

KAR Auction Services, Inc.

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David: Up next, we have KAR Auction Services which I'm sure you're all very familiar with. I have Michael Eliason and Ryan Miller joining us from the team today, so thank you both.

I'll kick it over to Mike. I think he's got a few slides to walk through, and then we'll open it to Q&A which I'm sure there are plenty. Thank you.

Michael Eliason: Thanks, David. I'll go through a quick overview of the company and then we can jump into Q&A for sure. If you look at a brief overview of the market positions that we're in and the companies that we operate, we operate in three main segments at KAR Auction Services.

The first one is branded ADESA which has whole car markets or used car options, where you have dealers, captive finance companies, OEMs, rental car companies -- those types of customers buying and selling cars in our marketplace.

We have a number-two market position with the number-one leader in that market being Manheim which is owned by Cox Automotive, or Cox out of Atlanta. They're a private company with the two leaders in that industry with being Manheim and ADESA. They have a 70, 75 percent market share between the two of them with ADESA selling the bulk, a little over 3.2 million units in 2017.

In 2017, one of the important points for you for ADESA is last year, we sold about 45 percent of the vehicles being sold were sold to an online buyer. So far for the first half this year, that's over 50 percent. One of the changes that is happening in our industry is the digital transformation.

More and more customers, whether they be a dealer or a captive finance company or OEM, are getting comfortable transacting online. There's been a great opportunity for us not only to gain share with the digital transformation but able to provide more services around the digital transactions that are happening in our marketplace.

We still have physical footprint within the ADESA business. There are 75 physical locations throughout North America. Many of those on average are 70 to 80 acres, so we have a significant physical footprints to marshal the cars no matter what happens in economy as we move forward.

The second segment is insurance auto auctions, which provides salvage auctions largely for the insurance industry. When an insurance industry totals out a car, they will use a salvage auction industry to liquidate that asset that they own as they get that from the consumer when the car is totaled out.

In that marketplace we have a co-leadership position of about 40 percent market share with the other leader in that market would be Copart which is a public company.

Between the two, we have what, 80 percent market share between the two of them. There's a lot of secular changes happening in that industry, driving growth. One of those is, again, there's been more cars sold online. A little over 60 percent of those cars are sold online.

The main difference between the main competitor of IAA which would be Coparts and IAA One is IAA leases its facilities. Copart owns its facilities, so if you look at the margin profiles between the two businesses, you'll see a difference in COGS because of the lease expense.

In addition, there is a difference in COGS because IAA hosts live auctions, and also simulcast all vehicles on the physical auction site. So you have about 150 bids of revenue being expended on hosting a live sale with auctioneers in setting the sale. As a result, there is different margin profiles between the two companies, largely because of that.

In that business there are smaller locations and more locations. Throughout North America there is over 170 locations. Throughout North America, generally those are at 20 to 30 acres instead of the 70 to 80 acres there are in the whole car business.

Supporting the two auction businesses we have a four-plan finance company that's providing liquidity in our auction lines, so our buyers can buy more cars and more cars at a higher price. But it's a very unique type of finance business. We're providing more planned lending, specifically to independent used car dealers that are buying cars in our auction industry, and is very short-term in duration.

There's 60- to 65-day loans. They're secured by the specific vehicle, and loans are vehicle-by-vehicle in basis. We get a personal guarantee from the owner of the dealership where we have lots of assets to go after, if something happens with that loan. We're also expending a significant amount of resources mitigating that risk, and as a result, we have very low credit losses in that business.

One of the ways we mitigate that risk is having loan production offices in over 120 locations in the communities where our dealers operate, where we can shake his hand, and understand the success of his business.

We also do over 80,000 lot checks every year where we show up at the dealer's lot, unannounced, and check to make sure that the collateral that we are using for supporting the loan is in the condition it's supposed to be in, and is in the position it's supposed to be in as well. So it's a very unique business in that respect where we're spending more money to make sure risk is mitigated.

All that to be said, we sold over 5.5 million units last year and earned revenues of about $3.5 billion. We move on for you, for the investment profile, and what KAR Auction Services looks like for you as an investment opportunity. We operate in a very unique industry, where we're standing in the middle of buyers and sellers in generating fees for that.

