KAR Auction Services Inc
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I appreciate you getting here on time. My name is Joe Edelstein and Rick Nelson in the specialty retail group at Stephens. This afternoon we have KAR Auction Services, who is the leading provider of auction services in North America. The company's core business units include Adesa, a leading provider of wholesale used vehicle auctions. Over 70 used vehicle sites, insurance, auto auction, salvage auction with 159 sites, and Automotive Finance Corporation provided floor plan financing for used vehicle dealers, with 88 locations. Eric Loughmiller, the Executive Vice President, and Chief Financial Officer, Mike Eliason, Vice President of Financial Planning Analysts are here with us today. With that I'll go ahead and turn it over to Eric.

Eric Loughmiller

Thank you Joe. It's nice to be in New York with Stephens again this year, I enjoy this conference and have had lots of one on ones already. Let me start by really describing the vehicle park, that's where I'll start today. In the vehicle park, this is what generates activity for our businesses. There are 270 million units on the road, cars on the road. Every year 10 to 15, and we're all routing for closer to 15 I think, new cars enter that market place. But 12 million units leave the market place. They are not re-registered with the DMVs or kept on the road.

We operate really, with cars that stay on the road and those that are taken off the road. Let's start with insurance auto auctions. On the right side of this chart you will see a red box. About 4 million, just under 4 million units a year are sent through salvage auctions. Where we auction the vehicle that has been in an accident, or has no remaining life to it, doesn't run. These auctions really generate quite a bit more money than most people would expect. That's out of 12 million units that are taken off the road immediately. So it's a subset of that market place that we are helping move the vehicles.

Our primary customer, over 80% of our business is with the insurance companies. So when you have that accident and they declare your car a total loss, that vehicle will be taken to the insurance company. They will then sell it to our offices or one of our competitors auctions. About 70% of those vehicles, maybe a little more right now, are being taken apart for after market recycled parts. Many of which are used in the collision repair industry.

The remaining 30% or so, are split depending, again, on the types of cars. Some are just crushed car bodies that are taken for the content of the metals. The rest, about half of that usually, are rebuilt. Even though they said they wasn't going to fix the car for you, someone has decided that they will fix the car using my own labor. Perhaps they think it's a unique car or something like that. So that's the salvage auction market.

Insurance auto auctions generate just right around $700 million in revenue, and is a strong contributor to our EBITDA. Now over $200 million in EBITDA generated by that business. Then we also have the used car auction business. Which is on the left side of the chart at the bottom. In the used car auction business, in October of 2011, we acquired Open Lane. Open Lane is an Internet only auction. Which really focuses on the commercial vehicles, predominately off of these vehicles. Add that to our 68, actually right now we closed a couple, or consolidated, Joe has more recent numbers. 68 car auction

facilities, where we can physically handle the cars and sell them to a live buyer, or simultaneously there will be online bidders buyers online at those auctions. That marketplace is 7 to 9 million. Right now we're looking at 2012, we're estimating about 8 million units will run through that wholesale used auction channel. At the peak we were above 9 million.

In fact we went, probably another eleven or twelve years, ending in 2009, where we were between 9.3 and 10 million units in the industry being sold. Over time it's been fairly stable, although we're at a low point right now, down at around 8 million units, but it's been very stable. In the lower right box now, Openlane is part of Adesa, there are, in that 7 million wholesale transaction, there are about 1 million units, including 300,000 from Openlane. That are online only and not included in the NAAA number in that left-hand box. That kind of pictures it. In addition to those two auction businesses, we do have a floor plan finance business, called Automotive Finance Corporation, which focuses on floor plan lending to independent used car dealers.

Although we don't really look at it as an independent financing business, it may appear that way in some of the marketing materials. It's really just an additional service we provide to the dealers who are buying cars at the auction. It provides liquidity, so that they can buy more cars to put on their lot, and it's really an additional service to the dealer base. In terms of what we're seeing, I kind of gave you some numbers. These numbers are the NAAA numbers with some forecast by our economist, Tom Kontos, as well as our competitor's economist Tom Webb.

