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KAR - Q1 2014 KAR AUCTION SERVICES INC Earnings Conference Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the KAR Auction Services Incorporated Q1 2014 earnings call. On today's call, we have Jim Hallett, KAR Auction Services' Chief Executive Officer; Eric Loughmiller, KAR Auction Services' Chief Financial Officer; and Jon Peisner, KAR Auction Services' Treasurer and Vice President of Investor Relations. Just a reminder, today's conference is being recorded. For opening remarks and introductions, I'll now turn the conference over to Jon Peisner. Please go ahead, sir.

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

Thanks, Debbie. Good morning, and thank you for joining us today for the KAR Auction Services first-quarter 2014 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended March 31, 2014. 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, Jon, and good morning ladies and gentlemen, and welcome to our call. First I'd like to start with saying that I'm very pleased with our first-quarter performance.

I believe that our first quarter exceeded our expectations going into 2014. Our revenue was up 5%, our adjusted EBITDA was up 8%, and earnings per share was up 32%.

And there's no question that weather was in the news throughout the quarter. We did experience some increased costs, in terms of clearing snow. We did have a delay in getting some of the vehicles sold, however, overall, I would say the weather did not have a major impact on our consolidated results.

In the long run, I believe that the weather has been a real positive for Insurance Auto Auctions as we have seen their volumes grow, which will be a very positive for KAR, through the first half of 2014. And certainly all this has led to strong free cash flow in the first quarter.

We did have our Board approve a payment of a dividend of $0.25 per share, which will be payable on July 3, 2014. In terms of our guidance, there is no change in our expectations for adjusted EBITDA of $580 million to $600 million, however we do expect to increase our free cash flow projections, based on the refinancing of our debt that took place in the first quarter, and Eric will comment on that more in his commentary.

Turning to ADESA, ADESA volumes were up 7%. Online sales represented 37% of the units sold in the first quarter, and online-only sales drove our increased volume. We're seeing franchise dealers continue to buy a high quality of off-lease vehicles.

And the dealer consignment volumes continue to be strong, representing 50% of the cars sold at ADESA. I've got to tell you I'm very pleased with the success that we're seeing in the dealer consignment segment. As many of you know, we began focusing on this dealer consignment segment five years ago.

In 2009, our dealer consignment was at 30% or less of our volume at that time. In fact, at one time, I think we went as low as 25% of our volume, and we've steadily grown and increased our dealer consignment business, and now we're focused on maintaining our share of dealer consignment, as the commercial vehicles and volumes grow.

The commercial volumes increased in the first quarter, and we're able to increase our dealer consignment volumes at a comparable rate. Conversion rates at our physical auctions were almost 64%, compared to about 60% last year. I believe this increasing conversion rate reflects the strong demand in the lanes.

Values have remained relatively steady through the first quarter, and our economist, Tom Kontos, believes that prices will moderate by less than 2% through the remainder of the year. This demand for the increase of off-lease volumes has remained steady, and we expect that the supply of off-lease volume will increase throughout the remainder of 2014. We spent considerable time talking about the increased supply causing more off-lease vehicles to get to the physical auction, and we do expect that this will occur throughout the balance of the year, for a couple of reasons I'd like to point out:

Number one, we've said that franchise dealers won't be able to handle all the volume that's coming their way. I want to make sure that we understand, I'm not suggesting for a minute that the franchised dealers aren't going to buy as many of these cars as they have in the past. In fact, I could suggest that they may even buy more of these vehicles. But when you look at the total number of vehicles that are going to arrive off-lease, I believe that ultimately these franchised dealers will reach a capacity where these vehicles will eventually make their way to the physical auction.

And the second point that I would make is the industry experts expect that in the lease residual values will exceed market values for the foreseeable future. I think that more of these dealers will pass the car at the point of being grounded, to the part that they will go into the funnel, and as they work their way through the funnel, more will eventually get to the physical auction.

So with that said, I think we'll just have to wait and see how that plays out over the next few months. Adjusted EBITDA at ADESA was up 4% for the quarter.

And now, if I could just take a minute and maybe speak to the broader market in the whole KAR business. The SAAR is expected to be at or above 16 million units.

Lease penetration rates on new car sales remain near 30%, and that number may continue to increase. And retail car and used car sales are increasing year-over-year.

We hear a lot about the franchise dealers and the number of CPO sales that are taking place. I would point out, let's not take our eye off the independent used car dealers.

In fact, CNW reported during the first quarter that the independent dealers doubled the rate of growth for used car sales. In fact, the independent dealers sold more used cars than the franchise dealers or the private transactions combined.