It's a consignment revenue model. As a result, there's consistent free cash flow in that business. We're not using capital to invest in inventory or raw materials. As a result, with creating a liquid marketplace for our customers, we'll see here in a couple of slides, there's been a very consistent free cash-flow generator.

In addition to that, many investors like the visibility of the sources of supply of our business. If you look at leasing, which is a significant portion of the supply of our ADESA business, you can see how many off-lease cars are coming back into our marketplace. Experience says the average lease term is roughly 36 months.

You can count the number of lease originations that happened in any one year, and count three years later, and have a good sense of how many vehicles are coming back into our marketplace. If something happens in the economy, as it did in 2008 and 2009, we have time to then adjust our business model, to make sure that we're still generating the free cash that we need for our investors.

For our growth platform, like I said before, many of the vehicles are transacting online instead of at a physical auction now. We're investing significantly in different technology platforms, to make the customer transactions more efficient. We're also investing in data analytics, to be that trusted business adviser for our customers, so they can maximize their portfolios.

For our buyer customers, our dealer customers, we make sure they have the right portfolios in inventory on their lots, to be able to sell cars in their local communities. Finally, with all that free cash flow that we generate, we have a shareholder-friendly capital allocation program, where we're allocating approximately 45 to 50 percent of our free cash into a re-occurring dividend.

The next priority would be in strategic investments or acquisitions. If there's not an acquisition or strategic investment imminent, we are in the market buying back shares, as we have in the past couple of quarters, and we announced that we would be in the current quarter.

If we move on to look at the markets that we serve, we serve a large total addressable market. There are almost 300 million units on the road in the US, in Canada. There's about 20 million new car sales coming into that, and about 13 million units that are de-registered every year.

Of those 13 million units that are de-registered every year, the salvage auction industry processes well over 4 million of those units, largely to a total loss for the insurance industry. Of those 300 million units that are on the road in North America, a little over 40 million used units changed hands every year.

There are many different ways that those have changed hands. One is that consumers transact amongst themselves. You can think of platforms such as Craigslist, or eBay Motors and like, where consumers transact amongst each other. That's not necessarily our business.

Of the remaining retail used transactions, franchise dealers and independent dealers facilitate those transactions. Where do they get their supplies, so they can sell cars to consumers? One is through our traditional legacy whole car auction industry, which should be served by ADESA.

The other source is through trade-ins, that they may retail themselves. They transact dealer to dealer amongst themselves, or they may use a wholesaler. We bought a technology company platform last year called TradeRev, that services a portion of that dealer-to-dealer market.

In that special platform, TradeRev provides a 60-minute flash auction for a franchise dealer who is looking to take price year trade in, as you're trying to buy a new car at his franchise dealership. We provide a platform where they can get quotes, and real quotes with real money, from dealers in his marketplace.

He can value his trade as what's happening in the marketplace during that day, instead of looking up in pricing guides or calling his friend on the street or calling a wholesaler that might have to earn a margin on that quote that he gives. We're finding significant traction in that new business and investment that we entered last year.

If we move on to look, like I said before, there's a long history of the whole car auction industry. The chart that you're looking at goes back to 2002. It may go back many years before that. It's a very stable industry where before the recession, we were selling 10 to 11 million units for a large number of years.

The recession came. We built some technologies to earn a higher penetration of share by facilitating some more off-lease transactions that were done in-house by some of the land and captive finance companies.

Now, we're selling about 11 million units in the industry. We've been able to not only consistently earn a return on the opportunity of the industry, but we have been able to grow the industry by investing in different technologies.

If you look at how we're making money from those opportunities, like I said before, we're a consignment- or agency-revenue model. We're taking fee from the seller, taking a fee from the buyer, and more importantly, we're providing services around that transaction.

I think that's one of the most misunderstood points about our business is that even though many customers in our marketplaces are asking for more transparent and more efficient transactions with online transactions that may have a lower fee opportunity, we continue to provide more services to those customers, and our revenue per unit has continued to grow as we have gone through a digital transformation in our industry.

All that to be said, as these fees are earned either as auction services or ancillary services, we've been able to generate free cash because again, we're not investing in inventory or raw materials to build a product. All that earns about $600 of revenue per unit at the ADESA business unit.

