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KAR - Q3 2013 KAR AUCTION SERVICES INC Earnings Conference Call

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PRESENTATION

Operator

Good day, and welcome to today's KAR Auction Services Inc Q3 2013 earnings conference call. Today's conference is being recorded.

At this time, it's my pleasure to turn the conference over to your host for today's call, John Peisner. Please go ahead.

Jon Peisner *- KAR Auction Services Inc - VP and Treasurer*

Thanks, Jason. Good morning, and thank you for joining us today for the KAR Auction Services third-quarter 2013 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended September 30, 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 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. At the outset, I'm very pleased with our third-quarter results. It's great to see all of our businesses doing well.

Over the past couple of years, we've told you what to expect. We've told you to expect the cyclical recovery for the used car market to begin in 2013, and it did. We told you that commercial volumes were expected to increase in the second quarter of 2013, and they have. We told you that the real recovery would begin in the second half of 2013, and it has. We also told you that the growth would be driven by commercial vehicles, and it has.

We told you that dealer consignment efforts would have stickiness going forward, and they have. We said that Insurance Auto Auctions' volume would continue to grow, and they have. We said that AFC would continue to grow their loan transactions during the cyclical recovery, and they have.

We said that we would continue to de-lever, and we did. Leverage is now below 3.2 times. And we also committed to providing a return to our shareholders, and we are.

So, with that said, you might ask -- what can we expect for the remainder of 2013? We would expect that these trends will continue throughout the balance of the year, that will result in adjusted EBITDA of $535 million to $540 million, which will provide free cash flow of over $290 million. As we look at our consolidated results for the third quarter, revenue grew 12%, ADESA was up 7%, Insurance Auto Auctions was up 19%, and AFC was up 18%. Adjusted EBITDA for the quarter was $130.6 million, which was an increase of 11% -- that was 17% at ADESA, 13% at Insurance Auto Auctions, and 8% at AFC. And Eric will provide more color when he goes through the financials.

If I can turn your focus to ADESA, ADESA had an increase of 13% in volume. This was made up of the 16% in the institutional consignors and the 10% in the dealer consignment segment. 35% of our vehicles were sold to online buyers, and approximately half of those were online-only buyers. And an online-only means that the vehicles were not sold from an ADESA property. ADESA benefits from the increased volume in any channel, however, the online-only vehicle has lower revenue per unit but a higher gross profit percentage.

The dealer consignment does not have the ancillary services, but higher gross profit. And sales in the Lane provide opportunity for higher revenue as we have the opportunity to provide ancillary services. We believe that as more vehicles come to market, we think that more of these vehicles will make their way through the funnel and arrive ultimately at the physical auctions.

As we saw in the third quarter, we're still seeing a higher percentage of vehicles sell in the online-only venue, and these vehicles are selling primarily to franchise dealers. But going forward, we don't believe that the franchise dealers will continue to absorb all of the increased volumes that we are expecting. So, the bottom line with ADESA -- we did see improved gross profit, and we did see an increase in our adjusted EBITDA margins of about 200 basis points.

Turning to Insurance Auto Auctions -- had a great quarter. We've seen a 16% increase in vehicles sold, a 19% increase in revenue, and we were able to realize increased fees from our buyers. There was a decline in gross profit percentage, and this we attribute to purchased vehicles. Purchased vehicles made up 8% of the volume in the third quarter, and what this was a result of is we were seeing higher gross auction proceeds with a lower gross profit contribution, and obviously this is not a good combination.

As well at Insurance Auto Auctions, we're seeing increased towing costs. We're seeing that the insurance companies are requiring us to pick these cars up faster. And in many cases, these cars are being required to pick up on the same day of assignment.

Ending off Insurance Auto Auctions on a good note is our inventory at September 30 is up over 15% compared to the prior year. This sets up very nicely for the fourth quarter.

Turning to AFC, AFC had an 18% increase in revenue; this includes Preferred Warranties. Without Preferred Warranties, the increase at AFC was 8%. The credit quality remains strong, and we continue to see many opportunities for growth within the AFC segment.

With this strong performance, I'm pleased to announce that our Board of Directors approved an increase in the dividend to $0.25 per share. This dividend will be payable on January 3, 2014, to stockholders of record on December 20, 2013. This annual dividend of $1 per share demonstrates our confidence and our ability to generate free cash flow. And our goal is to provide a superior yield to the average dividend-paying stocks in the

S&P 500. And after paying this dividend, we will still have sufficient capital to continuing de-levering, as well as to invest in strategic opportunities as we go forward.

