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EDITED TRANSCRIPT

KAR - KAR Auction Services Inc at Deutsche Bank Leveraged Finance Conference

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CORPORATE PARTICIPANTS

Eric Loughmiller *KAR Auction Services, Inc. - EVP, CFO*

PRESENTATION

Unidentified Participant

This afternoon, I'm very pleased to be able to introduce KAR Auction Services. Joining us today are Eric Loughmiller, EVP and CFO, as well as Mike Eliason.

Eric Loughmiller ***- KAR Auction Services, Inc. - EVP, CFO***

Thanks, [Brian]. I'll start with just a brief introduction of KAR to a few of you who may not know the Company well.

We operate in three major business segments. Our first segment we call whole car auctions. It's used car auctions throughout US, Canada, and we have a couple locations in Mexico. ADESA is the brand name that we use for that and it's been in operation since 1989. This is our largest business unit. It operates at about 65 locations and, again, throughout North America.

We then have a salvage auction business, Insurance Auto Auctions, which operates, again, for the insurance industry. Its primary customer will be at the insurance industry, selling total loss vehicles after an accident in order to recover a portion of the claims cost. They operate in about 165 locations in the US and Canada.

And then there's AFC, which is our floorplan finance business, which provides floorplan lending to independent used car dealers, as well as some other categories, such as salvage dealers, recreational vehicle dealerships, and places like that. But a majority of the portfolio is floorplan lending to the independent used car dealers.

In all three cases, we operate primarily in duopoly situations or at least oligopolies where there is two major players focused on the marketplace, and in each case, we consider them responsible duopolies to where we are able to compete on service and not fight over price all the time. So, essentially, we call them responsible duopolies.

ADESA's primary competitor would be Manheim, a subsidiary of Cox Media. Insurance Auto Auctions' primary competitor is Copart, a public company, and AFC's primary competitor is NextGear Capital, which is a subsidiary of Manheim.

So, that's our three major business units.

We define the marketplace in which we serve as really the cars in operation or the vehicle park. Each year, there is 15 million to 17 million new cars that enter the park in North America. That's predominantly US and Canada, as we measure it, and there are about 13 million units that are no longer in operation taken out of the car park.

Of those 13 million, about 4 million end up at salvage auctions in one way or another and then are remarketed for parts, rebuilding to put back into the automobile marketplace, or completely destroyed as scrap and recycled in their condition at the time of sale.

Within the vehicle park, there are about 45 million used car transactions a year. These are cars that are on the road that change hands annually, and that's a big part of the marketplace that affects ADESA and AFC.

Within that 45 million, 13 million units are consumer to consumer, many of them using AutoTrader or eBay to try to match a buyer and a seller together. Craigslist would be another source of getting contacts identified.

Then there are 32 million transactions that go through our dealer networks throughout the US and Canada, and of the 32 million, 20 million to 22 million of the inventory that they are going to sell to the consumer will be sourced from trades, trades with other dealers, wholesalers that will come and market cars to them, and 8 million to 10 million they will obtain at the auction businesses, such as ADESA or one of its competitors. So it's a very stable market.

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At the bottom on the far right here, you will see something called TradeRev. We announced with our second-quarter earnings results that we had made a 50% investment in TradeRev. This is an opportunity for us to enter into a new revenue source for our customers.

Essentially, 20 million to 22 million vehicles are sold, whether trade-ins or other activity with wholesalers, where they never come to the auction market. We estimate that approximately one-half of those cars change hands between dealers before they're retailed. That one-half is the opportunity TradeRev is addressing.

They provide instant valuation at point of sale, the ability for the dealer-to-dealer transaction to occur, and this is all using fresh trades typically while the car is in the dealership, perhaps even before the trade is consummated, where you are investigating the value of the card. It's an online offering. It's a virtual offering, and again, it's very short-term opportunity to open an auction environment for a duration of less than an hour to see what interest there would be in acquiring that car.