At the salvage business unit, IAA, there's less ancillary revenue opportunity than there is in the whole car business. That's why the insurance auto auctions has a little bit lower revenue per unit opportunity, but a great business model because of the free cash and the agency- or consignment-based revenue that the business has set up.

Within the whole car market, there are a bunch of fundamentals that are driving growth at ADESA. One is as we came out of the recession, there was more new cars being sold. More of those cars were being financed through a lease term.

A lease choice of financing has a high propensity to go through our auction industry. As a result, if you look three years later after lease origination, there's more and more off-lease cars coming back into our industry. You can see from the charts on the top left that we have good visibility through the next couple years for off-lease vehicles coming back.

Similarly, repossessions are a big part of our industry as well. Even though delinquencies have been fairly stable in the auto credit markets, total outstanding retail auto loans are at historical highs of over $1.1 trillion. A number of those default. We still see growth in repossession activity.

Some of those off-lease and repossession cars are displacing some of the dealer-consignment cars that are sold by dealers because dealers are the most price-sensitive sellers in the marketplace.

All that being said, our total volumes in industry continue to increase. The mix of where those vehicles are coming from ebbs and flows depending on where we are in the cycle and the economy. Right now, we're in the cycle where there's more commercial sellers in our marketplace versus dealer sellers in our marketplace.

All that to be said, that the average vehicle age and the average vehicle value that's being sold in out marketplace

increases, which supports not only revenue per unit on the auction services but the commercial seller also has the highest propensity to use our ancillary services. As a result, like I said before, our revenue per unit continues to grow in the ADESA segment.

Moving on to some of the growth drivers on insurance auto auctions, there are also some secular changes that are happening in not only the automotive industry as you're well familiar with since you're sitting here today at a automotive conference.

Vehicles are becoming more complex, which means that vehicle repair costs are increasing. If you talk to people in the collision repair industry, the number of parts per repair is going up, the number of labor hours per repair is going up. Labor costs in that marketplace are going up, which means a higher repair cost for the vehicle.

As that repair cost becomes higher, there's a higher likelihood that car is going to be totaled out and go through our industry. We're seeing volume growth not only from the complexity of vehicles.

Also, the age of vehicles is going up. An older vehicle has a higher propensity to be totaled out as well. Even though some people in the industry see miles driven moderating, there's still significant opportunity for volumes to grow in that marketplace.

Then, finally in ASE, like I said before, it's a very short-term-type of financing business where we're really providing liquidity for our customers in their salvage auctions for our buyers. It's not necessarily a growth driver of our business. It's there to support and provide another service of the many services that we provide for our customers in the marketplace.

You can see we have a long history of growth in that business. After the financial recession, very low credit losses as we've tightened some credit standards post-recession. Very unique and as a result of it being unique, we've been able to earn a nice return on that business.

Just a couple more comments before we open it up for question and answer.

We've been investing, like I said before, in technologies and also data analytics. You can see some of the assets that we bought over the last couple of years, one being TradeRev like I mentioned before.

Earlier this year, we bought a technology platform called Stratum, which is a platform for fleet owners. You think of how mobility may change in our economy over the next number of years where fleet owners will own more cars instead of consumers own more cars.

They need services done to their cars on their fleet, whether it be fixing a tire, fixing a windshield, moving that car from one part of the city to another. Stratum provides that platform to get those services completed for them.

We are very focused on technology platforms where we can earn a fee instead of owning the actual service itself in many cases. That happens with a number of these other type of technologies that we bought along the way, whether it be RVN or CarsArrive, which is a technology platform for transportation where we're marrying shippers and transporters together in a similar manner.

Then finally, like I said before, many investors appreciate the strong and visible growth in our business. We even say that, for example, in the salvage auction business, that volumes for the next couple grows should grow in the five to seven percent range because of the visibility we see and total losses, similarly for ADESA with off-lease and repossessions continuing to grow.

We see the mix of vehicles continuing to shift from commercial to dealer consignment, but we're not quite there yet. We have opportunity to gain revenues through that mixed shift. All that to mean that our capital allocation philosophy is, again, having 45 to 50 percent of our free cash flow being allocated to a reoccurring dividend.