So, in conclusion, I would say the cyclical recovery at ADESA is underway and expected to continue. New car sales are strong and expected to continue into 2014. Lease originations are growing faster than new car sales, and obviously this is a good outlook for our industry that now goes beyond 2015.

And I might point out to you that Canada is yet to come. As I've told you in past calls, Canada lags by about 18 to 24 months, and we're seeing -- starting to see some real improvement in new car sales in Canada as well. We expect positive volume trends in the salvage industry, and I think the 16% same-store growth speaks for itself in the third quarter.

AFC is capturing its share of the independent dealer market. And it's really gratifying, as I mentioned at the outset, to see all three of the business segments operating in a positive environment.

No question, we know that we will continue to face challenges in the future, but I think we've demonstrated over the past six-plus years that we're well prepared to deal with these challenges as they come about. I feel really good about our market conditions. Our management team remains cohesive and aligned. The morale of our employees has never been better. And the optimism that I hear in conversation with our customers is at an all-time high.

So, as I turn it over to Eric, I can tell you that it was only a year ago that I was wishing that 2012 would just come to an end. What a difference a year makes.

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

Thank you, Jim. And I would like to start by commenting on how pleased I am with the results for the third quarter. Not only are we seeing the performance in each of our business segments meet our expectations, but we are also seeing some trends that look good for the Business for several upcoming quarters.

I would like to start by going through the details of our guidance. As Jim mentioned, we expect adjusted EBITDA of $535 million to $540 million for 2013. We expect this to translate into net income per share of $0.77 to $0.82. This is GAAP net income per share, and reflects a reduction from our previous guidance for the profit interest expense recorded in the third quarter related to proceeds received by members of KAR and Insurance Auto Auctions management. I will get into more detail on this in a few moments.

We expect adjusted net income per share for 2013 of $1.15 to $1.20. This has not changed from our previous guidance. Both net income per share and adjusted net income per share assume an effective income tax rate of 42%.

There is no change in our expectations for capital expenditures of approximately 97 -- I'm sorry, $95 million; cash interest of $78 million; and cash income taxes of approximately $70 million. We define free cash flow as adjusted EBITDA less capital expenditures, cash interest and cash taxes. So, this results in expected free cash flow for 2013 of $292 million to $297 million, or $2.08 to $2.12 per share.

Now let me speak to a few more details on our financial performance. Let me start by commenting on the increase in SG&A in the third quarter. Our SG&A increased about $18 million over the prior year, and three specific items account for this increase. First, we recorded $11.3 million in profit interest expense in the third quarter compared to $5 million in the prior year. As we disclosed in our Form 10-Q, this expense relates to the portion of the return to our private equity firms that is earned by management. The funds are paid out of KAR LLC and Axle LLC, the entities used for the original [LBO] investments in KAR and Insurance Auto Auctions, respectively.

Profit interest expense will be recorded until 100% of the common stock owned by KAR LLC is sold. Once all of the stock is sold, these expenses will not continue in the future. Also, unlike our stock option expense, the profit interest expense is not deductible for tax purposes.

Another cost impacting SG&A is our annual incentive pay. Management of KAR in each of our business segments are incented based on performance as measured by adjusted EBITDA. The strong performance in all three of our business segments and on a consolidated basis results in increased incentive compensation. We also are experiencing increased SG&A at AFC related to the inclusion of Preferred Warranties for the full third quarter. And Insurance Auto Auctions had an increase in IT-related expenses in the third quarter as compared to the prior year.

In summary, about a third of the increase in SG&A relates to incentive compensation; about a third represents an increase in SG&A related to ongoing operating costs, including Preferred Warranties; and about a third represents profit interest expense that at some point will no longer exist.

Now, let me comment further on the revenue profile of ADESA. First, it is important to highlight the impact of improved volumes on our performance. The 13% increase in vehicles sold contributes to improved gross profit dollars and as a percent of revenue. I am pleased with our increase in adjusted EBITDA in both dollars and as a percent of revenue. At Insurance Auto Auctions, we experienced strong volume growth -- 16% in the third quarter, and even better revenue growth. And our inventory of vehicles at September 30 has us well positioned for the fourth quarter.

AFC performance remains consistently strong. Clearly, AFC is benefiting from the cyclical recovery at ADESA and other used car auctions. AFC's customers are the independent used card dealers and not the franchise dealers. As we have seen, the cyclical recovery increased the online-only sales at ADESA, sales through this channel are predominately to franchise dealers, and are less likely to be floor planned by AFC. This explains why the growth rate for AFC is less than the overall volume growth at ADESA.