If you go through 2011 you've seen a decline. That really relates to the activities of 2008 and 2009, when we saw significant changes in the automotive industry, and those have come through. We usually see a lag as to when those things impact the wholesaler used car marketplace, because cars are bought new, generally will run one to 3 years before they start becoming a used car in the marketplace. Some of you may drive them longer, but most cars, off-lease vehicles average 3 years, rental car fleets turn them within a year, and private fleets are one to 2 years generally. That creates a lot of the new car volume. In addition, every time a new car is purchased, a dealer has the option to wholesale that trade. He can retail it, or if it doesn't fit his model for his lot. The example that I like to use, if he happened to be a Honda dealer that took a Toyota in trade, there's a very good chance a Honda dealer does not want to be selling used Toyotas on his lot. Because he's actually probably targeting you to be a new Honda buyer in the future, and he doesn't want you to fall in love with that Toyota he just sold you.

A lot of the time they will wholesale that vehicle because they don't want that to be part of their strategy of customers coming in looking for Toyotas. That would apply to luxury manufacturers, as well. They tend to be very brand conscious and represent their own brand. They're more likely to have a domestic used car than they are, say, a Mercedes dealer with a used BMW, or even now an Audi. They stay away from that. What we've seen is, we're at the bottom in 2012. We've publicly announced, as a company, that we expect 2012 volumes to be very similar to 2011 and then start growing. What we're seeing, as we look forward, 2013, we're expecting about 8.4 million units, up from the 8 million, and by 2015 we think that will near 9 million units. These numbers exclude the online sales, those will begin being reported in AAA in 2012, and these numbers will all include Openlane and will go up by a few 100,000 units per year, and that number should grow, as well, as we get to 2015.

We're at a point where we're expecting to come off of these lows that we've had in the supplies of vehicles and start to see a greater supply. The good news is it's gradual. We're also not seeing significant impact on pricing of used cars. It helped that in early this year, the average new car value, or new car price, went up about $700 creating a bigger spread between the used cars and the new cars. That will help protect some of that pricing. Again, the increased supply, as you see from this chart,

we're still not back to the peak levels where we were having 9.5, to even 10 million units, come to the wholesale market channel. I think pricing, our expectation is pricing will remain relatively strong, perhaps off of today's highs, but not off significantly, as where we see it.

We acquired Openlane last year and many have asked, what did we accomplish by buying an online marketplace? Beyond having a better technology, in our view, than we had developed to date, we got a strong list of customers. If you look at it, on the top, these are the closed sales. This is the first opportunity to re-market a car. The closed-sales is where a manufacturer allocates his used vehicles, to be purchased by his franchise dealers. In many of them they have arrangements with their franchise groups where they'll offer even a certain number of vehicles every year. It helps supply into their marketplace.

That's the first opportunity, when you do an off-lease vehicle, a repossession from a captive finance company, this is the first chance for you to get the car sold through your chain. As you can see at the top of this chart, Openlane had a significant presence in the online closed-sale platform. Then you look below, Adesa was also a significant player, a close number, too, relative to number of businesses served. If you read through these names you'll find there's very few missing from this list. By buying Openlane we feel we can we can accomplish a couple of things.

Number one, we have the ability to enhance their offering. Openlane had three to four days to sell a car. After three to four days it was taken off of the website, because the car had to move. Once it moved it went into someone's auction network, hopefully Adesa, it may have been one of our competitors. Openlane is a virtual only, they had no physical presence to store the vehicles, to do work.

In addition, why did the car not sell? Perhaps it had a disclosure in its' condition report, engine ran rough, scratches on the rear bumper. At our sites we have the ability to repair that, update the condition report indicating it was repaired, and maybe achieve the value that the consignor was looking for in the sale of that vehicle. When you're buying online it's 'buyer beware', you don't get to go drive the car, it's going to be delivered to you. For some cars, still under warranty, one to three years old, that's pretty easy to think about, especially if your a dealer and you understand the market place. But you start getting a little more age on the vehicles you get a car with 75-80,000 miles on it, becomes more difficult and the physical auction locations may be a better location for those to be sold. Now that Openlane is part of Adesa we can continue offering that car online while it's moving through our physical properties, so that's been a big plus for us.