The next priority would be for strategy investments in acquisitions. If strategic acquisition or investment is not imminent, we have been in the market buying back shares to make sure that we're allocating capital back to you as an investor.

David, we'll leave it there as an introduction for KAR Auction Services, and open up for questions.

David: Great, appreciate it, Mike. Happy to open it up to Q&A. If you have any questions, feel free to raise your hand. I see one already, so go straight to the audience, and I'll follow up.

[off-mic question]

Mike: The manager of their fleets is very important to them. For our industry, rental supply is generally less than 10 percent of our industry. ADESA has history been underweight from a market share perspective. We still see many, many rental cars, but it's not a significant portion of our business.

[off-mic question]

Mike: Yes. Generally speaking within the industry, approximately 25 percent of the volumes are sourced from off-lease. Think of the captive finance companies and fincos. Approximately 15 to 20 are repossessions, which you can think, again, the captive finance companies and the fincos, some OEMs in there. Then the remainder are fleets.

Think of in there, that would be rentals. Then you also have OEMs with company cars, some fleet owners, that type of thing. Then generally, half of the vehicles, depending on where you are in the cycle, would be dealers who are selling cars.

David: Mike, a couple questions from my end. You mentioned you're continuing to provide more services on the digital side of the ADESA platform. Is that an opportunity that you see in TradeRev? It's still early days, but love to get, if it's a flash auction.

I don't want to say a split decision, but a 60-minute decision, and probably a quick move. The vehicle itself is probably going somewhere else in market, so to speak. Are there some ancillary services that you can tack onto that transaction?

Mike: Yeah. If you think about an online transaction, the most obvious service that can attach is transportation. Again, we have a transportation technology platform called CarsArrive. If a buyer is out of market and needs that car transported to him, he's going to use CarsArrive to ship that car, and find a transporter who has an empty slot on his truck.

If he's moving from Jacksonville to Atlanta, or something like that, and there's an extra spot on his truck, he's going to look on the CarsArrive platform, utilize his full trailer, and get that car shipped to the buying dealer for a fraction of the cost he would if he had to do that in another method.

We're getting a fee on that transaction. Similarly, if the buyer is an AFC customer, they can use AFC financing, would be another one. Similarly, we have other types of ancillary services. We have a significant key cutting business.

You think nowadays with key fobs being technology-oriented, that car only has one key, and they need two keys to sell the car, they're going to use to cut that key for them, those types of things. Many types of services, and it may not even be around the specific online transaction.

It may be just because they're a customer of ADESA, CarsArrive, or high-tech locksmiths, as an example, where we're going to that local dealer and cutting keys for them, no matter where they're sourcing the inventory from.

David: Thank you. As a follow-up on TradeRev, and just contextualizing the volume opportunity there, I guess A, the market share. Is this more the wholesalers that you see the volume grab ultimately coming from?

Is it the, like you mentioned, the very old school, the guy calling his buddy across town who owns the other Honda dealership? How do you parse out the opportunity of what's essentially existing volume already?

Mike: Right. We've sized that opportunity of additional total addressable market of 5 to 10 million units, and somewhere in that range. It's a bit nebulous of putting a specific number to that. If you think of a dealer taking a trade-in, he can retail that car.

That would not necessarily be a transaction for us, but there are many transactions where he took that trade-in, and then sold it to a friend on a street, sold it to a wholesaler. Those types of transactions, we've looked at, and said the total addressable market could be in that 5 to 10 million range, that above and beyond our historical market.

David: Is there any concern of some cannibalization of some of the physical, your more traditional...?

Mike: For sure.

David: Ultimately, I'm assuming the offset is that 5 to 10 million is nothing to sneeze at, that it's worth it. Is that the viewpoint going into it?

Mike: Yeah. If you think historically, if a dealer took a trade-in, he could retail itself. He could sell it to his friend on the

street, could sell it to a wholesaler, or he could have historically brought that to a physical auction.

That would cannibalize the physical auction dealer consignment business. What we've seen so far in the markets that we've penetrated in is that cannibalization has been lower than anticipated, which is a good thing.