A couple of other announcements that I think are good news for a ADESA, the national retailers, some of them have mentioned that they are in the process of opening dedicated used car locations, and growing that segment of their business. I expect ADESA to benefit as these retailers go about acquiring their inventory for these new locations. I view the increased focus on new cars by the national retailers as a real positive for ADESA.

Turning to ASC, I just continue to say, ASC is just a great business. Adjusted EBITDA increased 5%, loan transactions were up almost 9%, and revenue per loan transaction was down about 3%. Provision for loan losses accounted for about half of this decrease, but overall, I would remind you that credit quality remains strong, with 99% of our loans being current.

At Insurance Auto Auctions, we saw revenue was up on a 3% increase in vehicles sold, and I would point out that I believe this is extremely impressive, when you consider the number of Sandy cars that were sold during the first quarter last year. Excluding the Sandy cars and the related revenue in the first quarter last year, revenue increased 15% and volume was up 14%. Gross profit is approaching 40%. EBITDA margin is approaching 30%, and maybe the most important stat that I can give you for IAA for the first quarter is the vehicle inventory as of March 31 was up 15% as compared to the same point last year.

With that, I'll turn and talk about our priorities for our free cash flow. At the very outset, I would say to you that we are constantly analyzing all of our options, and we understand that investing in strategic growth remains an extremely high priority here at KAR. Although I don't have any specific initiatives or targets that I am going to discuss with you today, I do want you to know that we are evaluating opportunities and options in all of our business units.

Another point is providing a return to our shareholders is an extremely high priority, and we're currently allocating a substantial part of our free cash flow to the annual dividend, and we're balancing the level of capital allocated to shareholder return, with our opportunities to invest in strategic growth. With interest rates remaining as low as they are, we do not intend to repay debt, except what's required under the principal payments.

So before I turn the call over to Eric for his comments, let me conclude with a couple thoughts. First of all, I'm extremely pleased and extremely excited with the start of 2014. I can tell you this is the most enthusiastic I've been about our business in the course of the last five years.

I'm optimistic on the prospects in each of our business segments, and I can assure you that we are keeping a focus on controlling our overhead costs. We're looking to improve our adjusted EBITDA margins, and I see technology being a critical element of KAR's success. In fact, I think it's a game-changer, and I think we've experienced that in the past here at ADESA and at IAA, and we will continue to invest in technology accordingly, as we go forward.

I'm excited about the opportunities that I see for KAR, not only in 2014, but I can tell you I'm extremely excited about what I see in this industry for the next several years. I can also tell you that the management team is synched up and laser focused. We're passionate, and we're determined to grow KAR and are key to the goals that we've laid out.

So with that, I thank you for joining our call today. I'm now going to turn it over to Eric, and we'll be back for Q&A. Eric?

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

Thank you, Jim. Let me start with an overall comment, as well. We had a very good first quarter.

Revenue grew 5%, and this is better than it appears on its face. The Insurance Auto Auctions revenue in the first quarter of 2013 was unusually high, due to the sale of over 40,000 total loss Superstorm Sandy vehicles. Those vehicles accounted for over $26 million of revenue in 2013, that thankfully, was zero in 2014.

Gross profit was 44.4% of revenue, up from 40.6%. The current year gross profit was right in line with 2013, if you exclude Sandy.

Our consolidated selling, general, and administrative expenses increased $26 million in the first quarter. $16 million of this increase was due to increased stock-based compensation expense, and $6 million is due to higher incentive compensation accruals, reflecting our strong first-quarter performance. These increases impacted each of our reported business segments, as disclosed in our financial supplement to the earnings release last night.

We also had SG&A costs related to preferred warranty and High Tech Locksmiths, that were acquired after the first quarter of 2013. Adjusted EBITDA of $147.1 million was 25.2% of net revenue for Q1. At ADESA, revenue per vehicle sold was down year-over-year, reflecting the mix of increased online-only sales.

Similar to last year, revenue per vehicle sold for online only was $114, compared to $122 in the first quarter of the prior year. This decrease is due to the continued success of our private label closed sites, and selling off lease vehicles to the franchised dealers.

Physical auction revenue per vehicle in the first quarter was $663, compared to $641 for last year. This improved revenue per vehicle sold reflects strong ancillary services performance, including High Tech Locksmith, and increased revenue from other related services, especially from repossession activity at our KAR subsidiary of ADESA.

Insurance Auto Auctions had an especially strong first quarter. As you saw in the financial information released last night, revenue grew, gross profit improved to about 39%, and adjusted EBITDA margin was back to about 29%. IAA's purchased vehicles were down to 6% of volumes sold, compared to 7% last year in the first quarter.