On the Adesa side, we needed technology we've talked for a couple of years that we needed to improve our technology we were investing in it. As we invested in that, again think of a dog chasing it's tail, it keeps going around in circle and never quite gets to it. When it does get to it it's maybe unsatisfied let's it go and goes again. Well we're chasing somebody who's still investing in technology. If we're behind them how do we catch up? The quickest way to catch up was to acquire the company and we are very pleased with integration activities. We've already migrated our dealer block offering which was comparable to Openlanes onto the open lane platform. By the end of the year Adesa will be operating all of it's internet business through the Openlane organization. We think this will really be a good statement to the market place who recognize Open Lane as a leader in technology. But also understand that the comprehensive offerings of Adesa are important to wholesaling the cars that come to the market place.

In addition you've got a complete solution on both sides of this. Again, in the end-to-end marketing solution whether it be closed upstream, all the way through open down stream. Which means that the

physical auction, we are the only company out there able to handle all of those seamlessly with no blackout periods, for the customer where the cannot be selling the car. I talk a little bit about the businesses, who do we work for?

First, anybody that sells cars essentially is going to have access to our market place. You do need to be a licensed dealer, although individuals can sell vehicles at some of the auctions, as long as you can deliver the title on the car. The buyer must typically be a licensed dealer in that market place. Some states do mandate that we have public auctions, at least once a month. I think in Michigan and I think the state of Washington has some requirements, so we do have to have public auctions occasionally. However those are limited and that's not our general auction process, it's for dealers only. So, the dealers are showing up, lots of dealers within the salvage business we sold cars to dealers and to buyers from over 100 countries last year.

In the used car market place is typically going to be domestic, because of terrorist to import and export cars gets expensive. So, in Canada your going to be selling cars from the Canadian operations and in the US to the US operations. They don't really cross borders very often, unless it's a collectable car that might be different and we don't do a lot of those. We still have the insurance companies all the banks, all the OEM's are captive finance companies broad based. This actually creates one of the barriers entering into our market place. You can't walk out and say, hey I've got a big piece of property i'm going to put a wagon out there and an auctioneer like in the old days and start prattling about how i can sell these cars. It takes a lot more, there's a lot of technology, a lot of interaction with the consignors, so that they can track the activity on the car, track the status of the title, track the status of the sale of the vehicle.

Also, as we've said in the one on one meetings this morning, why do buyers go where they go. In the old days, when you had a dance, the boys went where the girls were at the dance. It's not one or the other, you need them both to have the dance, at least we used to think that way. But when you have that dance, you've got to have the cars, you've got to have the buyers, you've got to have all of it together, and if you have one, you will get the other. If you don't have one, you won't get the other. It's hard to attract the sellers, without telling them I'm going to have 200 buyers there every week.

It's really interesting. I urge all of you to go to our website, we have a virtual tour of our auctions that you can get to at Karauctionservices.com. It's about 4 1/2 minutes long, and it will walk you through both the used car, and the salvage businesses that actually show you the live auction in place. It's a lot more than you think, it's not one car at a time. We sell one car about every 45 seconds. At a used car auction we'll probably average probably 6-8 lanes, running simultaneously, and it's organized chaos. It's quite interesting to see, and you don't want to raise your hand at the wrong time, because the auctioneer might think you're buying a car.

In terms of insurance auto auctions, I talk a lot about used cars. This has been a business that has done very well over the last couple of years, while we've seen Adesa under pressure. Again, we talked about their business. I looked back to their 2012 Q-1 we were up 8% in revenue, EBITDA was up 3%, our volume was up 6%. This business has grown now, going on two years, at an outstanding rate. I would also tell you that the volume of the supply of vehicles in this business is far more stable. As I told you 12 million cars are going off the road every year, only about 4 million are hitting these auctions. So we have the ability to attract more non insurance vehicles into the marketplace, and keep some stability to the supply of vehicles.

