's the average for the online-only venues.

The online-only private label is about one-third of the fees we get on the online-only open, for just those two to three days. And the reason is, we do not get a buy fee in the private label site. We get the same sell fee. And when we go to open, we get a buy fee and a sell fee.

If it doesn't sell in that five- to seven-day period where it's offered online only, it ends up at a physical auction. The off-lease cars that do not sell will end up at a physical auction, because the captive finance companies are not allowed to sell directly to consumers, by laws and by their franchise agreements.

So, it has to go into the wholesale marketplace. It now will go into either ADESA's physical auctions sites or one of our competitors.

The relationship of ADESA, in blue here, to the gray competitors is intentional. We get, again in rough approximation, about one out of three of the off-lease cars that make it through the online-only venue will end up at our physical auction versus one of our competitors. That's just roughly our market share for the broad base of cars that come off lease.

So, you can see...but when it gets to physical auction, you can see on the left I can drive that revenue to $650 per car.

These are actual numbers out of our 10-K. The online-only was $118; we rounded it. And it was $651 for the physical auction, average revenue per unit generated for every car sold from our physical auction site.

And the reason being, the car did not sell online because of probably some damage. Probably something wrong with the condition, where it was not easy to buy that car sight unseen from an online venue, where it's sitting somewhere and you're just going to go pick it up and it's yours.

We do reconditioning. The $651 reflects reconditioning: body work, mechanical work. Anything disclosed on that vehicle that needed repair, we can do that work at a very low wholesale price on behalf of the consignor.

We also...when you're at the top of that chart, you probably have 2,000 to 3,000 franchise dealers eligible to buy that car. And for two to three days, you open that up to a broader spectrum, but not very many of the independent dealers.

At the bottom, there are 40,000 independent used car dealers engaged in this part of the wholesale marketplace every week. They're buying. This is where they get their inventory for that independent used car dealer space.

There's 18,000 franchise dealers, and about 40,000 independent used car dealers.

So, this is the big topic everybody is asking about. "Is there a secular change occurring, where cars are going to be sold online?" And the answer is, no.

The answer is, with the shortage of vehicles, the lack of three-year-old or less used car inventory, the franchise dealers have been dying for that inventory. We are just in the early stages of this recovery. Naturally, they're going to buy a higher percentage early on. They've been starving for this inventory for the last three years.

But as more cars come back, which they will in 2014 and even more in 2015, the current information available from the national retailers that are public companies is their average used car inventory is up to 60 days of sales.

They're going to run out of capacity to store these cars, as they did in 2009 when there was an abundance of vehicles as well. And these cars will end up further down this funnel, generating more revenue for us and getting more of these cars spread out to the broader marketplace.

So, again, it's a thesis today -- it's a hypothesis, actually -- but it's happened before. And at that point, there is a capacity.

Also, with new car sales increasing, the three-year-old off-lease vehicle is the only used car that can compete with a new car sale in terms of quality, condition, and the options available on the vehicle.

So, at some point, the trade-off is going to be, "Do I carry more used car inventory, or do I try to sell more used cars?"

So, we're pretty confident that as more vehicles hit the supply, more will get down through the funnel, generating a higher ARPU, as they're calling it, especially in New York, and that will be good for our business.

So, it's a growth story for the next several years, in a mature business that has excellent cash flow characteristics that I'll let Jon cover.

I'd like to just quickly...the salvage business is an unbelievably strong business, despite the fact that we read about the Manheim Index declining, the Cantos -- I call it the Cantos -- the relationship of used car prices to new car prices has been declining. So, that's the ADESA analytics ratio that we monitor.

We've seen proceeds, or the values paid at auction, for salvage vehicles hold fairly steady. They're declining, but declining low single-digit percentages year over year. And it's because of the demand by the collision repair industry.

Fourteen percent of insurance claims, auto insurance claims, result in a total loss. That math works means one out of every seven accidents that result in a claim will be a total loss.

So, if you think about our business, 70% or so of these vehicles will end up dismantled for parts. Each one car that's sold as a total loss must supply the parts for six cars that are being repaired by the insurance company through the claims process. We all know that the supply-demand characteristics of that relationship is quite good for holding values up.

More importantly, the collision repair industry will tell you the lowest cost part that they can acquire is the after-market recycled part, and the LKQs of the world and their competitors will tell you, "Not only is it the lowest price, but it's the highest margin part we can sell."

So, it's a rare situation where my lowest cost part has the highest margin to the supplier of that part, the highest margin to the collision repair shop, and its alternatives are higher cost, less margin for both of them.

So, it's interesting. That's what's really...that's really fueling the demand side for the salvage industry, which has remained quite strong since, really, 2009, and it will continue to be strong.

We're nearing 40% of all parts used in the repair of vehicles by the collision repair industry are after-market recycled parts coming off of salvaged vehicles.

The other business, AFC, again, just a strong performer. This is, again -- I mentioned earlier -- a fee-based business. Very high profitability. Very strong credit characteristics.

This is floor plan lending. We loan per vehicle. This is not a revolving credit, not a credit limit where you have to keep a certain loan to value.

We loan for each car, and when you sell that car you must pay off that loan. They are loaned 100% loan-to-value on the wholesale value. We use the retail spread as our cushion against that.

And we have gone through, since 2008 and 2009 when there was a complete disruption of the market -- a lot of used car dealers went out of business, a certain amount of fraud where they were selling cars and taking the cash and disappearing.

Since then, there's been very low credit losses. And over the course of the last 30 years, there's been very low credit losses, except for that one, about a six-month, period of time that really covered from August of 2008 through February of 2009 where there was so much disruption.

But, again, it's an asset-based lending business. We do a lot check on each of our dealers that has a floor plan outstanding every six to eight weeks. We are actually touching the collateral ourselves through a subsidiary called AutoVIN, a part of ADESA.