We also had $5.1 million of revenue from the Preferred Warranties acquisition that is in our Q3 results. We are in the process of integrating the Preferred Warranties business with AFC, and it is not contributing to adjusted EBITDA in the current year. We expect Preferred Warranties to begin contributing to adjusted EBITDA beginning in 2014.

KAR continues to generate very strong free cash flow. As you can see in our earnings release and our 10-Q, we generated over $300 million of cash from operations in the first nine months of the year. We utilize cash for working capital as we grow the AFC loan portfolio, as about 22% of new loans end up on balance sheets funded by KAR; and the remainder is securitized. And the rest of our businesses typically do not require substantial amounts of working capital to fund their growth. So, we are in a real good spot in terms of our cash generation.

I will stop right there, and that will conclude my remarks. And I will now turn it back to Jason, so we can get to your questions and see what you're interested in hearing more about.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Simeon Gutman.

Simeon Gutman - - *Analyst*

Can you talk about as a follow up on SG&A piece, you mentioned a couple of them will continue. Is there any way we can think about them, how they should flex, how they should grow year-over-year, because I think that would be helpful understanding that you will keep selling up over time until a certain point?

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

Well, again, without getting specific into the future on that, the incentive compensation is just as we hit these targets it's up over the prior year where in some of our business segments they were not earning their incentive pay at target. So, I would not expect going forward that the total pool of incentive pay would grow. So if we're at target, I would expect this year's growth, it would be abnormal. If we consistently hit our targets it would flatten out.

Profit interest expense, I mentioned, goes away. And then with respect to the operating costs, yes, I think we are experiencing some adds. Like preferred warranty, you put that in, it will not grow at that pace because it will be in our numbers going forward. The Insurance Auto Auctions IT costs, those move around a little bit based upon projects they're working on and how we spend the money. I don't think you're seeing a long-term trend consistent with high-level growth there. This was an unusual quarter, where we haven't had to point that out in past quarters.

And our other operating costs, generally I don't see them increasing at the same pace as our revenue growth, and even probably more like inflation, generally, would be how we see those categories growing. There is one area where we're a little concerned, like all businesses, and that would be our medical costs. They are growing, and as we look forward to 2014 and beyond, we're a little concerned that we could have some growth there. But, again, we will report on that after it happens.

Does that help you, Simeon?

Simeon Gutman - - *Analyst*

Yes, it does. Following up on the incentive piece, if we see volumes continue to increase, you had 13%, could you get leverage on the incentive comp at a 13% volume?

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

No, we have caps on the incentive pay, so that they won't continue to grow. And we reset the targets every year, so -- and in those targets there is an expectation for growth, as well. So, I don't see that as causing it to continue to grow at a faster pace.

Simeon Gutman - - *Analyst*

My last question, just thinking about how the cycle will play out, what we saw this quarter were volumes were good, more of it was done online. Why -- could that be a scenario that continues to play out going forward? Why should it reverse when more volumes come, especially if prices seem pretty stable at this point?

Jim Hallett - *KAR Auction Services Inc - CEO*

Simeon, I talked a little bit in my commentary, this is Jim, I talked a little bit in my commentary about how the KARs kind of flow through the funnel. And, as you know, all of these vehicles start in an upstream closed sale, and these are primarily being sold to franchised dealers.

After the franchised dealers, as more and more volumes come, we just don't feel that the franchised dealer can continue to absorb all this volume that's going to come, and they'll become more selective in terms of what they buy in the closed online sale, and more of these vehicles are going to make their way through the funnel to the physical auctions.

Simeon Gutman - - *Analyst*

Are you seeing the age of cars already coming down, or is it still a somewhat older inventory?

Jim Hallett - *KAR Auction Services Inc - CEO*

It's not so much about the age of vehicles. I think we're still looking at the average age of a vehicle on the road is somewhere in the neighborhood of 10 or 11 years, so that hasn't really changed. But, as you know, these lease cars that are coming through these private label sites are 3- and 4-year-old vehicles.

Simeon Gutman - - *Analyst*

Okay. Thanks a lot.

Operator

Matt Fassler.

Matt Fassler - *Goldman Sachs - Analyst*

So, I have one question on ADESA and one question on the salvage business. The ADESA question is a quick two-parter. The first is, can you talk about the gross profit for KAR profile of the institutional cars getting sold online versus those that would be sold in physical auction? And then, secondly, related to that, understanding that we're still kind of early days and the mix of cars getting sucked up online is a little bit higher than it would be, at what point in time would you expect to see that mix even out a little bit more?

