**KAR Auction Services Inc**

**November 29, 2017**
**3:15 PM EST**

Unidentified Participant: We have KAR Auction Services with us today. It's a name I followed for a long time. It's a very interesting business, profitable business. I think a unique offering. And with us from the company, we have Eric Loughmiller, the Executive Vice President and CFO, and Mike Eliason, the Treasurer and VP of Investor Relations. We're going to just make this kind of like a fireside chat, open format, and if you guys can contribute some questions and topics that would be great. So want to have it interactive.

We have management here for 34 minutes and we'll try to make the most of it. So without further ado, let's kick it off. I'm going to grab my seat. So I guess the first question we can open up for in the industry is how have you seen the used car prices in the market? We've been following Avis, and Hertz, and Penske, and the other auto retailers. I know you guys are a different business but you have a great look to that. So I think it would be great color.

Eric Loughmiller: I was going to grab this. I've got visual aids here.

Unidentified Participant: Excellent. That's good.

Eric Loughmiller: I have to go to page 29. So used car pricing on a like for like basis, we see declining, and this is all the way to the end. And there's a number of used value indices that we track. And interestingly enough, when you follow the Manheim Index, it would lead one to believe that the average used car price might even be increasing and that's a published index. When in fact, what that's measuring is the average price paid for a vehicle at auction. And what we have is a richer mix of vehicles coming. We have more late model, low mileage, used cars in the marketplace now than a year ago, and the year before that, and so on and so forth going all the way back to probably about 2011.

However, there are other indices, Doug, that are out there, and if you look at this, I like the bottom one. It's not the most widely spread, the RVI. And the reason is it limits the population to cars two to five years old. That's the car that you should be comparing to and so now, the top level is basically -- it's the entire industry. The Manheim Index is only cars sold at Manheim auctions. Our economist publishes an index, a used car index, which is all cars sold in the industry using auction net data, which would include Manheim, ADESA, and all the independents. So that plus 3.2% year to date compares to late model used cars are down 4.5% because it's only the two to five-year-old cars.

And then you've got black book, which is two to six, 4.8, and NADA, which is zero to eight, which is down 6.7%. So giving you an indication and we think that continues with the number of leases that have originated. They're being returned. I have all kinds of charts I would show you but none of you could see it because they're not up there. But this is for the next two and a half three years going to be a continuing influx of vehicles and it's going to cause pressure on used car pricing. And the reason is that late model car is going to start setting the pricing as it trickles down as the cars get older and that late model car is going to, again, like for like.

Our economist, Tom Kontos, is publishing a new index. He's tracking two specific vehicles every month. It's a Nissan Altima and a Ford Escape, and that index in the month of October, my recollection was down 2%. And what he's doing is he's fixing it for option packages, mileage

36,000 to 45,000 and it's three model years old. So whenever a car flips a new model year, it's always a three model year old car. And we're tracking that like for like so that we can give everybody an indication of what's happening to a specific. And that's the number that the rental car companies probably would pay most attention to.

And I would tell you, this is consistent with what they're experiencing.

Unidentified Participant: I'm not sure the extent that investors may be new to your story if you could just maybe go to a slide towards the beginning that gives a little bit of an overview of your business offering and your competitive advantage, and a little bit about what the company specializes in.

Eric Loughmiller: Yes, bear with me. I was on Page 29. I have to rewind it a little bit for you. Basically, we operate three major business segments. Segment one is a used car auction segment. These are wholesale transactions. We're selling cars that any of us might want to drive on the road. And we call them clean cars. They're all ages, all makes, models. We do not -- the Barrett Jacksons and Mecums of the world are different types of auctions, more on collectible specialty cars.

This is a mass audience of cars. This is the cars that are on the road everywhere. We happen to sell, as you can see over there, we're selling over 2.5 million cars in that business every year now and growing, especially with the online component. We sell them online as well at physical locations. The second element of our business, insurance auto auctions, is selling total loss vehicles for the insurance industry and in that industry, we're selling close to 2.4 million cars a year. Again, in there, it's U.S., Canada, and a small number in the U.K. And of those cars, so think about that, when a car is in an accident, they'll either repair the car or declare it a total loss. In the United States and Canada, if it's declared a total loss, the insurance company takes ownership of the vehicle and then sells it to recover a portion of the claim that they've paid to the individual.

