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KAR - Q1 2013 KAR AUCTION SERVICES INC Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome do the KAR Auction Services Incorporated First Quarter 2013 Earnings Conference Call. Today's call is being recorded. Today's hosts will be Mr. Jim Hallett, Chief Executive Officer of KAR Auction Services, Mr. Eric Loughmiller, Executive Vice President and Chief Financial Officer of KAR Auction Services, and Mr. Jonathan Peisner, Treasurer and Vice President Investor Relations of KAR Auction Services. I would like to now turn the conference to Mr. Peisner. Please go ahead, sir.

Jonathan Peisner - *KAR Auction Services, Inc. - Treasurer & VP IR*

Thanks, Lexie. Good morning and thank you for joining us today for the KAR Auction Services First Quarter 2013 Earnings Conference Call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended March 31, 2013. After concluding our commentary, we will take questions from participants.

Before Jim kicks off our discussion, I would like to remind you that this conference call contains forward-looking statements within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties that may affect KAR's business prospects and results of operations and such risks are fully detailed in our SEC filings. In providing forward-looking statements, the Company expressly disclaims any obligation to update these statements.

Lastly, let me mention that, throughout this conference call, we will be referencing both GAAP and non-GAAP financial measures. Reconciliations of the non-GAAP financial measures to the applicable GAAP financial measures can be found in the press release that we issued yesterday, which is also available in the investor relations section of our website. Now, I'd like to turn this call over to the KAR Auction Services CEO, Jim Hallett. Jim?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Great. Thank you, John, and good morning, ladies and gentlemen, and welcome to our call. We've had a number of accomplishments since our last call, so just before I get into a review of the business, let me speak to those. We were able to complete a secondary offering on March 6; this now leaves the private equity ownership group with 56% of the outstanding stock. As well, we were able, or successful, I should say, in amending our senior credit facility. This has reduced our interest cost by 125 basis points and will reflect an annual cash savings in cash interest of over $21 million. Finally, our Board has approved our second quarter dividend. We will pay a dividend of $0.19 per share; this dividend will be payable on July 3 to shareholders of record as of June 24.

At the outset, as we look at the business, we continue to feel very good about our annual guidance and we're looking forward to sharing some of the positive trends that we're seeing here as we head into the second quarter. Looking at KAR's overall performance in the first quarter, we were able to generate revenue of $557.6 million; this resulted in adjusted EBITDA of $136.2 million and on a year-over-year basis, this represented a $1.3 million increase in adjusted EBITDA. Taking a look at ADESA, ADESA performed very much as I expected going into the year. Our volume increased 3%, 34% of our vehicles were transacted on line, and our dealer consignment segment represented 47% of the cars sold at physical auctions and our conversion rate came at just a little over 61%.

I've spent considerable time over the past year talking to you about the cyclical recovery that's going to take place at ADESA in 2013 and I want to reconfirm that the volumes and time lines are very consistent with what I've been telling you to expect in our earnings call over the past year, in terms of what we're seeing heading into the second quarter. There's no question the commercial volumes are expected to increase in 2013. We will begin to see the anniversary of these lease originations that were written in 2010 as we get into the second quarter, but the real impact of these lease returns is expected to be seen in the second half of the year and I'm sure that's welcome news for all of us.

At Insurance Auto Auctions, we had adjusted EBITDA of $54.7 million; this was a decline of $4.9 million from the prior year. We sold over 40,000 Sandy cars with no contribution to adjusted EBITDA. The good news is that Sandy is getting behind us. We've only got a few thousand Sandy cars left to sell. Perhaps the better news is we had a healthy supply of total loss vehicles from collisions this year. The inventory of total loss vehicles on March 31 is up well over 10% from the prior year, so I hope I'm done talking about Sandy in future conference calls.

A couple trends that I would point out in the salvage industry, we do have a positive outlook in terms of volume. The weather has been good for the salvage industry. Proceeds are softening and this trend is expected to continue throughout 2013, but I do not expect that proceeds will fall off significantly and this is based on the increase in utilization of alternative parts in the collision repair business we're seeing, as well as the strong international buyer demand that we're seeing.

AFC continues to perform at a very high level. AFC had an 8% increase in the number of loan transactions in the first quarter, the revenue per loan transaction increased by $5, and the portfolio remains over 99% current. As well, we expect to have the extension of the securitization with increased capacity completed sometime here in the second quarter. We're looking forward to AFC benefiting from the improved wholesale used car supply over the next few years; more vehicles going to auction equalling more cars being financed by AFC.

