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KAR - Q2 2013 KAR AUCTION SERVICES INC Earnings Conference Call

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CORPORATE PARTICIPANTS

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

Jim Hallett *KAR Auction Services Inc - CEO*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the KAR Auction Services second quarter 2013 earnings conference call. This call is being recorded. Today's hosts will be Jim Hallett, Chief Executive Officer of KAR Auction Services, and Eric Loughmiller, Executive Vice President and Chief Financial Officer of KAR Auction Services. I will now like to turn the conference over to Mr. Loughmiller. Please go ahead, sir.

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

Good morning. And thank you for joining us today for the KAR Auction Services second quarter 2013 earnings conference call. Before Jim kicks off our discussion I would like to remind you that this conference call contains forward-looking statements within the meaning of safe harbor provision of the Private Securities Litigation Reform Act of 1995. Investigators are cautioned that such forward-looking statements involve risks and uncertainties that may effect KAR's businesses, prospects and results of operation 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.

In light of the Company's recently announced proposed secondary offering there will be no Q&A session after Management's prepared remarks and the Company will not be speaking about the offering during this conference call. 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 measure 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 will turn the call over to Jim Hallett, KAR Auction Services CEO.

Jim Hallett - *KAR Auction Services Inc - CEO*

Thank you, Eric and good morning ladies and gentlemen and welcome to our call today. First, let me start by saying that I've been looking forward to providing everyone with this update. We are pleased with our second quarter results and I believe each of our business segments are well positioned for the foreseeable future as I have seen since we formed KAR in 2007. I will admit these calls are easier to look forward to when things are generally positive for our businesses.

I will start by letting you know that we are confirming our guidance of $535 million to $540 million of adjusted EBITDA for 2013. In fact, I would say that I am very confident with our guidance now that half of the year is behind us and we've had a look at the start of the third quarter and we've begun to get more information on how we believe each of our business segments will finish out 2013. As you saw in our announcement last night, we expect free cash-flow to exceed $290 million for the year. As I have said in the past, our free cash-flow is a financial metric we believe that demonstrates the strength of the KAR businesses. Our Board of Directors have approved the payment of a $0.19 per share dividend on October 3 to stockholders of record as of September 24.

In addition to our strong free cash flow we are also pleased with our most recent financial performance with consolidated net revenue of $541 million for the second quarter, an increase of 11% over the prior quarter. This generated adjusted EBITDA of $140 million for the quarter, an increase of about 9.5% over the prior year. Adjusted net income of $0.34 per share for the second quarter was up over 30% for the prior year. We continue to target net leverage of three times or less.

Now, let me share with you the reasons for my positive impressions on our current performance, and why I believe we can look forward to an improved performance over the next few years. I would like to start by talking about ADESA. ADESA's performance starts with volume and our second quarter volumes were up 10% over the prior year. This is the type of increase that we've been expecting and we believe is just the beginning of the cyclical recovery our industry will experience over the next several years. We saw volumes increase in both the institutional and dealer consignment segments. ADESA's revenue grew 8% in the second quarter and the gross profit margin improved 120 basis points over the prior year. These are both positive trends that reflect the impact of improved volumes on our ADESA business segment.

Most importantly, our adjusted EBITDA for the ADESA segment grew 15% year-over-year for the second quarter. Our volume improvement is at the physical auction as well is through our online venues. In the second quarter, approximately 35% of cars sold at ADESA were to internet buyers, of these approximately half were sold online only on ADESA.com and the other half were sold from the physical auction location to an internet buyer. The primary source of vehicles sold online only is the off lease segment. We saw our online volumes increase 25% year-over-year in the second quarter and this is primarily driven by the increase in off lease supply. I will remind you that we provide the private label sites for substantially all of the manufacturers' cap to finance sites in North America and this provides us with the first opportunity to sell the off lease vehicles before they are assigned to an auction.

Insurance Auto Auctions has now moved beyond Superstorm Sandy. After a very quiet weather year through most of 2012 we have seen unusually severe weather in 2013. We continue to have strong assignment levels from our insurance customers, our second quarter revenue at Insurance Auto Auctions was up 14% year-over-year. Our salvage business goes into the third quarter with a strong inventory of vehicles. Inventory levels are up more than 15% over the prior year at June 30, 2013.

Our AFC segment continues its record of strong performance. Net revenues increased 14% year-over-year for the second quarter. This contributed to an 11% increase in adjusted EBITDA. I feel very good about AFC's positioning in the marketplace and expect AFC to benefit from the increasing volumes at ADESA over the next few years. With that said, we are seeing increased competition in this space from our direct competitors and also from local and regional banks.

We closed the acquisition of Preferred Warranties, a used vehicle service contract business, during the second quarter. While this was a small acquisition, less than $30 million in purchase price, it is an important addition to our product offerings to the independent used car dealers. We have only owned Preferred Warranties for a couple of months but the early results are very encouraging. We believe the combination of Preferred Warranty products in the underwriting process combined with the distribution cables of AFC Network will provide an opportunity to grow this business over the next few years.