So that's a great business. That's actually one of the strongest performing businesses we would have. And then the third business is a floorplan finance business, where we're actually providing liquidity to the customers who are buying the cars at ADESA and Insurance Auto Auctions and their competitors. Now, there we're serving the entire industry, not just our own auctions and we're providing inventory financing, average term of less than 65 days, and it's a fee-based business in which we charge a fee plus an interest rate spread on the loan. And it's a very high performing portfolio.

In all three of our businesses relative to the niche that we're serving, we operate in duopolies. ADESA's primary competitor is Manheim. Manheim is a subsidiary of Cox Enterprises, part of Cox Enterprises, Cox Automotive then Manheim. Manheim owns NextGear. On the finance side, that's the number one competitor, NextGear Capital owned by Manheim. And then in the middle, insurance auto auctions, it's a duopoly and its competitor is Copart, a publicly traded enterprise that has done very well, just like insurance auto auctions.

In each case, the consolidation is probably meeting about 70% to 80% of the market through the two major players. I will give you the head's up, it's like anything. You can be the best at anything. In the floorplan financing business, this is floorplan lending to independent used car dealers. So this is like me saying I'm the best golfer sitting on this stage that is on the right side as I look out. It's narrowly defined because floorplan financing is provided by banks, captive finance companies, but they don't provide it to the independent used car marketplace where we are focused. So that's why I say the others are more broadly defined as the entire market.

So that's the business we're in. We see a lot of transactions. We process over five million automobile transactions a year. Within those businesses, we transport more vehicles than anybody

in the world. We probably move between seven million and eight million cars a year, which is -- and by the way, there's no OEM that sells that many so they can't move them. And by the way, we do this all the time. And when we move them, we might be moving them to auction. We might be moving them from auction or we might move them to the auction, then move them from the auction when somebody buys them.

We have a logistics company that's part of ADESA that we don't own any trucks. We've created a technology platform that sits in the middle between auto transport companies and dealers and other OEMs, et cetera, who need to move vehicles. And we are one of the largest repo companies in the U.S. and Canada. The repo company, Par North America, we don't have any repo agents. We are sitting in the middle creating the middleman so that we can facilitate the transaction. Across all of our business, they're fee-based businesses. We charge you a fee for our services generally not taking risk on the underlying collateral value of any asset and that's where the business model has its strength.

So when you sit in the middle of it, we're a transaction based business as opposed to a value driven business. So when Doug asks me about used car values, it's not really relevant other than it can have a significant impact on our relationships with our customers and how they feel because it's like anybody here. When my stock doesn't do well or my bonds aren't doing well, I blame the analyst, right. You've got to blame somebody. We sit in the middle and get blamed but the truth is that's just what the market is willing to pay for an asset.

So other than customer satisfaction issues, we're agnostic as to the value of the underlying asset that we're dealing with.

Unidentified Participant: Right. It's an auction. Margins, nonetheless, are very high on an EBITDA basis. We have you at a 23.9 and it looks like you've kind of been pretty steady at high level. What is the opportunity for A, keeping those margins, and B, is there any -- we had a peak. Could we expand those? They're pretty high.

Eric Loughmiller: We would expect those margins to continue creeping up. I don't want to give you a targeted number but the reason being is they've settled in at the mid-20s temporarily because we have gone through a private equity transaction in 2007. We took out all the private equity players. We had taken cost out of the enterprise and we've grown substantially. And there's a step function. So in 2016 into 2017, we were seeing a little bit of an elevation in our SG&A, not temporary, meaning we needed that to support the bigger business we put together. But now, we're leveraging that SG&A.

Our incremental margins across the enterprise were very high in the third quarter. They've been high all year but even higher in the third quarter. We're in a situation where we think we'll see some steady improvement of that for some time. Again, until the business reaches a scale level where I might encounter another modest step function. And the step function, the biggest SG&A component for us is people and the people around technology. I talk about our locations and the number of sites. On this slide you'll see it up there. This has become a technology business.