If I could just take a moment and focus on the used car wholesale industry here for a moment, recently, the National Auto Auction Association released its annual survey for 2012. They reported that 7.9 million units were sold at physical auctions and including OPENLANE, this means almost 8.2 million units were sold in 2012. The Auction Association stated that more independent auctions had reported in 2012 than what had been the case in recent years. As a result, we've updated our outlook to reflect those 2012 survey from the National Auto Auction Association. We now expect that, in 2013, that industry volumes will be approximately 8.5 million vehicles and we expect this number should grow to over 9 million vehicles in 2015. We are looking forward to the next several years of growth within the industry. The primary drivers of this growth will be the off-lease vehicles, as well as the repossessed vehicles.

We're seeing strong retail new and used car sales, which is supported by the credit markets. As most of you know, the SAAR is expected to be over 15 million units, lease originations are over 25% of all cars sold in the US, and that number is expected to continue to grow. I would say overall, the automotive sector is performing very well, as we speak. Just a couple words of caution as we go forward. I would say that our volumes will probably be somewhat choppy. It won't be a straight line from here to the end of the year. Then I would also point out Canada, where ADESA has a very significant market share, the Canadian market is lagging the US recovery in commercial volumes and it may be another 18 to 24 months before we get back to what we see as a normalized commercial volume market there.

Many of you may have seen a press release that went out here in the last couple of weeks on the new ADESA.com. Now, all US inventory is available in one online venue. Previously, views of the inventory were somewhat fragmented. Some were on ADESA, some on OPENLANE, and now buyers can view all of the inventory on a single website. We have been able to improve our search capabilities on the site; this makes it much easier and much friendlier for our customers to be able to search for vehicles. As well, we've been able to improve our market guide offering, we've integrated third party valuation data into the market guide, and we've added tools for our consignors to manage the re-marketing process online. I'm truly excited about the power of ADESA.com. I believe that this is going to have a positive impact on the customer experience, both for the buyer and for the seller.

As well, we've spent considerable time over the last 18 months integrating ADESA and OPENLANE. As we get to this one site, we've already seen the number of unique customer visits increase substantially. I'd just like to speak to the integration a little bit. When we did this acquisition of OPENLANE, we said that it was going to be critical for us to get this integration well-orchestrated, well-planned, and executed at a very high level, as we prepared for these volumes that were coming in 2013. I can say, of all the acquisitions that I've been involved with and all the integrations I've been involved with, this was the most highly planned, orchestrated, and executed integration and it's going to serve us very, very well as we go into the second quarter.

In terms of guidance, I said at the outset that we are very confident with the guidance that we've laid out. We remain unchanged in our guidance. We expect adjusted EBITDA to be $535 million to $540 million of adjusted EBITDA. We expect free cash flow of over $275 million and Eric will walk you through those details here in a minute. I continue to believe and continue to point out that our strong free cash flow is what truly differentiates KAR. Our priorities for cash remain the same. We're going to continue to focus on repaying debt, we're going to provide our shareholders a return in the form of a dividend, and we will continue to evaluate strategic opportunities to grow as we go forward.

With that, I will turn it over to Eric, who will walk you through a little more color and give you a financial review and then we'll come back for Q&A. Thank you and Eric?

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

Thank you, Jim. I would like to start by commenting on our first quarter performance. Consolidated revenue of $557.6 million increased 10% over the prior year. About half of this increase is the revenue generated from the sale of Superstorm Sandy vehicles. If one were to stop the analysis there, it would be easy to conclude that our revenue growth related to our recurring business was more like 5%. Please note, however, with the number of Sandy cars being processed in the first quarter, this has pushed out some of our so-called normal total loss business. I believe this sets us up well for the second quarter because, as Jim mentioned, we're going into the second quarter with strong inventory levels carrying over from the first quarter activity at IAA and we also have expectations for improved commercial volumes at ADESA.

Moving on to our consolidated gross profit, which was 40.6% for the first quarter, I would also like to point out that the Superstorm Sandy vehicles sold in the first quarter cause our margin to be unusually low. When I eliminate the revenue and all of the related costs for the Superstorm Sandy vehicles, our consolidated gross profit was 44.6%. This is more representative of how the businesses are performing in Q1. Consolidated selling, general, and administrative expenses declined to $100.8 million in the first quarter compared to $114.1 million the prior year. I will first note that there are no Superstorm Sandy costs included in SG&A in any period. The decrease in SG&A on a year-over-year basis is attributable to a decline in cash and stock-based compensation at ADESA and a decrease in stock-based compensation expense in the holding company. The reduction in holding company SG&A is primarily related to the recording of expense related to our equity compensation plans. We had a credit, or net reduction, in this expense aggregating about $2 million in the first quarter compared to a debit or an increase in this expense of about $5 million in the prior-year first quarter.