These dealers, well over 80% of the vehicles that we floor plan are bought at auction, our auction or a competitor, which means there's a current value determined in a marketplace.

So, all of this lends itself to a very low-risk transaction, as long as the car exists on the lot of the dealer or is paid off as soon as it's sold.

We have an experienced management team.

We've had really excellent growth the last three years. And one of the things we're looking at, with the acquisition of Preferred Warranties, what other products can we offer to this dealer base through our distribution network that would be of value to them?

So, with that, I've introduced the businesses. I'm going to ask Jon to give you some highlights of our financials. And we'll have a few minutes left for questions.

Jon Peisner: Great. Thank you, Eric.

Let me go through this very quickly.

This slide gives you a nice overview of our financial performance over the last five years, and you can see that despite an industry decline of about 400,000 units over the last five years, that we grew our revenue by 25%; we expanded our gross profit margin over 200 bps, to 44.5%, which excludes the impact of super storm Sandy; and we grew adjusted EBITDA by over 25% and adjusted EPS by almost 60%.

Let's talk quickly about our leverage. Bottom line is our business throws off a lot of cash, and we're focused on leveraging our balance sheet to continue to support our growth.

A couple of quick comments on the capital structure. Net leverage is now at our target ratio of three times net debt to adjusted EBITDA, which is down significantly from our 2009 IPO.

Our current capital structure is L+2.75, with a LIBOR floor of 100 bps. There's also $1.2 billion of interest rate cap on that.

And, as we announced on our earnings call in February, we are in the process of doing a credit refi, and as soon as we have something to announce in that capacity, we'll keep you all updated.

So, last, before we take some questions, again, this slide pictorially represents our greatest investment attribute, which is having a business model that throws off a significant amount of free cash flow.

And we're going to use this free cash flow, first, to evaluate strategic opportunities for profitable growth; second, to return capital to shareholders in whatever form that may take; and lastly, in the event that there's not an opportunity for the first two opportunities, then you may see us temporarily de-leverage.

And with that, Eric and I would be happy to answer any questions you may have.

Hamzah Mazari: Maybe I'll start off the Q&A. Could you give us a sense of what kind of sensitivity your business has to used car pricing? Is it to the Manheim Index? Or, whatever metric you want to use?

Eric Loughmiller: Good question. Essentially, and nothing's 100%, but we have very little sensitivity to used car prices, because we're a transaction-based business. We draw a fee from the buyer, a fee from the seller. We use fix-tiered pricing.

So, yes, it could have a minor impact, but the truth is it's more the number of transactions.

What typically drives prices down in the used car marketplace is supply, and more supply means more transactions. So, I would argue they offset and, in fact, I'd say they almost more than offset. More transactions is actually more valuable than a higher price on the car, as proven...

We have a unique business. We've actually stress-test our business. We did an LBO in 2007, raising about $3.7 billion at about 6.7 or more times levered.

We've paid back over $1 billion in debt. We've gone through the biggest decline in all of our...in 2008 and 2009, it was more in the salvage business. We saw a 60% reduction in the average price paid for a salvage vehicle very temporarily. We saw the leasing industry shut down. We saw no ability to finance a car transaction.

And yet, our model worked in that environment. When we did the LBO, I'm proud to tell you, you did your typical, what if there's a 25% drop in this, 10% here, 15% there?

What we experienced was greater than any of our stress tests, and our performance far exceeded even our most bearish case scenario, because what we found is we are such an integral part to the marketplace.

We became a higher value transaction under stress, as opposed to a commoditized transaction, because we created liquidity, whether it be for the rental car companies, the captive finance companies, the OEMs at a point where liquidity was critical when their capital structure was under pressure.

So, I would tell you, the answer is numbers of transactions is more important to us.

There's always limits. A 25% drop in used car prices within a week would be disastrous temporarily, because I would have an AFC business that would probably have underwater loans that people would react to.

But even that was such...our model self corrects within weeks not even months, because, again, these variable start...prices would drop; the new loans would take over; we'd make our money and figure it out. And we'd just go get the collateral and try to mitigate the loss.

Other questions? Yes.

I think she wants to...we are probably webcasting this.

Unidentified Audience Member: During the downturn when transaction volume decreased, were you able to maintain your margins by increasing the fees? Or, were you running leaner operations in SG&A?

Eric Loughmiller: Good question. All of the above. It took all.

We were able to increase fees, because the transactions became...getting a car was such a premium for these dealers, they would pay more.

Very important in the ADESA business, our total fees represent less than 4% of the transaction value today, and it was even less earlier. So, we have a lot of room as we demonstrate value to gradually increase those fees.

Second, though, the entire industry but especially our businesses focused on leaner operations. There's one thing to do it because we want to pay down debt and we did an LBO transaction and our customers say, "Hey, you're just doing it for yourself."

It's another thing when they said, "Okay, the market is really disrupted. We don't know how it's going to be. Becoming more efficient is critical. All of us need to be more efficient."

If you're more efficient, they then will get a better transaction. It actually will result in more proceeds to them.

So, it worked out for everyone. It was, really, a good situation for the entire industry, and I think it was a sum of the two.

We operate in responsible duopolies, at least to date. So, that's the good news, is we're not in...the race to the bottom has occurred on the consignor fees, and now we're in a situation where, really, it's about, "Hey, there's two of us. Let's not beat each other up."

Again, pricing is competitive, and it's on the buy-side, not the sell-side. And the sell-side is where you get the cars, and the buy-side will pay whatever they take to get the car.

So, the fee pressure is actually measuring on the buy-side, and the sell-side is pretty much at the level I think it will be for quite a while.

I think that's all the time we have. Thank you.