The best example I can give you is if you were driving a BMW and you decided to try that in for a Mercedes, that Mercedes dealer may not know the exact value of a BMW. He is going to know the averages. He's going to have a book value. He's going to compare it to his Mercedes, but he's looking -- he is probably not looking to retail that car in a Mercedes lot. And so, what he's going to do is he's going to be able to go out and solicit interest in that vehicle, determine the price point so he can give a better trade-in value, or perhaps even sell the car immediately before literally the ink is dry on the paperwork with the consumer to a BMW dealer in his general location.

It's a great opportunity. We've made a 50% investment and we have invested about $30 million, with a substantial amount of that investment retained in the business to roll this out as it's been introduced into some local Canadian markets, and we think it's a huge opportunity to introduce it into the US markets.

Beyond TradeRev that I just discussed, how do we make money? Well, the first thing we will tell you is we make money from about anything we do. It's a fee-based business.

What we will do is ADESA and Insurance Auto Auctions charge the buyers and the sellers of the cars a fee for the transaction. On the ADESA front, I'll start there, the sellers of cars will be -- about one-half of the vehicles in that industry are provided by dealers where they are trading agent inventory, off brand, some alternative. They are looking to move inventory to another dealer because, for whatever reason, they don't intend to or have been unable to retail the vehicle at their location.

The other one-half comes from what we call commercial consignors. These will be captive finance companies and OEMs. That would be the cars used by the management teams, basically the dealer cars or the factory cars that they are using for their reps.

It would be off-lease vehicles. At the end of lease, the captive finance company ends up with title to the vehicle and they are going to remarket through auctions. And then, you'll have repossessions from the captive finance companies.

In addition, we have banks and commercial fleet operators that will remarket their vehicles at the end of service for them or repos or it could be off lease. It could be any number of things. And last is rental car companies.

Those would be the consignors of vehicles and we will get a fee when they sell the car, and when they sell the car to a buyer, the buyer will pay a fee based typically on the value of the vehicle. It's not a percent. We use fixed tiered pricing where that price determines what the amount of the buy fee will be, but that buy fee will increase in dollar amount as the value of the car goes up. But generally you will start as it gets to be a higher value, it would be a lower percentage of the total transaction value.

So we call it fixed tiered pricing. Those tiers are $500 to $1,000 apart, so they are very wide tiers. Most importantly, when the prices start moving it's not a significant impact on our revenue per vehicle because, again, it would take -- the average car we are selling at ADESA is about $10,000, and so $1,000 change is a 10% change in price and you don't see that happen too often.

In addition at ADESA to the buy and the sell fee, we get fees for other services -- transportation, mechanic, body shop, any of the work -- reconditioning. The cars that come to auction, we are often providing services to them to make that car in a condition that will achieve the highest possible proceeds to the consignor, and we charge a fee for all of that.

And it's not a retail price. It's typically more like a factory or wholesale price because we do such high volume of the services on our sites.

Insurance Auto Auctions, the salvage business, a little simpler in some regards, other than the cars are in much different condition. These are total loss vehicles, very low-end, low-value vehicles that we think this marketplace would be a better opportunity to sell the vehicle at a higher price, or charity vehicles, if you donate your car to charity.

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So you'll have a dealer car that was taken. They gave you $500 in trade because they give everybody $500. They are likely to take that to a salvage auction.

So these low-end cars, we collect a buy fee and a sell fee, and again, generally, the sell fee is fixed. It's per car. And the buy fee is going to be based upon the value paid by the buyer for the vehicle, and in this business, we use fixed tiered pricing.

One major difference between Insurance Auto Auctions and ADESA is Insurance Auto Auctions and the salvage industry as a whole uses a national pricing model, so wherever you buy the car in the United States or Canada -- it's by nation; it's actually not across borders -- you would pay the same fee based on the value of the car, no matter what location.

In the used car auction business, it's actually local pricing. Each auction will have a different pricing metric, so it can be different based on local conditions of supply and demand, the type of vehicle it may be.