I believe Jim has given you a good view of our expectations in each of the business units. The only additional comments I would like to make relate to the performance at Insurance Auto Auctions, which, in turn, has impacted our consolidated performance. Excluding Sandy revenues and related costs, our IAA gross profit declined to about 38% in the first quarter. This is below the 40% or better gross profit we have generated at IAA for the last couple of years. As I have mentioned before, internally, we measure the net revenue from sale of purchased vehicles as our provider fee. Utilizing this internal management reporting for purchased vehicles, our first quarter gross profit was in line with our performance over the past couple of years, but it was below the same measure a year ago. We also mentioned in our last earnings call that we did not expect the number of purchased cars to increase in 2013 over 2012. This remains our view for 2013, even though IAA purchased and sold more vehicles in the first quarter of 2013 as compared to the same quarter a year ago.

Now let me turn to our guidance and free cash flows. First, let me summarize the components other than adjusted EBITDA that effect our pre-cash flow. We continue to expect cash taxes of $85 million and capital expenditures of $95 million for 2013. This guidance has not changed since our last earnings call. The only change is our expectations on cash interest expense related to our corporate debt. Previously, we had expected $94 million in cash interest expense. This is now reduced to $78 million to reflect the amendment of our term loan B facility.

I would like to provide a quick reminder of the changes to the term loan B facility. We reduced the interest rate on term loan B to LIBOR plus 2.75% from LIBOR plus 3.75%. This accounts for 1% of the interest savings Jim mentioned earlier. In addition, our term loan B facility has a LIBOR floor of 1%, which was reduced from 1.25%. We also increased the term loan B facility by $150 million and the proceeds were used to retire the same amount in floating rate notes on April 3. The amendment was completed on March 12, so interest savings will be realized over the remainder of this year. The annual savings from this amendment will be about $21.7 million. This assumes a LIBOR rate below the floor.

Let me summarize our guidance for free cash flow. We expect adjusted EBITDA of $535 million to $540 million in 2013. This is reduced by cash interest expense of $78 million, cash taxes paid of $85 million, and capital expenditures of $95 million, resulting in expected free cash flow of $277 million to $282 million for 2013. Now, to earnings per share guidance -- as a result of the interest expense savings expected for the remainder of the year, partially offset by the non-recurring expense associated with the amendment, we expect our GAAP earns per share to be about $0.82 to $0.87. Our adjusted earning per share guidance is amended to $1.15 to $1.20 per share for 2013. Adjusted earnings per share excludes stepped-up depreciation and amortization from the 2007 LBO, non-cash stock-based compensation expense, non-recurring charges incurred in conjunction with the debt amendment, and the non-recurring impact of Superstorm Sandy on our performance in 2013. We have provided supplemental financial information in conjunction with our earnings release to assist you with your analysis of our performance. We expect to file our quarterly report on Form 10-Q in the next few days.

For that, that ends my comments. I thank you for your time today and I'll return the call to Lexie to handle the Q&A portion.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Matt Fassler, Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

The first question I'd like to ask, I want to dig a bit deeper into the impact of Sandy on the business above and beyond the losses that you excluded, just to make sure we understand what the trajectory looks like from Q1 into Q2. It sounds like there was some crowding out of more profitable traditional business. If there's any way you could quantify that and talk about what kind of catch-up you might expect to see as we make our way into the second quarter?

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

Matt, thank you for the question. It's a very good question. As you know, we don't give quarterly guidance or segment guidance, but what we've highlighted for you is the build up of inventory at IA reflects the fact we've had a fairly severe winter throughout much of the United States and these collision repair cars are sitting, waiting to be sold. That will occur, as you know, it's typically 75, maybe up to 90 days from the time a car's assigned to us and on our lot to the time it's sold. I would expect that inventory would move in the second quarter.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Matt, I was just going to add, and I think you may have made the point, is that a number of our customers were focused on clearing out these Sandy cars and it possibly delayed some of the sale of these collision cars.

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

Yes. It's safe to say, you can only sell so many cars in a day, in a week, in a location, Matt. If you were selling Sandy cars, you could not possibly be selling the same number, because there just isn't the physical capacity for the buyers to consume them, move them, and move them around their network all in the same day.

Matt Fassler - *Goldman Sachs - Analyst*

My second question relates to ADESA, and the contours of the model here in Q1 versus other quarters. At least relative to our expectations, you had a higher revenue number and a lower gross margin rate and the gross margin rate was down pretty substantially, year-on-year, albeit from a pretty good quarter. You mentioned in the release more ownership vehicles, and I think I know what you're talking about, but can you talk about whether that was a factor behind the different revenue and gross margin dynamics for the quarter?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Yes, Matt, I would just point out that, without getting into the specifics of the different segments, which we don't do, I would just say, as you know, we have commercial volumes and we have dealer consignment volumes. Within those commercial volumes, there are a number of different customers that we sell for and some of these segments have lower economics. We had, perhaps, a little bit higher mix of those lower economic cars during the first quarter of the year.

Matt Fassler - *Goldman Sachs - Analyst*

Got it. When you talk about ADESA, I don't have the text in front of me, but when you talk about ownership vehicles, just make sure I understand what you mean?