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

Matt, your phone has a lot of static, so I'm going to repeat what I believe was your question. We couldn't pick all of it up. The first is you've asked, and I think Jim will answer this, the difference in the revenue and gross profit in the mix of vehicles online and as they get through physical, more clarity on that. Is that correct?

Matt Fassler - *Goldman Sachs - Analyst*

Can you hear me now? Yes, that is correct.

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

And then the second question was about the mix of vehicles and we didn't catch that one.

Matt Fassler - *Goldman Sachs - Analyst*

When the mix would revert towards what you would expect mid cycle?

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

Okay, great. When the mix will revert as we progress into the cycle and have more cars end up at physical auction is, I believe, the question. So, I will let Jim get back to kind of the revenue model and how that works.

Jim Hallett - *KAR Auction Services Inc - CEO*

Matt, as you think about the vehicles coming off lease, and these are primarily off-lease cars that we're talking about here, as these vehicles come off lease and they start, as I say, at the top of the funnel in a closed online sale, that is our least economic outcome, which represents about $100 per car revenue. If the car then goes from a closed online sale to an open online sale, then the revenue goes up to about $300 per car.

And then if it makes its way to a physical auction and gets sold in the physical lane, we now picked up the ancillary services and that gets us to about $350 per car. And then the best economic outcome for us is if the car gets to a physical lane, we pick up the ancillary services, and we get an additional fee for selling it online in the lane, then we get to about $450 per car. So, that gives you the economics as to the way the cars flow.

And then, I think if I understand your comment about when do we see this changing, this mix changing. I think it's just going to evolve as we go into 2014. I can't tell you there's a specific date in mind. I think as the franchises get more and more of these vehicles, as I said earlier, they'll make their way through the funnel, they'll be more selective in terms of what they buy, and eventually over the course of 2014, I just expect that these cars will get to the physical auction and the point I made we will then pick up the ancillary services and that will drive the revenue per unit as we go forward.

And, as you know, we do get a higher margin on the vehicles that are sold online. It's about a 70% margin on those vehicles sold online. And then if the car gets to the physical sale, that margin drops somewhere closer to the 60% range.

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

At let me just clarify, Jim's numbers talk about auction revenue and exclude any ancillary services that go with the cars. And so, if you'll look at our queue, you'll see that our average revenue per vehicle in total this quarter was about $535 per car. That was just the auction revenue. So, Matt, that's question one and I think he got into question two. Do you want to ask anything further on that?

Matt Fassler - *Goldman Sachs - Analyst*

I will wait for a better line so you can hear me for my followup.

Operator

Ryan Brinkman.

Ryan Brinkman - *JPMorgan - Analyst*

My first question is just regarding all of the puts and takes on ADESA average revenue per unit, I understand that there are quite a few cross currents there, but do you think that you received a benefit year-over-year from the trend in used car and scrap metal prices such that the pressure on average revenue per unit can be moved toward online-only auctions might have been even greater than minus 5% year-over-year?

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

Ryan, as we've said many times, it's -- the auction price is not really that big of an influence on our auction revenue per vehicle. It's something that we read a lot about, it's really a function of supply wouldn't you say, Jim? The more supply, these prices are going to tend to soften or moderate, but we haven't seen big moves plus or minus. And, you know what, there's strong demand for used cars and we're seeing that in the number of vehicles we are selling, but I don't think it's driven by the pure used car value or scrap metal or any of those comparisons that we often make relative to our revenue per unit.

It really is down to the mix that Jim talked about. Online -- in fact, our auction revenue per vehicle is up year-over-year. It's just that we have fewer vehicles using the ancillary services, and as these cars have come back, while it's only 35%, it was 35% last quarter, they're getting more cars sold in that first part of the funnel, which is the online-only venue. And that just has a little revenue per unit as Jim gave in his example in the previous question.

Ryan Brinkman - *JPMorgan - Analyst*

Okay. I think the answer to this question is somewhat related, and may be complicated as well, but do you think you can grow gross profit per vehicle in 2014 and 2015 at ADESA even if average revenue per unit were, say, flat or down?

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

That's speculation that I prefer not to get into, specifically to a year or to the specifics of it, but we're constantly looking at ways to reduce direct costs and generate higher margins on the existing business.

Our confidence is, yes, we can grow our profitability in both the gross profit line and the EBITDA margin line as we have said over time and that comes from scale. More volume through, even with the mix we have today, gives us scale and efficiencies that will drive higher profitability on the gross profit line and ultimately, because we can control the SG&A, higher EBITDA margin as a percent of that revenue and in total dollars, Ryan.