At [RA], the only opportunity for revenue is really around the buy and sell fee, where there is a small number of ancillary services, and typically we would include the fees for that services in the sell fee or the buy fee, depending on who is providing it.

And then, the AFC business unit is, again, a floorplan lending business where we average about $160 per loan transaction unit, and, again, it's the loaning of money to the independent dealer and the fees there. It's about two-thirds fees and one-third interest rate related revenue, so interest related revenue. So it's really a fee-driven business and it's a very attractive business.

The average term of those loans is typically less than 60 days and it currently is less than 60 days, and this portfolio turns several times -- up to seven times a year for us and there is very low losses as a result of it.

These are all collateralized, perfected liens. The loans are car by car. They are not revolving credit agreements, so each car, when it's sold, has to be paid off, and then when they purchase a vehicle at auction, they will do a loan on that specific vehicle.

In terms of KAR's investment profile right now, what we have really been talking about is an opportunity to participate in the growth of the Company as we have entered a cyclical recovery. The cyclical recovery is heavily driven by coming off of the recession that occurred post 2008 where we saw new car sales drop, lease originations drop, and we experienced that.

As you can see on this chart in the whole car industry -- this is industry data, not ADESA data -- you can see that in 2011, we hit the bottom with about 8 million units, of which 7.7 million were at the physical auction, about 300,000 in the virtual space for us.

That number is now returning back to the levels between 9 million and 10 million that we experienced for about 15 consecutive years prior to 2008 -- actually, 2010 is when we started the declines below that.

It's really a cyclical recovery. Many of the factors contributing to this recovery have already occurred. We were driven by several factors. One is the SAR, which creates trade-ins, which can create dealer consignment volume. That's a current metric that we are watching.

But also, a big part of this recovery is actually lease originations. The average lease term in the United States is 36 months, so the lease originations that occurred in 2011 are the cars that are coming back to our marketplace. What caused this big decline more than anything was a lack of off-lease vehicles.

Perhaps a smaller contributor would be a lack of repos. Despite the economy, there was a reduced amount of repo activity, which is big for our market, and both are recovering with the subprime lending occurring and the lease originations that occurred beginning -- really picking up in 2010, but accelerating in 2011, 2012, and 2013.

So a lot of the factors that drive this we can anticipate because they are transactions that occurred in our past and we're just waiting for those transactions to mature or come to termination, and when that lease terminates, it will create activity in our marketplace.

One of the ways we are participating in the marketplace was with our acquisition in 2011 of OPENLANE where we are now the clear leader in the providing of private-label, closed transactions for the OEMs in order for them to move these off-lease vehicles to their franchise network. These are private-label sales where the franchise dealers get the first opportunity to buy that inventory before the rest of the market gets it, and we depict that by looking at the funnel.

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In essence when a car comes off lease, before it gets remarketed, the first opportunity is for that car to be acquired by the consumer at a residual value stated in their contract. If they choose not to, which is a majority of the time the consumer does not buy the vehicle at end of lease, it then goes to the grounding dealer when they turn it in and the grounding dealer can buy at residual value.

If I go back to the shortage of vehicles in 2011 in particular, those residual values were well below wholesale market values, so these dealers were buying at residual value, even if they turned around and wholesaled the car afterwards, because it was called in the money. It had positive equity where the wholesale market value was above the residual value.

That has now reversed where the residual values have been increasing and the wholesale market values have been declining, and so now it's less likely that the residual value will be attractive to the grounding dealer, although it still occurs in some cases.

As it enters the funnel, though, for a large number, over 30 of the over 35 brand names offered in the United States and Canada, we'll represent their private-label sites. The first stop is two to three days where it will be offered to the franchise dealer network only. And that's a limited number.

There are about 17,000 to 18,000 franchise dealers in the United States and Canada, and for each brand, it will only be their brand of franchised dealer, so when you take a Toyota or a Nissan dealer, that's a couple of thousand dealers. For General Motors, it's probably, I think, 4,000 or so dealers. That might be moving a little bit down. And Ford would have several thousand dealers, but it's only their network.