So I think there are two strong moats around the business. One is it's hard to get the land in which to handle this many cars and that was probably the moat that's existed for a very long time. In the last five to eight years, it's become the technology spend. Us and each of our competitors in any of these businesses is spending hundreds of millions of dollars a year to provide the technology to support the existing business. That's nothing to do with our trade revenue acquisition or things like that, which were also…

Unidentified Participant: Is it customer interface? Is it diagnostics? Is it pricing?

Eric Loughmiller: It's everything and again, remember, and you can think about it, you sit in the middle of financial markets and there's somebody in the middle providing quotes and trying to extract all the data. That's what we do and to do that, we need to be integrated with many of our customers are sellers, many who are buyers, and also all the sources of data that's changing hands. So the technology spend has become in my opinion equal to or maybe even a bigger moat. We run all these private label sites. The cost of change would be huge and one thing we've done as an industry, we have retained all rights and proprietary ownership of our technologies. Even though we've run private label sites for many of the OEMs, they do not own one piece of that technology. It's our technology.

And so that's been an important attribute and we do it, and the exchange for that is I only make $112 a transaction. So it's a low cost transaction. So there's no pressure to turn over that technology because if they did, it might cost them more for their small group because I'm spreading it across 30-some OEMs who run their private label sites through us.

Unidentified Participant: Right. There's a question here in the middle.

Unidentified Audience Member: As you see the industry shift into the (inaudible) long line, are you seeing any signs of (inaudible) where customers are auctioning vehicles direct?

Eric Loughmiller: We're seeing faster growth of the number of cars sold online, but there are more cars going through physical auctions every year than there ever has been. So it's a little of both. The interesting part is the smallest component is the online sale and the fastest growing component is that smaller component. With that said, the most significant driver of online sales is the off lease volume. Very few cars that are sourced other than off lease sell in the online venue. About 90% of our online only volume are off lease cars.

And why? It's because you have the best information for that transaction. I've got an independent condition report that's extremely detailed, prepared when the consumer is ready to turn that car back in. It is signed not just by the independent inspector but also by the consumer that they agree with the assessment. You have to sign that acknowledging why. Because that's how you get your security deposit back.

So we have more perfect information in that transaction. So the disintermediation we're not seeing. I'm probably seeing more of that on the retail side than I am on the wholesale side and it's because I need to collect and aggregate these cars. I need to recondition the vehicles and you can't do that online. The reconditioning is a physical act of doing body work, repair work. I will tell you, though, the market has accepted technology. If there's a car in retail ready condition, there's virtually no reason it needs to go to a physical auction.

Unfortunately, and you know, look at your driveway, look at your neighbor's driveway, look at the cars you see on the street. How many cars do you say that you've said if they drove that onto a used car lot, it would be ready for sale today. It's very few. They have little nicks, dents. So again, I talk about our services. We own a paintless dent repair company, PDR. That pops dent. All that is what happens before a car is retailed. That's why used cars look so good when you get them. Sitting there, these cars look great. Well, they've probably done something to repair them.

So the disintermediation, we do think more cars will sell online from physical auction locations because the cars that can sell are selling before we touch them and the rest of the cars probably need some type of reconditioning to get into retail ready position before we are able to wholesale them at maximum price.

So I do think there's a lot said. There's a lot of business models out there. Most of what is brought to me by name, and I'm not going to name them because they didn't pay for this advertising and I won't want to name all the retailers, but most of them with these retail concepts, we're a supplier to them. This is how they're getting their inventory so that's the advantage and we have all the inventory. It's actually strengthening our hold on the market because they need one place to buy the inventory. They need technology. If you look at them, their systems are built on fewer employees so they need technology to be a decision maker for them as opposed to people saying, oh, I'll buy that car or I'll negotiate for that car.

And we're, again, the best wholesale, our industry, us and our competitor, are best equipped to service that market. I do think you'll see more online sales. I think you'll see over time when this off lease volume starts to level off, you'll see the growth being in the physical lanes, people buying online because the car is retail ready.