That's not to say that it would cannibalize more in the future, but we think there is opportunity more than offset, like you said, by the additional total addressable market. It would cannibalize a small portion of our business.

David: The go-to-brand strategy, or go-to-market brand, is it TradeRev via ADESA, or is there some sort of attachment? What I'm getting at is, clearly you have very strong relationships with the national independent dealer base, and a lot of the franchise guys as well from the ADESA side.

I think that's a pretty obvious open door you can use to add on or inject this TradeRev opportunity. How do you go in -- and I think you mentioned you were at NADA this year with TradeRev -- what's the strategy to penetrate the market?

Mike: We do use some of our ADESA resources to penetrate new markets. More importantly, we're going after markets where we're not in, for example. We're only in about 77 markets in North America. That's means there is many significant MSAs that we're not in, and many customers that we're not doing business with.

That's where we're seeing significant success up to this point, is doing business with those customers that maybe have not done business with us, or not in the way that they could have in the past.

David: Great, thank you. A couple questions here.

[off-mic question]

Mike: A commercial seller has a higher propensity to use our on-premise ancillary services. Lloyd and some of you guys that have been to a physical auction, I encourage you to go to an auction, if you get a chance.

Our ancillary services on-premise are very focused on getting a car retail-ready for that dealer as he buys a car. If you think about dealers that are maybe here today or that you talk to, they don't have the luxury anymore of buying a car, and waiting a couple weeks to get it reconditioned.

We provide services to get that car reconditioned before he buys it. Our reconditioning facility is focused on body work, and that would be light body work. We're not doing major, if a car gets totaled out on one side of the car, getting that fixed.

We're doing light bumper work like light dings, dents, and that sort of thing. Light mechanical work -- think of batteries, tires, oil changes, that sort of thing. We're not doing engine overhauls. We're not doing transmissions.

Because of our focus, we're having and transaction for those reconditioning services that are a fraction of what a retail facility could do it for. You can think of our reconditioning facility as almost being like a manufacturing plant. We're doing hundreds of bumpers a week, instead of doing one or two bumpers a week, that maybe a retail facility would do.

As a result, we're doing that for that seller. The seller's paying for it. The buyer, when he buys that car on a Thursday, he can put that car on his website on Thursday night, and sell that on Friday. Time is money for him.

[off-mic question]

Mike: Yeah, we have national contracts in place with suppliers for that stuff. Correct.

David: We have a question at the front here. Right in the front, and then we'll move our way back.

Audience Member: Thanks, Mike and Ryan. It just seems like over the last 10 years, you've gone from an auction company to a logistics technology company. With that in mind, more recently, Driven was purchased. Could you explain exactly what that is, what the opportunity is, and how it works? Thank you.

Mike: If you think about a customer, even if it's a large OEM, or large captive finance company, they have great data on their portfolio of assets, but we have data on the industry portfolio. Much broader data sets, we have access to retail data, and as well as other data.

We're being able to be that trusted business adviser, not only for the seller, to be able to tell them what market to sell that car in, what reconditioning provides the greatest return for them, but what pricing they should set the car in to maximize

the total value of the portfolio.

Some cars may have been sold historically for not enough money, and they may have asked too much money for another, and let it sit too long on their lots, where time is money. Similarly, on the buyer side of the equation, if you think about the number of cars that a dealer has access to with our industry online, there are millions of cars that they can look through.

We're providing analytics and doing analytics for our buyer customers to give them targets, where we can send them an email to say, "These three cars in your community, because we know your profile of your business, and we know what's selling in your community. These three cars would be good for your inventory today."

Doing that, to be that trusted business adviser now. The second question is how you monetize that.

[laughter]

Mike: One would be market share, it being able to earn that business that may have gone to maybe an independent auction, or something like that. Secondly, over time, if that customer chose to use our analytics and chose to maybe use us to sell that car, then we would try to monetize that in a subscription, or something like that in the long term.

That's more of a long-term play right now. Question.

Audience Member: What impact has the consolidation of the dealer network, big national chains with dealers, and the disappearance of a lot of the independent local dealers, what effect has that had on your business?