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

Again, in all of our businesses, we will buy cars under certain circumstances. It is not significant. However, it reached the level where in our 10-Q that will be released later this week, we have to mention it because it was a negative on margin by a little bit. That's just the gross up of the revenue, it's not the economics of the transaction. GAAP requires me to report the gross sale price as the revenue, offset by the cost to acquire.

Matt Fassler - *Goldman Sachs - Analyst*

Thank you.

Operator

John Lovallo, Bank of America Merrill Lynch.

John Lovallo - *BofA Merrill Lynch - Analyst*

First question would be related to your outlook, I'm just thinking about the $21 million in reduced interest expense, but the EPS, or the adjusted EPS guidance only going up by $0.02. I would think that the $21 million would equate to closer to $0.09. I was wondering if there's any non-cash costs hitting the P&L that's creating the differential there?

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

Yes, you have the write-off of debt issuance costs that has occurred and we have the retirement of the bonds that occurred in the second quarter, not the first quarter. Those items impacted our calculation.

John Lovallo - *BofA Merrill Lynch - Analyst*

Okay. Thank you.

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

It's not a change in the underlying business, John. It's really the net economics on 2016, as you know, we paid a 1% premium as related to the 101 soft call that existed on term loan B and there is some accounting for that.

John Lovallo - *BofA Merrill Lynch - Analyst*

Okay. That's helpful, thank you. I'm thinking about the ease in the recovery in whole car volumes. What we're hearing from a lot of the new vehicle dealers is that they're really making a push into selling more these off-lease vehicles themselves. How are you guys thinking about that and the potential effect on the business?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

John, I would say that we continue to see increased volumes, and one of the things that we've been doing now for well over the past year, as we prepare for 2013, is we've melt with all of our commercial sellers for the most part. We've checked in with them and seen what their anticipated volumes are and there has been no significant changes with our commercial customers in terms of the way that they plan to resell their cars in 2013 and going forward.

John Lovallo - *BofA Merrill Lynch - Analyst*

Great. One of the things I found pretty interesting about OPENLANE is the ability to sell vehicles in transit. How is that effort gaining traction?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

It's not a huge, not a huge number, but I think the thing that's important is once the vehicle has gone through the closed cycle and then it's gone through the open cycle and it hasn't sold in either one of those venues, it then gets dispatched to a physical auction. We leave that vehicle for sale

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on the website, while the vehicle is traveling in transport and there are a number of those vehicles that do arrive at the physical location with the sold sign on them. Again, not a big number, but a number that continues to grow somewhat.

John Lovallo - *BofA Merrill Lynch - Analyst*

Great, thank very much, guys.

Operator

Bret Jordan, BB&T Capital Markets.

Bret Jordan - *BB&T Capital Markets - Analyst*

I think in the prepared remarks, you mentioned some softening of the proceeds at IAA, and maybe if you could talk about the trajectory and the major of drivers to what's changing at IAA right now?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

I just think as these volumes come back, I think that there's more supply and as there's more supply, the proceeds, we've seen somewhat of a softening. But as I mentioned in my remarks, and I'll restate, the increased utilization of the increased use of alternative parts continues to be very strong for collision repairs and again, that international buyer demand continues to grow. With those two things, will it soften? Yes, but not significantly that we would say it's going to have a material impact.

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

Bret, I'll remind you, in the first half of last year, the salvage industry hit the all-time peak of auction proceeds in the industry. The entire industry knew that, right? You're also, when we say softening, it's against a number that was the highest in the history of the industry in the first quarter of last year and that extended into the second quarter and then started to ease off.

Bret Jordan - *BB&T Capital Markets - Analyst*

Okay. Great. One question as relates to the whole car side and as the dealers are talking about trying to retain used cars for resale, are you seeing any change in the profile in the whole car that you're seeing? Are they putting cars to auction that might have been higher mileage or older cars, and trying to retain the more of the trade-ins or really no change to what you're seeing?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

As we look at the first quarter, last year in the first quarter, 46% of our business was dealer consigned cars. This year, 47% of our business was dealer consigned cars. I don't have any data, but I would tell you I would tell you that my general thoughts are as there are more supply become available and more and more of these lease cars and repossessed vehicles come into the marketplace and the dealers have more to choose from, I believe that they will send more of their high mileage older trades to auction, and I think that will serve well for the whole car industry.

Bret Jordan - *BB&T Capital Markets - Analyst*

Okay. Great, thank you.

Operator

Gary Prestopino, Barrington Research.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Could you maybe tell us what, I think you said Insurance Auto inventories were up about 10%, right? How much of that is ex-Sandy, how much is it up ex-Sandy?

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

It's over 10% and that would be -- there's only, as Jim mentioned, a few thousand Sandy cars left.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Most of that's ex-Sandy? Okay, that's good news. Do you have any industry statistics as to what the units coming into the auction were for Q1, as of yet?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Just make sure I under your question, Gary. Statistics, you mean as an industry?