Equally important, is companies like LKQ, who's often at this conference. I don't know if they're here

today. They're seeing increased demand for after market recycled parts, which is creating a demand side for people wanting to sell their cars. I often ask people, what do you do when you have a car that just dies? You often have to pay someone to tow it away, and take care of it for you. Well guess what? We will come get the car for you. We will pay you cash for that vehicle, and resell it. Many of these cars that don't even operate have a lot more value than any of us think. To us, when it quits running, it has very little value left, but there's a lot of opportunity out there.

Charitable organizations are taking car donations. Most of those donations are getting sold at salvage auctions. It's a safer place, because it's as is, no expectation that the buyer will expect to run the car and it's very safe for the charitable organizations to turn that contribution into cash very quickly. That's a lot of what's happening in the salvage industry. In fact, that's becoming our second largest source, to the insurance companies for salvage vehicles.

This is a technology driven business, as well. Again, we think of wrecked cars, but there's a lot of technology for the consignor to track what's happening to the vehicle. A lot of our systems are integrated into the insurance companies, so that they can actually track what's happening to their asset that they're trying to turn into cash, to help reduce their claims cost. So it's a technology driven business.

AFC is our floor plan business. This has been, again, an outstanding growth part of our organization for the last two years. I won't tell you what happened in '08 and '09, or I at least won't tell you this year, because I had to talk about it then. Where we saw that market decline, we were able to rebuild that business on the strength of our processes. It's a core lending business that sticks to floor plan lending for independent used car dealers. This isn't growing because we're expanding our risk profile. In fact, if anything I would say we've tightened up the risk profile from 5 years ago, and this business is performing at all time levels for us.

We grew the revenue in Q1 by 16%, we were able to increase adjusted EBITDA by 17%, and saw the number of loan transactions, the driver of the volume for this business up 17%. Despite the fact that there were fewer used cars in the wholesale re-marketing pipeline, which is their primary focus. This business is performing extremely well, with ample liquidity available to continue growing this portfolio. Our current securitization goes until 2014, and we are in relationships with institutions that support us there, are quite strong and we're comfortable with no issues going beyond 2014.

In terms of financial performance, again, as a public company it's a little late, we're almost to the end of the second quarter, and still talking about Q1. Again we were able to drive revenue growth, we saw the gross profit increase, adjusted EBITDA was up, and our adjusted net income per share was down, but that's a function of a tax rate in the first quarter. That went from 2% last year, to about almost 41% this year. That's just a function with some interaction with taxes. You take that out of there, again, we've been very strong growers. The tax rate for last year was 20%, the first quarter was the biggest anomaly, but the effective tax rate was only 2%.

In terms of our capital structure, we do have $1.8 billion of net debt, including our capital leases. Out of that, our focus has been to reduce leverage with our free cash flows. We have a business that generates strong free cash flows, we've been paying down debt since the LBO. In fact in 2007, we were nearly 7 times levered, and now we've got that down to 3.6 times levered, through cash we've been able to generate, plus the proceeds from our 2009 IPO was 100% used to repay debt.

Really, the strongest features of this business are the diversity of the business model. We talked about

the pressure that Adesa has felt, with the reduction in supply. Yet the company continued to be able to increase it's adjusted EBITDA, generate stronger free cash flow. Because our business operate in somewhat of a diverse manner, actually compliment each other. The strong used car values that were driven by low supply of used vehicles at Adesa, was very good for insurance auto auctions. Seeing the average purchase price of a salvage vehicle go up, generated more revenue per vehicle, so we were very pleased with that.

With strong used car pricing and tight supply, there's fewer defaults in the floor plan lending business. That's generated more profitability out of the loans there. So we've seen that be a strong performer.