Unidentified Audience Member: Do you see the auto rental companies making a push into alternative disposition channels like direct to retail as a material headwind for you guys?

Eric Loughmiller: I've been CFO of KARA since its inception in April of 2007 and since April of 2007, and they were doing this before. They've been talking about it and yes, if they can sell a car, it's no different than my other suppliers. Online sales we just talked about in your question. If there's an off lease car that doesn't need work done to it, why not sell it without taking it to an auction facility.

And there will be cars the rental car companies have. That can happen. But there will be other cars that no, that's not retail ready. And so I think we're hearing it but I've been hearing it since I've gotten into the industry and nothing's changed. At the end of the day, they have hundreds of thousands if not millions of cars to sell at any point in time and they can't do that one car at a time. They need to bring it to our site where we, again, we're selling 5 million cars a year through our various networks. They're a drop in the bucket to that and when they're selling hundreds of thousand a year through us.

So they need liquidity. They don't -- how much credit risk are they willing to take? Well, when they come to us, there's no credit risk. We guarantee check, guarantee title. We guarantee a check to the seller and we guarantee a valid title to the buyer. And you can't get that. A gain, there's all these minor barriers. I do think they'll be successful in selling more cars direct in different ways. It'll be harder at some point though when they have large fleets, not every car is at the right answer. So I think there's room for both, their proposed solution, but I don't think their auction volumes go to 25% even to be honest. They need to move the cars quicker than that. Otherwise, the interest costs will more than offset the retail profit they can get across the few cars that they can sell.

We have a question up here. Oh no, we're going to wait. We have one ahead of you and he has the mic.

Unidentified Audience Member: Can you give updates on both your digestion of the vehicles in Houston and Corpus from the storms? And also an update on your perspective of Europe and any expansion plans you might consider from this point?

Eric Loughmiller: Sure. Hurricanes in Texas in particular, all the cars have been collected by us and our competitor. And actually, the only update I'll give you is they're selling at a very rapid pace. We have projected that the sale of those vehicles would occur more than likely over Q4 and Q1. I would tell you the only update I have, again, as expected, we're selling them as fast as we can and our competitor just announced earnings last week, and they had an extra month. And consistent with

what they said, we're seeing the pace of those sales actually a little faster than we originally expected.

So I think it will be through substantially all of them this year with a small amount of hangover. Some of the cars have title issues. There may be a dispute over the value and the way you have to hold those. I think you'll see a relatively small number move into next year, which is good for us. The other thing it allows us to do is eliminate the incremental cost for land and things like that, that we have, even though we made some commitments that as soon as we can move off of it, it reduces our operating cost around the catastrophes.

So it's moving quickly. We feel good about it. In our last earnings announcement, we told you we'd lost $4.3 million in Q3. We expected to recover that. There's been no change to our expectations that it'll be a near breakeven event more or less for us. So we're pleased with that.

The next topic is international. We're very excited about international growth. Now, it doesn't look like how we built the U.S. based business where we've basically been an aggregator of various independent auctions, creating a network, building a large national if not international business around it. What we're looking at is being asset light, moving into the markets like we've done in the U.K. Our first foray internationally outside of North America was to go to the U.K. We bought an online auction there. We have a small salvage operation there. We think we can take the advantage of the technologies we've developed in the most mature used car market in the world, the United States, and Canada, and take them over there. There's a lot of interest in that and now, it's just a function of finding the right entry points in the various markets, whether it be Europe, Asia, Australia, any market that has a mature used car marketplace with regulation around evidence of ownership. That's the one thing is we don't need to be -- despite the lunch speaker today -- while we see great opportunity in emerging markets, it's really too high risk.

Keeping in mind, I made $781 per transaction in my physical auction and $112 per transaction in my online auctions in Q3 on an average sale price of over $10,000. One fraudulent transaction, I lose $10,000. One good transaction, I'm on average making, if you blend those, $560 per car sold. It takes a whole lot of good work to make up for one big mistake, which is why we need mature used car marketplaces and we need large transactions.