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Yes, for the industry.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Yes. No. We don't have any numbers from the industry that would be anywhere close, there would be no numbers that we could point to factually, I don't think. Eric?

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

AuctioNet does give us some more real-time information, but it's not a full survey, Gary. We quit quoting the AuctioNet numbers a couple of years ago because they tend not to be as accurate, they move around. But, Jim, I think we feel we're doing very well relative to the industry, because of our strong representation in commercial, especially with OPENLANE and what we're doing online.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Okay. Lastly, we talked a little bit about channel optimization last quarter. With OPENLANE and your ability to retain these vehicles going into the physical auctions, could you maybe comment on what you saw as the trends throughout the quarters with having OPENLANE now integrated on the website?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Yes, again, I'd just point out at the outside, Gary, our outlook or our stance has always been get car, sell car. Whether it sells online or whether it sells in the physical auction, we don't really feel it's up to us to determine that or to push it to one market or the other. We think that as the car works its way through the cycle, the economics take care of itself to support the guidance that we've given you.

Currently, I mentioned 34% of the transactions were online in the first quarter. Keep in mind that half of those online transactions are through our live block at the physical auctions and the other half are actually on OPENLANE. Those are the numbers that we're seeing. Will those numbers move around a little bit? We didn't see any significant change in the first quarter in terms of percentages.

Gary Prestopino - *Barrington Research Associates, Inc. - Analyst*

Thank you.

Operator

Ryan Brinkman, JPMorgan.

Ryan Brinkman - *JPMorgan - Analyst*

I know that there was a question earlier whether we might, in fact, be seeing some early emerging evidence of the long anticipated turn in whole car auction volumes. You stated we don't have official figures as of yet, but you might remind us that I think it was 4Q '11 was the first quarter that your volumes fully reflected OPENLANE and that your volumes appeared to have improved on a year-over-year basis as we move from the fourth quarter of 2012, minus 1%, 2% plus 3% in the first quarter of '13.

Also, I'm looking at the average sequential increase from 4Q to 1Q at ADESA auctions, in terms of unit volume, it seems to have been about 9% over the past these years whereas it was plus 17.5% sequentially, at least according to our math. Any comment on that and whether you might at least be privately encouraged that we could be starting to see that long anticipated turn?

Thanks.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

That's a lot of numbers. I think I'm going to let Eric answer that.

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

Yes, Ryan. Without commenting on your specific math, the trends that you identified are the trends we're seeing and things are improving. We are actually quite pleased with the 3% volume growth at ADESA over the prior year, both periods including OPENLANE transactions, et cetera. Yes, you are correct. While again, we aren't giving specific detail, the sequential growth in Q1 over Q4 was also encouraging to us, as well.

Ryan Brinkman - *JPMorgan - Analyst*

Okay. Appreciate that. Thanks, and just last question. On the average revenue per unit at ADESA, I know that this can oscillate with changing amounts of ancillary services, although I wouldn't think that would necessarily be the case, that it would be supported by ancillary services just because of the higher mix of dealer cars. But your average revenue per unit was up, and it was down in each of the four quarters of 2012 and we were looking at, as a modeling item, the Manheim index, which averaged minus 3% year-over-year in the first quarter of '13. What allowed your average revenue per unit to increase at ADESA? Thank you very much.

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

Okay, Ryan. Thanks for the question. Again, Jim mentioned the mix. This is pluses and minuses adding up, and I'm not going to go through all the details, but the bottom line is it demonstrates the pricing power and within the commercial vehicles, getting ancillary services partially offset, though, by the fact that some of these cars have a lower revenue profile if they're sold in a closed sale, whether that be online or physical.

You've actually pointed out a very nice trend, which we were highlighting in the 10-Q that will be filed, and it's also in the supplement, that we're up 2% on revenue per vehicle and again, we're pleased with that. Part of it, though, is pricing where we have increased buyer fees that we can pass on throughout last year and into this year at individual auctions.

Ryan Brinkman - *JPMorgan - Analyst*

Okay. Thank you for the color.

Operator

Bob Labick, CJS Securities.

Bob Labick - *CJS Securities - Analyst*

Thanks for all the details up to this point. I just wanted to go back on IAA gross margins for a second. Just to make sure I understand that you said, it was partially due to mix of higher purchased cars in this quarter and then partially due to proceeds that the gross margin ex-Sandy was down year-over-year. Where do you see it stabilizing with the new mix of purchased cars? I understand that you think it'll be roughly equal to last year's mix. So, should we expect a stabilization on a go-forward basis in IAA margins or where do you see that going?

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

Bob, what I pointed out in my comments was ex-Sandy, we're at 38%. However, I think we're still, if you take it the way we look at it and you de-emphasize purchased cars, which is our expectation for the year, where there's not growth in that number, it stays in line with the last couple of years where our margins were over 40% or more.