Now, as I close my remarks I would like to recognize that for the first time since early 2008 we are seeing all three of our business segments experiencing improving performance conditions. At both ADESA and Insurance Auto Auctions we've had positive results from recent RFP efforts. In both businesses our focus on servicing our customers has served us well in picking up additional market share with existing customers. I recognize that our markets are extremely competitive and we can take nothing for granted but focusing on servicing our customers and maintaining strong professional relationships with the suppliers of vehicles provides the foundation for our success. In addition to those things within our control, we seem to be in a good spot with those things that are out of our control. So, the strong SAR currently at about 16 million vehicles, the expectation for interest rates to remain low for some time, and increased leasing penetration all contribute to my positive outlook for ADESA for the next few years.

Insurance Auto Auctions is experiencing a steady growing supply of insurance vehicles and is attracting an increased number of non-insurance vehicles from various sources to meet the continued and growing demand for after market recycled parts by collision repair industry. When I'm questioned on how long the demands for salvaged vehicles is expected to remain strong, I would like to point out that about 14% of auto insurance claims result in total loss, this is only 1 in 7 insurance claims. This means that each total loss vehicle has the potential to supply parts to six damaged cars being repaired by the insurance companies. We believe this is the reason there is strong support overall for salvage auction values despite the modest softening of used car values that we see at ADESA.

And last, AFC continues to be the leader in providing floor plan financing to the independent used car dealers. We completed the extension and the expansion of our securitization facility. We now have $900 million of capacity and facilities that are in place through June 2016. In addition, we have expanded AFC service offerings to the dealers with the addition of preferred warranties. AFC has a proven track record of providing value added, back office services to our AFC customers which contributes to their efficiencies and profitability and strengthens our relationships with the independent dealers.

The bottom line is, I am pleased with our performance in the second quarter, but I feel it is just the start of good things to come. I recognize that the future will include things that we can't anticipate today, but I feel that our management team has used the last few years to learn valuable lessons from the challenges that we have faced. As a team, we are well prepared and focused on delivering results that will enhance shareholder value. Thank you for your support as shareholders and I will now turn it over to Eric for some additional comments.

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

Thank you, Jim. I have just a few things to add to Jim's comments today. I would like to start by walking through the details of our guidance. As Jim mentioned, we are expecting 2013 adjusted EBITDA of $535 million to $540 million. This will result in net income per share of $0.82 to $0.87 and adjusted net income per share of $1.15 to $1.20. Our cash interest expense on corporate debt is expected to be approximately $78 million. And capital expenditures is expected to be approximately $95 million. None of these numbers have changed since our last earnings call.

The only change to our guidance is we expect cash taxes of approximately $70 million, a decrease from our previous guidance for cash taxes of $85 million. The decrease in cash taxes does not change our expectations on our effective tax rate of approximately 40% used in computing net income per share and adjusted net income per share. The reduction in our cash taxes reflects our ability to deduct in the current year a number of IT related costs that are capitalized in our financial statements. This deduction only impacts the timing of the deduction. However, we will be able to currently expense for tax purposes similar types of IT costs in future years as well. The net result is our expectation for free cash-flow, defined as adjusted EBITDA less capital expenditures, cash interest expense on corporate debt, and cash taxes of $292 million to $297 million. This represents free cash-flow of $2.08 to $2.11 per fully diluted share outstanding.

At our current dividend rate we have allocated approximately 37% of our free cash-flow to the payment of dividends. Our priorities for use of free cash-flow have not changed. We are focused on reducing our net leverage, providing a return to our shareholders in the form of dividend payments and utilizing our cash for strategic growth opportunities as they arise. The acquisition of Preferred Warranties is an example of our use of free cash-flow to acquire a business that we expect will provide future growth in revenue and earnings.

I would also like to provide some additional color on the gross profit at both ADESA and Insurance Auto Auctions. Let me start with ADESA. Our second quarter gross profit at ADESA of 45.3% was up from 44.1% in the prior year. We are especially pleased with this performance given revenue increased 8% over the prior year. As we have discussed in previous earning calls the key to our margins is generally driven by various components of mix. We continue to have strong dealer consignment volumes which have lower revenue per vehicle, but overall higher gross profit margin. We also had a fairly heavy mix of close sales representing the online only activity for the quarter, which, again, generate lower revenue per vehicle but higher gross margin as a percent of revenue.

Insurance Auto Auctions generated gross profit as percentage of revenue of 36.2% for the second quarter compared to 40.6% the prior year. A couple of key factors contributed to this decline. First, selling Superstorm Sandy cars negatively impacted margins. Excluding Superstorm Sandy cars, IAA's gross profit would have been 38.1% of revenue. The other impact is the recognition of the gross auction price as revenue and the corresponding purchase price of the vehicle as cost of services. Internally, we measure the net revenue from sale of purchased vehicles as our provider fee. Utilizing this internal management reporting for purchased vehicles, our second 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.

The last topic I would like to cover is our capital expenditures. We have spent $53 million in the first half of 2013. We expect capital expenditures for the year to be about $95 million. In prior years we have generally had less than half of our capital expenditures in the first half of the year. This year will be different as we had a number of projects scheduled for completion early in 2013 that had been started in 2012. And several of our larger projects for 2013 were initiated early in the year. IT-related capital expenditures represent about 45% of the capital dollars we have spent to date. This concludes our remarks for the second quarter and I thank all of you for joining us today.

Operator

Again, that does conclude today's conference. We do thank you for your participation. Please have a great day.