So I'm looking at markets where the number of used car transactions is a multiple of new car transactions. I'm probably looking for a market with an established dealership network who is going to mitigate fraud amongst car ownership. And I probably want cars that are exchanging hands on a regular routine basis.

Unidentified Audience Member: Given that you're going to go ask a client, do you feel like you have the technology stack that you need to (inaudible) or is that something you're looking to (inaudible)? Or is that something you kind of meet in the middle?

Eric Loughmiller: We have the technology stack, but as you know, there's two kids in a garage coming up with the next technology. So that stack is likely to have some changes. So we just, October 3, we closed on the rest of our Trade Rev acquisition. That's an example where we didn't feel we need that. We now feel that's a great offering that would go and we've introduced that into the U.K. market. And so owning it was more important because we're actually increasing its value in the market that the principals of that business weren't even touching.

So generally speaking, we think we have the technology stack. As you learn in this business, though, or in any business, as soon as you have that technology is ever changing, it's likely we'll find alternatives to that, like GRS in the U.K. was an online only auction and what they had that we didn't have over there was a back office operation for the online transaction. So I think you'll

see us meeting in the middle in that we have the technology stack but we'll have to add around it a little bit, because in each market there's probably a different business process or platform that we need to accommodate.

We also will probably be adding to it. One of the most important aspects of an online offering is having an established buyer base. It's hard to sell a car if you don't have the buyers on the system and so that's -- with GRS, we got an established buyer base in the U.K. When we're buying physical auctions in the United States, we bought 13 sites I think or 14 sites in 2016. We were not buying the physical site alone. We were buying the buyer base and what we have found is when you have an online offering for us, our greatest success is in a market where we have a physical presence.

Even though you don't have to touch the physical location to buy online, for whatever reason, when we heat map it, the biggest, strongest red circles were right around our physical auction location and it's probably because it's a more confident transaction when you know who's sitting on the other end of that computer is also down the street if there's an issue. Again, we all know how we buy retail items nowadays. First thing we look at is can I return it, right, and how do I return it. Now, most of it we will do UPS or FedEx, but with a car you can't do that.

So how do I return it. If it's really not what I want, how do I return it and who do I return it to? And I don't want to know everybody on the other side, but if I know ADESA, in our case, it really gives comfort to everybody. So I think I would describe it you're meeting in the middle. It's probably not dead center in the middle. We're probably a little further along on technology and adding along the fringes a little bit.

But we're excited about the international growth opportunity and the good news is I'm not dependent upon it in the next few years. We still have 2.5, 3 years left on this cycle of off lease vehicles. So it's not like, okay, that's my next growth. We're building the platform in what we call a responsible, patient manner. We're being disciplined and patient because I don't have this burning need for, well, where's my growth come next year. We have some time to build it up and I think that's been a sensible strategy for us.

Unidentified Participant: New question.

Unidentified Audience Member: Help me understand when you have a totaled car, you're putting it on the lot. Are you shipping it down and selling the parts on it?

Eric Loughmiller: No, we sell it as is and there's a company you can visit tomorrow that's coming, OKQ, that buys it from us and then strips it down and sells it as parts, or it's a pick and pull. There's all kinds of businesses around how you extract aftermarket recycled parts. So we sell the cars as is and they have a lot of value. And there's -- part of it is that's just the most efficient transaction for us and our land is tied up. We need to get it off our land.

Ironically, when you see one of our lots, and the one in Indianapolis has about 7,000 total loss cars on it almost all the time, about 7,000. It's a big -- because in Indiana, we handle most of Indiana. We're in South Bend, Indianapolis, and nothing until you get down to Louisville. So it covers a wide area.

And people say, well, that's just a junkyard. The cars just sit there. No. We sell 8 to 100 to 1,000 a week and we get 800 to 1,000 wrecks in a week. The cars are constantly moving but when you look at it, if you drive by every day, there's just a whole field of wrecked cars out there. So we don't really -- we are not set up nor do we want to be in that business of dismantling the car. It would take a lot more land.