Bob Labick - *CJS Securities - Analyst*

Okay.

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

I'm not going to guide you to a specific numbers, it's just too hard to do. But you point out a good point, Jim mentioned the softening proceeds. That, of course, has an impact on what they're paying, which affects the buy fee, but that can still generate very strong margins for that Salvage business.

Bob Labick - *CJS Securities - Analyst*

Okay. Great. Thanks a lot.

Operator

John Healy, Northcoast Research.

John Healy - *Northcoast Research - Analyst*

I wanted to go back on the question on the IAA volumes and the inventory being up over 10%. I was curious your thoughts, because it sounded like that there was some insurance companies that held back the normal collision activity. If you were to remove that anomaly, I'd be interested in knowing what the inventory might look like. Would you attribute it to the accident frequency picking up or are you starting to see a turn in the salvage frequency in terms of the percentage of vehicles that are in the collisions?

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

John, good question, very complicated. First, let me correct the perception. The insurance industry isn't holding back cars, they're selling them as fast as they can. But there's a reality, they had Sandy cars and they had collision cars, and there was clearly an emphasis on moving the Sandy cars as fast as they could and the reason being, you really want people to understand that's a flood car and it's from a salt water flood, right? If you mix them up with everything else, it really might confuse the buyer base because they might value the cars differently. But it's not they're holding up, it's just the market only has so much capacity each day in each location.

Looking at it, we're not going to comment on what the inventory growth means, other than it's a positive sign. But you are correct, in fact, I saw an insurance industry statistic where the number of total losses year-over-year is up, I know it's well over 2%, but I can't quote the precise number. That's total losses as a percent of total claims, so that's a positive sign, frequency, with the accidents. Jim, you have more to add?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

No, I would just add when you draw the comparison between the winter that we experienced last year versus the winter that we experienced this year, it's completely a 180 in terms of the weather and as a result, the number of accidents that occur and number of total losses that take place.

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

I think we had snow in Colorado and Kansas last night and it's May. It's been a spring, as well, that's been a little bit volatile and not just Sandy; hail damage, all kinds of floods, I mean it's been quite a year, already and here we are only in the early part of May.

John Healy - *Northcoast Research - Analyst*

I appreciate that. I wanted to ask just about your strategy, and if you think about the average age of a vehicle that's on the road today, as those cars become refreshed, are you seeing any change in that because the vehicles are older that historically they would have been sold at ADESA? Do you see people try to sell those to the IAA business, just because it might attract a different buyer and their proceeds are better? I was just wondering if you're seeing any mix back and forth in terms of vehicles being sold due to age, where they might sell the best for?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

That's a good point. There's no question the average age of the car is currently over 10 years and back three, four, five years ago, that number was eight years old. There is an aging car park out there that we've spoken to many times. We have had some of our customers sell some of their low-end, what I would call push-pull-drag sleds. We've had some of our customers sell those cars in a salvage venue versus selling them in a whole car venue.

I think that's one of things that I would point out, is KAR is really the only company that's in a position to do that, because we do have such a strong whole car offering and a strong salvage offering that we can really give the customer the choice of selling in either venue. We do have some customers that do take advantage of that on some of their lower end vehicles.

Certainly, then also, in the Rental Car business as well, some of these rental cars that are damaged, the rental cars are mostly self-insured and some of the rental companies have chosen now where they maybe tried to sell some of these cars in whole car auctions in the past, they're know sending more and more of these cars to the IA auctions. Again, this is based on the whole relationship with KAR owning both ADESA and IAA.

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

With all that said, John, in the first quarter, we had an increase in the number of our vehicles sold that were insurance-related over non-insurance compared to probably most of last year. In fact, it's back, it's above 80% and if you took out Sandy, it's still quite a bit above 80%. Part of that is, there's a lot of insurance-related vehicles in the market right now and that's a majority of all of this volume that you're seeing.

John Healy - *Northcoast Research - Analyst*

Great. I appreciate that. Thank you.

Operator

John Lawrence, Stephens.

John Lawrence - *Stephens Inc. - Analyst*

Just to go over the mix issue again, I mean you talk about the whole idea of some of those mix cars, what I was thinking as the volumes improve, as we get to second and third quarter, second half of the year, does any dynamic change where more of those cars, because of volume, get to the bottom end of the funnel, if you will?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Yes, I think what you're going to see is you're going to see more of these off-lease cars and more of these repossessions, and if you think of all the various segments, those are two of our most profitable segments. Number one, they're very desirable cars, cars that dealers are very much in search of, and secondly, to what we've talked about earlier, these are also heavy users of the ancillary services, which bodes very well for our Business as well. Again, as we think about mix going forward, we spoke about how that mix may have shifted a little bit in the first quarter, as we look at the mix going forward it'll be a positive thing that'll be more off-lease cars and more repossessed vehicles.