To make matters probably more restrained, you are also not going to move most of these cars more than 350 to 500 miles from the point at which they are parked. It's just expensive to move them and you don't gain enough in the transaction economically to probably afford that move. You'd rather wait until one is more locally oriented or you wait until one is turned into your store or taken to an auction closer to your location. So anyway, there's a restriction on limited buyer base.

After two to three days, if the bids are not sufficient to the consignor that they are going to sell the car, they are going to move it into an open environment where they are going to offer it not just to those franchise dealers, but also to every dealer of any brand. There is, again, that 17,000 to 18,000 franchise dealers in the US and Canada and an additional 38,000 independent used car dealers in the United States and Canada that will be interested in buying that car online from the grounding dealer location.

And that will occur for another two to three days. So within a week of turning that car in, that car is either going to be sold or it's going to be moved, and when it's moved, we have checked if it has not been sold on the online venue, it means to a physical auction. There are really no alternatives for the captive finance company to move that car, other than to take it to the physical auction.

It may end up at our physical auction at ADESA or it could end up at a competitor. And again, what's really important on this slide and it's depicted through the graphic, we for the brands that we are representing have 100% of the market if we sell that car at the online-only venue, whether it be private label or open.

When that same vehicle moves down into the physical auction, we generally are going to get about one out of three, so we have much lower market share in the physical auction than represented for those brands as we have in the virtual auction space. So, it's really important.

As you can see on the left and right of this, the economics change. There is far less revenue per vehicle when it's sold online only and far more revenue, because we can provide additional services called ancillary services at the auction -- the bodywork, the mechanic work, the reconditioning of the vehicle, transportation, because the car is moving.

The margin, though, is much higher as a percent of revenue if it's sold in the online space because I don't have any touches. I don't have to handle the car, and lower because of the physical auction. So I have a higher revenue profile at the physical auction with a little bit lower gross margin profile.

Interestingly enough, those gross margin dollars, I can't pay my employees with percentages so I have to look at the dollars. The dollars win in this case, so really we benefit and we have been looking forward to this cyclical recovery as we hope -- we plan to see more cars at the physical auction from the commercial space increasing the revenue per unit over time. And that's what we are waiting to occur.

As we see the cyclical recovery play out, we expect that to happen, but we can't predict when that will happen.

Now let me turn to the salvage market, very robust, and the bottom right chart is the key to focus on. Why is the salvage market remaining quite strong and performing so well for us? Number one, it's the consistent volume of the more we drive, the more we wreck, whether we like it or not.

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I know we're all safe drivers in this room. You know why? Because we are not in our cars. The minute we get in our car, we get distracted. There is accidents. And of every insurance claim made, about 14%, or one out of seven, results in a total loss.

That's interesting to me, though, because that means that one car that is a total loss vehicle is a source of supply for the repair of the other six that aren't totaled. That's quite a dynamic, and in the bottom right-hand corner, you see it. Alternative parts utilization is increasing because the most economical part to use in a collision repair is the recycled part. It has the quality of an OEM manufactured part, it has the consistency, and, more importantly for us, it actually has the highest profit in the entire supply chain.

It has the best economics for the collision -- for the insurance company, for the distributor of that part, for the collision repair shop itself, for the participant in the auction, that's us. It's really the most attractive part. Rarely do you see it's the lowest cost part compared to a manufactured part and the highest margin for everybody that participates in the transaction.

Now, you can't always find the right part, so this isn't going to be 100% of the marketplace, but to the extent that they can find these parts, and that has given great price support for the salvage vehicles. Even though we are seeing some softening in used car prices, you don't really see the same impact, as the performance in the salvage industry has remained quite strong and values have remained very strong for us.

At AFC, again, a strong performance that has been growing. We are seeing that business continue to perform because it's a fee-based business. We have a significant securitization in place and we are looking at that securitization to fund some of the capital. About 78% of the capital that we loan to the dealers is funded through the securitization and roughly 22% remains on balance sheet and is funded off the balance sheet of KAR Auction Services, and that has really been attractive.