Unidentified Audience Member: One more question. On environmental, oil, radiator fluid, et cetera, and you're getting -- I assume I know you just -- many years ago, you sold the ADESA site to Manheim. Manheim just sold that site to North Miami to an industrial developer. How are you dealing with the environmental issues?

Eric Loughmiller: Environmental issues are very important to us. We do Phase 1s all the time. And there's processes around extracting fluids from the vehicles before they park, before they're sold. That's all part of the responsibility. The fight is over who owns the fuel, for example, is it the insurance company or is it us. We'll get into that fight occasionally, but basically, we operate responsibly on all of our sites and most of it is, again, you're extracting the fluids. By the time the accident has occurred, it's usually on the highway or it's in the collision repair shop yard that the fluids have drained.

But we have processes around draining fluids from the vehicles where it's appropriate. A lot of these cars, to be honest, are going to be sold as is and the fluids are not at risk. But you're constantly looking at that to see that we don't create environmental hazards, and we're measuring and making sure that we're responsible.

Unidentified Participant: Eric, maybe you can just go over a little bit of the cap structure in the last few minutes. You've had a revenue growth for the last five years plus 10%. The balance sheet has been stable. If you could just give me a picture of how you want the balance sheet to remain, acquisition growth, pipeline.

Eric Loughmiller: So Doug, good question. We generate a lot of cash. That's the nature of a business like ours. And our free cash flow yield is turning into actual cash is above 100% because our balance sheet, working capital doesn't eat a up a lot of it. So as we look at it, we target about a three times leverage as our ideal leverage position. We have such a strong balance sheet position with minimal if any risk on the valuation of the underlying assets. Our DSO and our receivables, when you look at our balance sheet, you'll think it's over 100 days. It's five days to seven days and the reason is our revenue is the net revenue. It's the fees. My receivables and payables are the gross transaction value.

And so it looks different. So this is a business that's set up perfectly to utilize the balance sheet to create some leverage in growing the business. So now, how do I allocate capital? I allocate capital. First, we have a recurring dividend that we think we established in 2012 that has been very good for our shareholders. They like the fact that it's a foundation. It's them getting a little bit of return in cash and I think it provides at least some defensive floor on valuation. After that, we have a lot of remaining free cash flow and our preference is to allocate to strategic growth, which means M&A. But there's not always, I said, I used two terms, patience and discipline. Discipline around pricing, patience around how fast you have to move to grow the business.

Unidentified Participant: And what would you be buying? Would you be buying another smaller local auction?

Eric Loughmiller: We've been buying location auctions. We've been buying GRS. We've been buying technologies that are used in the auction process. We have stayed very close to our core businesses. Even in our technology purchases, they've been technologies used by our existing customers. We have not had to venture off -- we are not at this point in any retail transactions. We're a wholesale business and technologies around wholesale.

Then to the extent that I've exhausted my opportunities at least in the near term, I have cash left over. We've used it for share buybacks at the appropriate time. Interest rate environment, we would also pay down debt. Something that's long been forgotten, I think, is from 2007 to 2009,

we paid back over $1 billion in debt, paid back, not reduced our leverage ratios. We paid back $1 billion in debt.

Since then, we've been in an environment of just unusually low interest rates where we've decided the better use of capital is other opportunities for deployment. But again, we have the ability to pay back large amounts of debt in the right market conditions if that were the case.

Unidentified Participant: That's helpful.

Eric Loughmiller: So it's a really strong capital -- and again, when I meet with investors, which we do all the time after each earnings announcement, we have been disciplined and consistent in our capital allocation strategy. If we -- in 2016, we spent $432 million on acquisitions and still managed to buy back $80 million of stock in the fourth quarter because we saw the equity value drop in the market and we said this is opportunistic. And our leverage ratio is back below three times in total as of now our net leverage. So we have a lot of cash.

Unidentified Participant: Well, that was really helpful. That was a good fireside chat. We have just 20 seconds left so let's end it here and we'll get everyone to the next meeting on time and thanks so much. That was awesome, Eric. I appreciate it.