All in all, we look at our businesses, they operate in a complimentary fashion. So, again, we've performed well in all market conditions over the last 5 years, and are very pleased, that again, the strongest attribute though, here on the right side of this chart, is the free cash flow generation at this company is consistent, not dependent on one business over the other. We generate cash in all aspects of our business. I think that's a feature of the business that should be recognized. It is not a high growth business on the top line, it's a more stable business as a result.

We will grow the top line as we've demonstrated, even in tough markets conditions, but it's not going to be a high top line revenue growth. With the debt pay down though, we have the ability to hit 15%-20% earnings per share growth, per year. So it is a bottom line growth story for the market place. So, with that I'll conclude with a couple of minutes on the clock. Joe, am I taking questions here first?

Questioner

We've got time for a couple of questions here, and then we'll go to the break out room down the hall.

Eric Loughmiller

Yeah, go ahead.

Questioner

(inaudible)

Eric Loughmiller

Because we're webcast, I'll paraphrase the question. Does the impact of hybrids and alternative fuel vehicles impact our business over the next 10 years, and he mentioned values. The answer is, we're a transaction based business. We aren't really, we'll just re-market the car, it will be worth whatever it's worth. If the batteries are worth something, I'm confident that people will be coming and buying these cars for their batteries down the road. Again, there's a lot of uses. We are not tied to the vehicle, we're not tied to the type of vehicle. In fact we've been handling hybrid vehicles already, and they're not much different for us. Other than we have to have charging stations, maybe to get them through the lines occasionally, if they were all electric.

Most of it is really, we're just dealing in transactions, and we are not closely tied to the value of the vehicle. We collect a fee from the seller, we collect a fee from the buyer, and while they have some relationship to the sale price of the vehicle, it's not linear, so we are really striving for more transactions, and we'll be able to handle it. Recently though, it's been published in some of the material

I read, that the hybrid values are coming down again, they've been a high valued vehicle in the used market place. Which makes them high value in the after market if there's a wreck, because they want the parts off of it. I think over time that will stabilize, and probably not a big influence, from what we've seen.

Questioner

(inaudible)

Executive

Well the life of the vehicle is getting longer, and the domestic manufacturers in particular, are producing cars expected to run 150,00 to 200,000 miles. That is very good for our market place. Number one, a loaner car is more likely to be totaled, because it's not worth as much. If you hit the bumper of a one year old car or a ten year old car, it cost about the same to repair the bumper, because most of it's labor. So that's good, and they total more cars.

Also, though, in the used car market place, the longer a car stays on the road, the more likely we're going to get a transaction out of it, so that's another component that's good for us. The life of the vehicle has extended, the average car on the road is over 10 years old now. So, I mean that's been good for our business, because again we often sell cars more than once through the whole sale market place in the auctions, it'll come through a couple of times. I think we're out, one more question. I'm over time but not much.

Questioner

Why are you so comfortable, are you comfortable in fact, with down turns and whole sale sales (inaudible) cyclical and not secular?

Executive

Well, would I be comfortable in all conditions? No, but we actually have visibility in what's going to happen, I mean, we talk to the customers. A lot of our marketplace is determined three years ago. And the steady increasing saw with more lease origination’s is actually going to create supply, so that's why it's not. It is cyclical, because we're really talking about events that occurred in '08 and '09, not what's happening now. On the other hand, there could be secular changes and we watch those all. How many of the off lease vehicles end up at auction could change. Those are the things that we monitor that you do have to be careful on. But the cycle that we're really talking about, we're in an increasing star environment, we know lease origination’s bottomed out in early '09 and began increasing after that. And we have a lot of visibility.

We also know, though we've gone through an incredibly light default period on car loans. And everybody's speculating that I'm normalizing. So the volume trends as you saw are not getting back to pre 2010 levels, but they are going to begin improving. A lot of the dealer consignment vehicles are a function of new car sales and trade ins. So again, a lot of that activity is rebounding, but you'll notice it's more than cyclical. There is a secular shift because were not going back tonight. You don't see us projecting back to that nine in a half million. That probably is the component I will call more secular than cyclical. Does that answer your question? Thank you very much, and look forward to seeing you at the break out session.