So, yes, I think you're seeing it in the current order with a 44.8% gross profit at ADESA up from about 42.7% was the prior year. When you see that, a lot of that comes from just more cars going through the various channels that we have. It's not just mix.

Ryan Brinkman - *JPMorgan - Analyst*

That's great to hear. I think with all of these questions on ADESA and average revenue per unit, there haven't been as many questions on IAA and the volumes that were up like 16% year over year, that's pretty much the highest it's ever been up. Can you just talk about that and why the revenue at quarter end was up 15%, very, very strong. Does this relate to new contract wins? Is one of your competitors maybe doing something differently, pulling back?

Jim Hallett - *KAR Auction Services Inc - CEO*

Ryan, the interesting thing is, again repeating, but that was all same-store growth, as well. I would just say that the folks at Insurance Auto Auctions are doing a phenomenal job of competing in the marketplace. Again, we've told you we don't talk about our wins and losses, but obviously 16% up in the quarter. We continue to experience some wins, obviously.

And I think that the folks at Insurance Auto Auctions would tell you that the work that they have done related to Superstorm Sandy has paid off well in terms of the goodwill they extended and the way that they managed through the storm in getting those cars picked up and processed has won us additional business through RFPs that we've mentioned previously. So, I think the folks are just doing a good job and our customers are responding to the service that we provided.

Ryan Brinkman - *JPMorgan - Analyst*

Last question on the dividend. It is our job, the investor's job, to read the tea leaves. Is there anything that investors can read into either the magnitude or the timing of the (inaudible) up by a third, sooner than most investors were thinking? Does it demonstrate increased confidence in the multi-year earnings ramp? Were you waiting for something in particular like the institutional volume [inflecting] ADESA which it did, or is it too much of a stretch to read into -- you already shot down my -- this doesn't mean that you see less acquisition opportunity I think you said in prepared remarks. Anything else we can read into this?

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

Ryan, I think the only thing to say is we're very comfortable with the improved cash flow generation of the current year. It's actually, as we gave today in the call, the guidance, it's higher than when we started the year and I think our board is responding to the fact that we have confidence, that we continue paying dividends at this higher level.

The other thing I'll remind you is we paid four dividends at the lower level and it got reviewed a year later. It's probably coincidental but it's probably worth pointing out that it was the fourth quarter of last year when we evaluated our dividend and decided to pay one and it's the fourth quarter of this year when it was increased.

Ryan Brinkman - *JPMorgan - Analyst*

Thanks for all the answers, clarity, and color.

Operator

Gary Prestopino.

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

A couple of questions. Were there any Sandy cars left in Q3 that Insurance Auto sold off?

Jim Hallett - *KAR Auction Services Inc - CEO*

No, Gary. The Sandy cars have been completely cleared previously.

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

Okay. And in terms of the volumes there, the growth was pretty phenomenal. Was there anything there besides insurance cars, was there really strong growth outside of that market where you're going after non-salvage vehicles that helped to give you such great inventory growth?

Jim Hallett - *KAR Auction Services Inc - CEO*

Gary, primarily it has just been consistent growth. Nothing outside, no more in the purchase side and consistent growth within the insurance companies.

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

Gary, we were 8% purchased cars third quarter this year and it was 8% a year ago. So, it's really across all sectors.

Jim Hallett - *KAR Auction Services Inc - CEO*

I think the numbers still run about 80% insurance and about 20% non.

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

Jim, where is leasing as a percentage of sales going to end up this year? What are you guys here in terms of new cars?

Jim Hallett - *KAR Auction Services Inc - CEO*

We're starting to hear numbers that are approaching 30%. And that represents probably an all-time high, as many of the articles that we've been reading point to, I think most recently I heard it was up to 27% or 28%, and expect it to get to as much as 30% before the year is out.

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

And from what you're hearing, do think that can increase even more in 2014 or just stays around there?

Jim Hallett - *KAR Auction Services Inc - CEO*

Gary, and I have spoken to this previously, there are a number of folks that think that leasing will continue to grow. And if I go back over a year ago I commented on a conference call that there was an article out that said that some expect leasing to grow to 50% of all new car sales by 2017, which would obviously be a very good thing for our industry. And there's no question that we're seeing it get to the 30% level and, yes, I think that it's possible that you could see it continue to grow beyond that level.

Operator

Craig Kennison.

Craig Kennison - *Robert W. Baird & Company, Inc. - Analyst*

Jim, you covered the way off-lease cars flow through the funnel, which was very helpful. You mentioned that the economics get better as the car flows through the funnel, but isn't it also true that your share of off-lease volume is better at the top end of the funnel and drops as you get into the physical launchings? And how does that all play out in your economics?