Mike: It has an effect, because the dealer and buyer network has become more sophisticated as those buyers have become larger. All that to be said, if you look at...I think Automotive News puts it out, and David would have the statistics.

If you take all the public retailers together, and that would include CarMax, they make up less than, I think, it's four percent of used retail sales. If you take the top 100 dealers altogether, it makes up, I think, less than eight percent of all retail sales.

Although consolidation is a phenomenon that's happening in our industry, it hasn't materially affected our business yet. It could in the future to get to your question. Many of those customers are good buyers and sellers in our marketplaces as well.

Audience Member: What about the consolidation, new car dealer who are [inaudible] the lot?

[crosstalk]

Mike: Remember, we're a used car transaction platform.

Audience Member: [inaudible] .

Mike: Correct. That's what we were saying is the new car dealer would be those public franchise dealers or the top 100 franchise dealers that are new car sales. They have a portion of the used car marketplace. Remember, from the slide up on top there, you can see there are over 40 million used car transactions that happen every year. It's much more fragmented than some people realize at this point.

One of the things investors always ask us is, "What about the retail changes with the Carvanas of the world and some of the online sellers?" They're great buyers in our marketplace. If you think, "They need to source inventory in an economic way from us." One of the ways they do that is getting from our online platform or from our physical auctions.

Audience Member: Thank you very much.

David: Question at the front here.

[off-mic comment]

Mike: We have access to retail data, but we have chosen not to purchase a DMS like maybe one of our competitors has. We see having access to that data as important but not necessarily owning that asset as important, up to this point at least.

[off-mic comment]

Mike: We have not chosen to integrate it with DMS partners at this point. Could at some point in time, but we've chosen not to do that quite yet.

David: Got about two minutes lefts if there's any other questions in the audience. Go ahead. Take it.

Audience Member: [inaudible] not quite directional, about the operating.

David: What do you think directionally the operating leverage on one percent incremental volume growth at either IAA or ADESA, which one do you think will have more operating leverage going forward? We can ignore TradeRev for the purpose of this conversation if you think that's the way people should think about it.

Mike: I don't want to pick one child over another if that's what you're asking [laughs] to do.

I can tell you that generally speaking, the fixed COGS in our salvage business is more on the 40 percent side because we have lease facilities like I mentioned earlier where many of the ADESA facilities are owned. That has more of a 30 percent COGS fixed leverage. That gets to your point about where the incremental leverage is from a gross margin basis, but you hate to pick one kid over another.

David: I guess switching to IAA, we haven't talked about much, how should we think about capacity in the market to take on? I think it's pretty universal agreement. The volume trajectory's pretty strong for the industry. Your competitor out there has been expanding yardage. You guys have been a bit as well.

What do you think about capacity pricing in the marketplace? Has any dynamics underlying the duopoly really changed?

Mike: I think both players in the marketplace have learned how to acquire I'll call them NIMBY-type of sites, not in my backyard-type of sites. If you think about having wrecked cars in your municipality, many municipalities are saying, "I don't want that in my sight."

Generally, that's one of the competitive advantages that the salvage auction industry has against new competitors coming into the marketplace is we've been able to understand how to go through the cycle. Many of those cycles are years to be able to register, license new facilities like that.

Both of us are expanding. The strategic difference is that if the population migrates from, say, the west side of an MSA to the north side of the MSA, IAA would then not renew the lease in maybe 10 or 15 years on the west side of the MSA. Just open up the new one in the north side of the MSA.

Our competitor would sell their facility on the west side of the MSA and open up a new one MSA. Strategically just a little bit different in how those sites are financed.

David: Great. Thank you. We'll squeeze one more in here.

Audience Member: Just a data question, the 42 million used vehicle transactions, is there any double counting in that? in the sense of a consumer trades into a dealer, a dealer sells it to another dealer, a dealer sells it to another person. Is that four transactions or one?

Mike: That would be retail transactions. NADA is counting consumer to consumer. If a consumer buys a car in January, doesn't like it, and sells it in June, that would be two transactions because it'd be two different parties on the other side of the transaction. There could be more than one transaction in a year if that's what you're getting at. They are retail counts.

David: Mike, Ryan, really appreciate your time. Thanks everyone, for joining.

[applause]

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