Our securitization is not intended to spread risk. It's intended to create access to capital, and so we retain all of the risk on the portfolio by taking first loss on the retained portion of these loans. Our losses -- this is overcollateralized -- our losses, even in late 2008, never came close to approaching the retention amount of these loans.

So, it's very secure, which gives us access to low-cost capital because we are not having a significant risk profile on the lending through the securitization facilities. That's really been an attractive -- and we have had no limitation on our availability of capital, despite all the economic twists and turns we have experienced over the last five or six years.

So it's been a great tool. It's a strong contributor to our profitability, a very high-margin business. And again, its market is the independent dealer space. We do not do loans to the franchise dealers. There is a few that we would do where they don't have a captive finance alternative, but generally speaking if you have a availability of captive finance lending, why would we give you the money, because typically it's a captive, it's subsidized, it's more attractive.

We are really looking to that independent marketplace where they don't have this type of source of capital from any other location.

In terms of finances, before I get into a little bit of Q&A, our revenue has been growing. We went through a very difficult time in the audio industry and the financial services sector in 2008, 2009, and we have come out of that. But during that period, the diversity of our business model showed up by our ability to continue growing, even at a modest rate, our revenue, continue to grow our free cash flow, which starts with our EBITDA, and improving our gross profit. And equally important, our net income per share has been on a growth trend.

So it's been a very attractive investment and it's a very consistent performer, and our free cash flows are really what differentiate us. Here is a summary of our second-quarter performance, which, again, it's quite old now since it's been a couple of months since we announced it, but this is a late conference for me, so I'll leave that up there.

But really, what we are here for is to talk about our leverage. We have a Term Loan B facility that we did. In March, we did a refinancing. We broke it into two tranches. Term Loan B1 had a three-year tender at the date of refinancing, about $650 million, $648.4 million. It matures in 2017 and it's at very attractive interest rates with no LIBOR flow and a spread of 250 basis points.

Term Loan B2 was also refinanced in March. It has seven years through 2021. It has a LIBOR floor of 75 basis points with a spread of 275 basis points on LIBOR, and again goes through 2021. Both Term Loan B1 and B2 are cov light, so there is not significant covenants.

We also have some capital leases. So we are down to below our target leverage of 3 times levered.

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So our current focus is using our free cash flow either for expanding the business through acquisition or return to shareholders as we have declared $1 per-share dividend for our shareholders, which provides a nice return at 3.6% yield to the shareholders and still leaves sufficient cash flow for strategic growth or investment and growth through acquisition and additional return to shareholder, if that were the option.

The attractive cash flow model has been consistent. That's probably what's been pointed out. When we went through 2008, 2009, a lot of investors, including the bond investors who I used to speak to at this conference, it was back in that day we had some outstanding bonds, which were quite a good investment for everybody, and our cash flows were sufficient that we have been able to repay all the bonds, all of the senior notes, and now get down to having really a senior debt capitalization structure that fits well with a company with public equity.

We continue to focus on reducing debt. Although we've hit our target of 3 times, we do not intend to repay debt in the short term as we think with the low-cost interest we have the opportunity to invest in growth and even improve the cash flow profile of this business over time. So other than mandatory principal payments, currently we are not repaying the Term Loan B ahead of schedule, unless required.

In terms of investment highlights, I think I've covered most of these. We are a market leader and proven and resilient growth through our diversified business mix. Like many investments you look at, especially in the credit market, as you look to stress test these things, well, we're survived the stress test.

It was an actual stress test, as opposed to financial models, and to be honest, the business stood up quite well in that environment and was able to service the debt, was able to really improve its risk profile through the balance sheet, and I think that's -- again, that's something important about considering the leverage position of KAR and the ability to handle the leverage that we have.

So with that, Brian, I'm going to turn it over. There's a group here. If you have any questions, I'll answer them. Anybody out there have anything interesting they'd like to talk about?