Jim Hallett - *KAR Auction Services Inc - CEO*

There's no question that our share at the top of the funnel is stronger, because if you think about it, our OPENLANE platform is the dominant platform in the industry. There are only a couple private label platforms that we don't have these OEMs, so if you think about it, every off-lease car starts on a private label site on a closed online platform. So, there's no question we're getting probably in the magnitude of 90% of all lease cars that are coming off lease are starting on one of these private label sites that is powered by the OPENLANE technology.

Craig Kennison - *Robert W. Baird & Company, Inc. - Analyst*

Would you rather get a car at the bottom of the OPENLANE funnel, if you will, or take your chances of getting whatever share you're going to get at the top of the physical auction channels?

Jim Hallett - *KAR Auction Services Inc - CEO*

Craig, as I've said before, the most important thing is that we get the car and we get the car early. And I think the earlier in the process we get the car we're going to have to let the market decide how the car gets sold. Our job is to provide the best venue we can in the online platform, provide the best physical footprint we can, let the cars work through the funnel, and let the economics take care of themselves. And at the end of the day we know we're going to come out with an average revenue per car somewhere in the magnitude of what we've been showing you here over the last little while.

Craig Kennison - *Robert W. Baird & Company, Inc. - Analyst*

That's great. Shifting to the salvage side a little bit. We've seen more activity globally in this space, LKQ, one of your buyers, is sourcing cars directly in Australia, and one of your leading competitors has acquired businesses in Brazil, Germany, and other markets. Interested in your current thoughts as your balance sheet gets stronger where you see the worldwide opportunities to date? Thanks.

Jim Hallett - *KAR Auction Services Inc - CEO*

Craig, we've always said that we have an interest in international expansion. We've certainly been around the globe, as I will say, visiting many of these markets, establishing many relationships. I think the people in these markets, they are well aware who we are. They are certainly aware of our interests in all of our businesses. And we continue to look at opportunities and ways that we might expand internationally.

And we think that we have a number of technology plays that we could deploy, as well as looking at the possibility of acquiring physical assets, as well. So, with that said, I would say that there's nothing that we can announce or nothing that we can talk about. But, I can say that we have stayed very close to it and continue to observe and evaluate these opportunities.

Operator

Bob Labick.

Bob Labick - - *Analyst*

Most of my questions have been answered, but I just wanted to go back for a second and focus on the IAA gross margins. Obviously, as was mentioned before, your volumes were fantastic. I was wondering, was there any price concessions to win some volumes on that, or have prices been holding firm on that end?

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

No. We don't want to get into the specifics of this, but you can see that our revenue per vehicle sold at IAA has increased as a result of our revenue increase being greater than the volume increase. And, as Jim mentioned in his comments, buy fees is where we have the ability to increase those fees, so we're very comfortable that in the current market conditions that we have the ability to continue growing our revenue.

So, Bob, I think that's the best way to answer it. It's a competitive world out there and we're competing in many ways, I would say probably more and service than we are on price. That is how I would look at the market today.

Bob Labick - - *Analyst*

Just on that point, could you elaborate. You spoke a little bit about the towing and the change there. Can you elaborate on other service changes and -- as I said, results are great, I'm just trying to think -- I would have expected with such volume a little bit better leverage on the margin line. So, I'm just trying to put it together and wonder if this is kind of a new normal for the gross margin percentage on a go-forward basis, or how to really think about it and model it on a go-forward basis?

Jim Hallett - *KAR Auction Services Inc - CEO*

No, we pointed out the transportation because we felt that was a change. We see rates going up with most of the insurance companies. Most of the insurance carriers demanding higher service levels. I didn't mention it, but I will say we expect that change to continue. Transportation costs will remain higher as we go into 2014.

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

I will also point out, there's a seasonal aspect. The third quarter is the summer months. It's probably historically where the Insurance Auto Auctions would have its lowest gross profit percent of the year in terms of the quarterly performance. That's a seasonal, that's not a change in the business. While we talked about the pressure on that margin by purchased vehicles and transportation, there's a seasonal impact and we don't see that as anything other than what we normally have experienced in the past.

Bob Labick - - *Analyst*

Everything looks great, great results there.

Operator

Bill Armstrong.

Bill Armstrong - *CL King & Associates - Analyst*

So, obviously you've got a lot of trends going in your favor. Your earnings guidance, if we back into Q4, would be adjusted earnings of $0.21 to $0.26 which actually is down year-over-year, which was a little surprising. Why would you have down earnings considering all the good things that are going on?