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

I'll add to that. You talk about the at top of the funnel when there's more choice, they're going to be picky and some of these cars need some reconditioning, as Jim mentioned. The reason they're going to go to physical auction is they're going to yield more for the consignor if we do a little bit of work on the vehicle, John. I think that's very positive for our Business that, again, with more opportunity to buy different cars, they're going to look for a higher grade on that car.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

When you're in a market where there's very tight supply, some of these sellers aren't as focused on doing the reconditioning and providing the repairs, they're just interested in getting it to the market and getting it turned quickly for the highest dollar that they can. As more volume comes into the market and more volume comes into the physical lanes and things become a little bit more competitive as to which cars are the prettiest and most attractive, as they say, the prettiest girl at the dance, these customers will tend to spend a little bit more money trying to differentiate their vehicles in the lane to try and attract more bidders and obviously, drive prices higher.

John Lawrence - *Stephens Inc. - Analyst*

To follow that, not to get too granular, but any type of particular services that you're doing once it gets to the bottom of the funnel that's changed any service offerings that's stronger than others?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

I would say primarily anything that does with the appearance of the vehicle, anything you can see with the naked eye in terms of taking out dents, and doing paint work, and doing the bumper scrapes, and the putting wheel covers on, and the things that people say when they first walk up to the car in terms of overall appearance. That doesn't mean we overlook mechanical and major mechanical and things of that nature, but I would say the primary focus is on doing those appearance items.

John Lawrence - *Stephens Inc. - Analyst*

Great, thanks.

Operator

Don, CL King and Associates.

Bill Armstrong - *CL King & Associates - Analyst*

It's Bill Armstrong at CL King. Getting back to the guidance, with the lower interest and taxes, I would have expected a bigger earnings per share increase in the guidance. Just to be clear, the guidance does include the costs of the debt amendment, which I think is about $0.02?

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

It does include the savings net of the costs. Again, without getting too granular, as well, I will just tell you there are some non-cash increases in costs related to the transaction that are capitalized and then amortized over the remaining term of the loan that are offset there.

Bill Armstrong - *CL King & Associates - Analyst*

Okay.

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

But on a cash interest, everybody has correctly analyzed this. The cash interest savings is quite significant and then you have that non-cash portion, which will be amortization expense over the next four years.

Bill Armstrong - *CL King & Associates - Analyst*

Got it. Okay. Moving on to ADESA, purchased vehicles, could you give us some -- how many purchased vehicles or maybe what percentage of your vehicles were purchased versus a year ago? Any kinds of metrics on that?

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

It's still insignificant. It's just, again, complying with the regulations of the SEC, it hit a level we had to point out on the gross profit, but it's still an insignificant part of our Business, a very insignificant part of our Business. Not near what we have to talk about at IAA in terms of what percent of volume. It's very low single-digit percent of the volume.

Bill Armstrong - *CL King & Associates - Analyst*

Okay. So, we're not looking at any kind of shift in your strategy in terms of intentionally getting more exposure to purchase vehicles?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

No, definitely not.

Bill Armstrong - *CL King & Associates - Analyst*

Okay. Finally, on IAA, I know you mentioned that proceeds per vehicle are softening, although it looks like in the first quarter, it was up about 4% just if we look at a 13% increase in units and a 17% increase in revenue. Is that mix-related or was there something else?

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

That is mix related. We actually are able to dissect it into like for like vehicles and the Sandy cars, on average, because of the level of damage tends not to have a lot of physical damage other than the flood, do pull up the average price pay per car, but within these different sectors, if you do like for like, you'll see some softening; very modest, but softening.

Bill Armstrong - *CL King & Associates - Analyst*

Okay. Got it. Thanks.

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

Bill, I would call that mix.

Bill Armstrong - *CL King & Associates - Analyst*

Got it, okay.

Operator

Colin Daddino, Gabelli and Company.

Colin Daddino - *Gabelli & Company - Analyst*

I'm curious on how the return of some of these off-lease vehicles will affect pricing at ADESA, maybe more segment pricing, but if the lease vehicles are supposed to be in higher demand, is there a portion of maybe the rental or OE vehicles which haven't been sold that could be disproportionately impacted either on price or volume if buyers are kind of gravitating towards these leasing units?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Good question. I would say to you that these lease cars are now going to get to dealers that haven't been able to get to them before. Many of these vehicles were being sold in a closed environment or they're being sold in an online environment where many of the independent dealers didn't have access to this kind of inventory. Now, as more dealers get more access to inventory, I think it will drive the prices of those cars up a little higher and it'll be little bit more competitive. Could that have impact on some of the other vehicles in the lanes? Possibly, but I don't believe it would be significant.

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

Yes, and keep in mind, over the past four years, Jim, there's been a significant shortage of one to four-year-old used cars in the entire market, because of the low SAAR, low lease returns we've experienced in the last couple of years. This is a situation where that age vehicle is in a shortage going to a more regular supply, right?