QUESTION AND ANSWER

Unidentified Audience Member

Can you talk about the (inaudible) physical location. Are you finding that the amount of real estate you have at this point in time (inaudible)

Eric Loughmiller - ***KAR Auction Services, Inc. - EVP, CFO***

That's a very good point. The bottom line is with the online presence, what's really interesting and confusing, we sold about 38% of our vehicles to online buyers.

But of our total sales, 22% or 23% were to online only where they weren't sitting on our property. A large percentage of these are actually sitting on our property. Yes, I do agree it has probably less to do with the online versus physical transaction and more to do with the processes we have invoked that have created efficiency.

We probably do need less space than we would have needed for this volume five to 10 years ago, but that's really a function of the process more than whether they are selling online. If the car doesn't make it to our site, we don't need any space for it. But the cars making it to our site are selling online, but we -- again, the cars aren't virtual, so we need the location.

We have some locations. We have one location that is 225 acres. I probably don't see us needing in one location that much parking in the future because we move the cars faster. But we still need -- we do not believe the physical infrastructure, or the brick and mortar, as we call it, will go away. In fact, we continue to need to invest in brick and mortar to make sure the fillies are up to speed, that we can repair the vehicles, have them show very well, and move quickly, actually efficiently, through the process.

So, perhaps less need for real estate in terms of sheer quantity at a single location, mostly driven by process and efficiencies in how we handle the vehicle. We also mainly need more locations closer to the -- to where the buyers are going to be, though, because again when they are buying online, they don't want to have to go too far to get that car.

Again, I don't see the physical infrastructure going away. If there's nothing else -- Brian has a question, okay.

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Can you talk about just the elusive dealer-to-dealer opportunity and how you're going to go after that?

Eric Loughmiller - ***KAR Auction Services, Inc. - EVP, CFO***

You said dealer to dealer, not consumer to consumer, right?

The dealer to dealer is through TradeRev. TradeRev is just very interesting. The dealers, when you talk to the national retailers -- they attend conferences; some will probably be here -- they're going to talk about their need to try to eliminate the cost of the transaction, the wholesale environment, which means sell direct.

Guess what? We are building the tools through TradeRev, through ADESA.com, which was -- really, the baseline is the OPENLANE, where they can transact business without as much movement of the vehicle. TradeRev allows them at the point of sale to take a fresh trade and move it dealer to dealer more efficiently than waiting and trying to move it through the auction process.

Could it cannibalize the auction? Perhaps a little bit, but those aren't trades that they are currently looking to the auction to move. They are actually doing it through wholesalers, direct contact, phone calls, access to maybe a friend or a dealer that has a different brand, and we want to make that a more disciplined process and a more efficient process for them.

The TradeRev offering, where we made this 50% investment in this Canadian enterprise, the TradeRev offering currently is really a matchmaking service, but with ADESA involved, it is exciting for us to perhaps offer some of our expertise, because we stand in the middle of very similar transactions that are done at our sites or done on our online venues through ADESA.com.

We have an opportunity not only to participate, Brian, in the transaction dealer to dealer, but also to make it more efficient and provide some value, as we do now, by standing behind the transaction, providing more confidence both in the collection of money, the transfer of title, and resolving differences of opinion when the condition of the car was not well known and you want to say, hey, I didn't get what I thought I was buying. Here's what you said about it -- called arbitration, which we can give them some protection that if someone didn't disclose, hey, there was no backend on the vehicle because of an accident and they didn't take a picture of it, there's a way for us to really help resolve that to be fair to both the buyer and the seller.

I think it's an opportunity for us and we are really excited about it. TradeRev, founded in 2009, is a technology play based -- a Canadian-based business, but for their rollout to be aggressive, they needed capital and it provided us the opportunity invest in the business, and we invested about $30 million with a substantial amount of that staying in the business to roll it out to the broader market, especially the US. And we are in the process of doing that.

Thank you very much for your time today, and have a good evening.

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