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

While we don't comment on quarterly earnings, I would point out that the tax rate in the fourth quarter of last year was extremely low, very low. So, I think if you correct for taxes on a consistent basis you would not see a decline in the analysis you have just presented. Again, I'm not getting guidance on the quarter, but I happen to know that our assumed tax rate that I gave you of 42% is much higher than what we had in the fourth quarter of last year.

Bill Armstrong - *CL King & Associates - Analyst*

Got it. Okay. I see that. On AFC, your gross margin was down, I'm going to guess PWI was the primary cause of that. What were gross margins if we strip out PWI?

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

Again, take out the revenue, it didn't contribute any meaningful amount, and you can calculate the numbers, and they're very comparable to what we had a year ago, very comparable.

Bill Armstrong - *CL King & Associates - Analyst*

Okay. Great. And then finally on Insurance Auto Auction, the big unit increase, it's sounding like you're gaining market share. Was there anything in the industry that may be driving unit increases. In other words, is there an overall increase in unit volume industry wide, and you're just getting a piece of it or do you think you're taking share? Or is there some combination there?

Jim Hallett - *KAR Auction Services Inc - CEO*

We think it's some combination of that. There's no question that we feel that we're doing well in the marketplace in terms of winning business, but I think also if you take a look at the overall volumes and the conditions that we've dealt with over the past year in terms of weather and whatnot, I'm sure that all contributes. So, I think it's a combination of maybe, pardon the expression, but maybe the perfect storm in the way that things have come together for us work

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Bill Armstrong - *CL King & Associates - Analyst*

Understood.

Operator

(Operator Instructions)

John Lawrence.

John Lawrence - *- Analyst*

Can you dig into this a little bit and just talk a little bit about just understanding the comment about the funnel and make sure I understand. The thing that changes, we've had two good quarters now of better visibility and throughput on the unit volumes at ADESA, but what is it that flips the switch when you say that the franchised dealer becomes full, if you will, and makes the funnel? Can you explain that piece at the franchised dealer level a little bit?

Jim Hallett - *KAR Auction Services Inc - CEO*

Yes. I can. I think if you think about it, if we look back to 2012 there was very tight supply. There weren't a lot of vehicles coming off lease and, basically, every vehicle that was coming off lease these franchised dealers were grabbing right at the top of the funnel because they needed inventory, and they were taking inventory that they might not necessarily take in a perfect world. They were taking inventory that might require reconditioning, that might require some things being done to them, but they needed the inventory, so they are able to buy it.

Now, as more and more inventory makes its way there, these dealers, these franchise dealers are going to become more selective. They are not necessarily going to take cars that perhaps will require reconditioning. There's going to be more volume. The example might be if there's -- last year if there was one or two vehicles coming off, this year there could be five or six of those vehicles coming off all at the same time. So, where they might need one or two vehicles, they're not going to need the five or six.

I also think that when you combine that with the new car sales and the number of trades that they are generating that they can possibly keep for retail, that again is causing them to pass on some of these cars at the top of the funnel. And all of these things contribute to working their way through and getting on to the physical sale. Does that help explain it?

John Lawrence - - *Analyst*

Exactly. And then the second part of that is just from an economic standpoint, your facilities like Indianapolis where you've got the body shop and all of those services, how does this volume -- obviously I assume there's a step function on the capital returns for those facilities as these volumes get to the bottom of the funnel?

Jim Hallett - *KAR Auction Services Inc - CEO*

John, it's interesting. That's one of the powers of this business model is that money is spent and capitalized, and we have converted over that last six years a lot of the cost to be variable, especially in the shops that you're mentioning. So, as the volume comes back, we bring the hours back in the workforce and we've already put the capital in place.

These aren't like services -- while these are complex services, they're not complex structures that need a lot of innovation of around them and we can do the work. That's one of the comments that I made earlier, one of the earlier questions, more cars coming to our marketplace provides a scale that allows us to leverage the facilities into a higher gross profit and a higher EBITDA margin, without a doubt.

John Lawrence - - *Analyst*

Great. Thanks for the clarification.

Operator

Matt Fassler

Matt Fassler - *Goldman Sachs - Analyst*

I want to go back to recap on a couple of answers you've already given. First, a little bit of clarification on my initial question. If you bottom line the gross profit per car, understanding that there's puts and takes on revenue per car and rate, and if you bottom line the gross profit per car for some of the cars that are being sold online from the top of the funnel today compared to the cars that are sold downstream, how different is that number?