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Right.

Colin Daddino - *Gabelli & Company - Analyst*

Got it. That's all I had. Thanks.

Operator

(Operator Instructions) Melinda Newman, First Pacific Advisors.

Melinda Newman - *First Pacific Advisors - Analyst*

Couple of questions, more mechanical and housekeeping. Just on the stock, you mentioned a decline in the first quarter. Can you give guidance on whether you expect this stock comp to decline from last year or is this just a timing issue?

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

In terms of our guidance, we've expected it to increase and I do not have it in front of me, but in our call when we announced guidance with the year-end call, I quantified it. We're not expecting that to change from what we expect for the year, so I would view that as timing, Melinda, and it was modestly negative this year, so we're all expecting that stock price to perform as we see our Business perform.

Melinda Newman - *First Pacific Advisors - Analyst*

Okay. In terms of working capital, maybe I'm sure when you file the Q this will be out there, but there was a pretty large increase in current liabilities. Can you just comment more on whether that was in AP or what area drove up the current liabilities?

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

Good question, Melinda. What happens, as you know, our balance sheet includes receivables and payables related to the transaction of the vehicle, and our revenue only includes the fees of the net revenue associated with our part of the transaction. The increase in liabilities just reflects the timing of payments to the consignors. Similarly, the receivables can be elevated the same way. It's most pronounced in the March and June quarters for us, because the day of the week that the quarter ends actually matters relative to the flow of payments.

Melinda Newman - *First Pacific Advisors - Analyst*

So, that will normalize in the second half?

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

That normalizes by year-end because the holidays always occur the last week of the year and there tends to be less business, so it tends to be less volatile around year-end.

Melinda Newman - *First Pacific Advisors - Analyst*

Okay. Great. You had commented on an increase in the funding for AFC for that funding line. What is the increase? Have you talked about that before?

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

We have not talked about that and again, in the next call, we would expect to give you an update on that, but it's consistent with what we think we need over the next year or two, three, whatever it turns out to be. It goes with term, the size will be matched up to the term.

Melinda Newman - *First Pacific Advisors - Analyst*

Okay. Perfect, and then last question.

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

Those discussions are going quite well, by the way.

Melinda Newman - *First Pacific Advisors - Analyst*

Okay. Do you expect the cost of that to decrease?

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

We haven't provided any guidance, but I have said we haven't expected any change in the cost. The markets have been pretty receptive and we think we're priced to market already, so we don't see a big change in that.

Melinda Newman - *First Pacific Advisors - Analyst*

Final question, you commented on Canada being definitely behind the US in terms of the trends. I know AFC, if I look at non-guarantor and foreign versus US and the filings, AFC is included in the foreign, correct? I'm just trying to ask, it seems even though the market share in Canada is very strong that it's still not going to overwhelm the trends in the US. Can you quantify maybe just on for ADESA and IAA what percent Canada is, because I know you have stronger market share there?

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

You've seen it historically. First, I'll give everyone a heads up with the repayment of the bonds, there will no longer be 12 pages of guarantor, non-guarantor footnotes, but it will also be that information's not out there. Again, the Canadian business in all of them is very similar; all three, IAA, ADESA, and AFC operate quite substantially in Canada, but, again, it tends to be mid-to upper teens as a percent of our revenue and performance for the year. Not something that we're required to disclose separately in our footnotes, other in the guarantor/non-guarantor notes which are going away and will not be in the 10-Q filed later this week.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Melinda, I was just going to add, and maybe most people are aware of it, but in Canada, we have a little of a different situation where banks aren't really permitted to lease vehicles. That's really the reason for the slow-down, more and more vehicles being sold in Canada are going to a retail finance contract. Through the melt-down over the last couple with years, we lost two of our cap-to-finance companies up there.

GMAC turned into Allied Bank and Chrysler Credit merged with TD Bank, so as a result, you don't have those entities leasing cars anymore and that was a big part of the market. I know that there's been a new player come into the market in Canada and we're seeing the existing cap-to-finance company write more leases, so we think 18, 24 months it'll get us back on track.

Melinda Newman - *First Pacific Advisors - Analyst*

All right. Appreciate it. Thank you.

Operator

It appears there are no further questions at this time. Mr. Peisner, Mr. Hallett, and Mr. Loughmiller, I'd like to turn the conference back to you for any additional or closing remarks.

Jim Hallett - *KAR Auction Services, Inc. - CEO*

Great, thank you, Lexie. I would just like to thank everybody for being on the call today. We continue to appreciate your interest in our Company. We feel very, very good about getting through the 2012 time period and we look forward to the trends that we're seeing in 2013. I'm looking forward to being able to report our second quarter results to you here in another 90 days. With that, thank you, and we'll sign off for now.

Operator

This concludes today's conference. We thank you for your participation.

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