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

Well, let's use the illustrative numbers Jim gave you. You're looking at, at the top of the funnel, something around, again, these aren't the specific numbers, these are just for example, the $100 would generate roughly $70 of gross profit, as compared to further down the funnel to physical lane, if you sold to an online buyer you're going to get roughly $400 to $450, let's use $450, and you're going to be able to generate $260 to $270 of gross profit dollars. So, Matt, it's that big of a difference.

Ironically, that car at the bottom of the funnel in physical lane will probably have the ancillary services which will generate even more gross profit dollars but at a lower margin, so the percentages start to change a little bit but the absolute dollars grow as you move through the funnel.

Matt Fassler - *Goldman Sachs - Analyst*

And just to clarify what needs to happen to get that mix and move in the right direction, does that revenue growth have to accelerate even beyond or the unit growth have to accelerate even beyond the levels that we see today or is it more about saving some of that initial demand in the marketplace?

Jim Hallett - *KAR Auction Services Inc - CEO*

No. It's more about the vehicles getting to a spot where were able to gain higher economics. Normally, if the car didn't sell online, there's normally a reason for that in many cases aside from maybe just sheer volume. It could need reconditioning, it could need something to happen to the car. So when it gets to the physical auction is then where the consignor really does a condition report on the car and really assesses what does this car need to put it in the best resale position, and that's when we pick up those ancillary services, and that is what will drive the revenue per car.

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

And, Matt, let's not forget what Jim mentioned earlier, when they started buying these cars this year, there has been a huge lack of supply of the 1- to 4-year-old used cars in the entire marketplace. The franchised dealers were hungry for that type of vehicle, because it had been missing. They hadn't had the trades and they didn't have the off-lease cars at the same level that they had had before.

Matt Fassler - *Goldman Sachs - Analyst*

So, it's that demand because I'm just trying to ascertain whether this is just the way the world is, or what has to change in the marketplace for the mix to normalize. It sounds like what you're saying is that 1- to 4-year-old car need to be in somewhat more plentiful supply, at which point it gets snatched up a little bit later in the process?

Jim Hallett - *KAR Auction Services Inc - CEO*

That's right. I think you got it.

Matt Fassler - *Goldman Sachs - Analyst*

Okay. Second followup. On the towing costs, et cetera, one of the questions that has been coming inbound to me during the call, why would the insurance companies have more leverage on you and on your competitors today to take their pricing up? Is it that their costs are rising or is it the element of competition for some of those fat contracts with some of these chunky players?

Jim Hallett - *KAR Auction Services Inc - CEO*

I think, Matt, it just comes down to service levels. They want that vehicle to be picked up and to be evaluated and assessed as they will as quickly as possible. More demand on us, I think, to provide that level of service. And as we provide that level of service we recognize it may be an increased cost, but we also recognize the intangible of getting rewarded with more volume as well.

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

And the reason they needed picked up faster is the claims cost can be controlled on our side more so than on a lot of the impound yards or the collision repair shops. If they're aren't doing the work, they charge a daily storage fee. And that's what they're doing, they're saying let's reduce our costs by getting it into the marketplace where our fees are all-encompassing for what we do. (Multiple speakers.)

Matt Fassler - *Goldman Sachs - Analyst*

Can you pass some more of that through? You said you took some price or some rate, to the extent that your costs are moving, do you have the ability to defray that a bit more?

Jim Hallett - *KAR Auction Services Inc - CEO*

Matt, let's just say that we will definitely look for ways to offset the increase.

Matt Fassler - *Goldman Sachs - Analyst*

One final question, a point that you haven't discussed yet. You discussed a couple of emerging growth opportunities, and one of them was in the C to C world, and providing some infrastructure for transactions. Any update on that exploratory effort?

Jim Hallett - *KAR Auction Services Inc - CEO*

What I can tell you, Matt, is that we continue to look at the C to C opportunity. We have refined the business model. In fact, we have now even built an experience center where potentially people can walk through the C to C transaction and see how that all falls in place, the various steps and components of it. And with that we would expect that we're at the point that we will do a pilot here in the near term with no specific date.

Operator

At this time we have no further questions from the phone lines. I would like to turn the call back over to Jim Hallett for any additional or closing remarks.

Jim Hallett - *KAR Auction Services Inc - CEO*

Okay, Jason. Thank you ladies and gentlemen. Thank you for being on the call and thank you for your continued interest in our Company. Again, in short, I will just say I'm very excited to see all three of our businesses doing so well in this environment. We look forward to continuing to bring you good news. With that, thanks for the call and we'll look forward to talking to you soon.

Operator

This does conclude today's conference. Thank you for your participation.