We are also pleased with AFC's performance in the first quarter. Revenue was up 16%, with two thirds of this revenue growth coming from preferred warranty, and one-third organic growth. As you saw in our financial disclosures, the provision for loan losses increased $900,000 over the prior year.

Typically, our first quarter has the highest write-off activity of any quarter in the year. As Jim mentioned though, the portfolio is in good shape as we enter the second quarter.

Holding Company expenses for Q1 increased $7.1 million, primarily due to increased non-cash stock-based compensation. For the remainder of 2014, stock-based compensation is expected to be less than the prior year. We also have increased incentive compensation accruals in the first quarter, due to our improved performance.

Income taxes had a positive impact on first-quarter results. The effective tax rate of 32% contributed about $0.03 per share, as compared to our expected effective rate of about 40%. As you saw in our earnings release, we are not changing our annual guidance of a 40% effective tax rate for 2014.

The first quarter benefited from some favorable state law changes, and reversals of certain tax reserves, due to the expiration of statutes on certain previously-filed tax returns. Also, pretax income was lower in the first quarter, due to the $30 million loss recognized when we completed the refinancing of our senior debt. The loss relates to the write off of unamortized debt issue costs from previous transactions.

Our ratio of net senior debt to adjusted EBITDA is 2.95 times at March 31, 2014. As I mentioned, we completed the refinancing of our term loan in March.

Our new senior debt arrangements include $650 million, due March 2017, that bears interest at LIBOR plus 250 basis points, with no LIBOR floor and $1.12 billion, due March 2021, that bears interest at LIBOR plus 275 basis points, with a 75 basis point LIBOR floor. Annual cash interest savings from this refinancing will be approximately $9 million, with about $7 million of cash interest savings realized in 2014.

Let me finish with a summary of our guidance for 2014. As Jim mentioned, we expect adjusted EBITDA of $580 million to $600 million. This will result in GAAP net income per share of $0.95 to $1.05.

This is reduced from our previous guidance of $1.01 to $1.12 per share. The change reflects the loss on modification of debt, cash interest savings, and lower amortization of debt issue costs for the remainder of this year.

Adjusted net income per share is expected to be $1.35 to $1.45. This is an increase from our previous guidance, reflecting the reduced cash interest expense, and the lower amortization of the debt issue costs.

Cash taxes are expected to be $105 million to $115 million. Cash interest on corporate debt is expected to be $61 million, a reduction of $7 million from previous guidance, and capital expenditures are expected to be $105 million. This will result in free cash flow of $309 million to $319 million, or $2.17 to $2.24 per share for 2014.

I will now turn the call back to Debbie, our operator, for the Q&A session, but I also want to send my thanks for joining us today. Debbie?

QUESTION AND ANSWER

Operator

(Operator Instructions)

Ryan Brinkman, JPMorgan.

Samit Kur - ***JPMorgan - Analyst***

This is [Samit Kur] on behalf of Ryan. The first question that I have was primarily on [LSR] volumes, which were up 7% this quarter. Was there any weather-related impact on that, and also when we think about the off-lease recovery going forward, how should we think about the cadence of car volumes going forward?

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

Okay. Let me just make sure understood the question, because you broke up a little bit. We are up 7% in the quarter and you're asking if weather and any impact on that?

Samit Kur - ***JPMorgan - Analyst***

Yes

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

And also what we think the cadence of the increases in off lease volumes through the remainder of the year, did I catch that?

Samit Kur - ***JPMorgan - Analyst***

Right.

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

Okay. So as Jim mentioned, weather-- early February, clearly when dealer consignment cars couldn't make it to the auction with all the weather we had, it probably had some delay, but by the end of the quarter, it works its way out, so our view is weather might affect the timing a little bit, but over an extended period of time, doesn't have much impact, right Jim?

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

There's no question we had some sales that were interrupted. In fact, we had some sales that were canceled. But to Eric's point, by the end of the quarter it pretty much worked itself through, and I think I said on a previous call that weather can be a good guy, and it can also be a bad guy. But pretty much on a consolidated basis, we would say it's neutral.

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

And IAA, we also mentioned that's probably the reason we have such strong inventory on the ground, is the weather builds up those cars, and it takes a while to sell them, an average of 70 to 80 days per vehicle, from the time of the assignment.

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

As far as the leased cars go, I think you asked about the leased cars, we would just tell you that we are expecting that the number of leased cars to grow, starting here in the second quarter, through the balance of the year, with no specific numbers or percentages in mind.

Samit Kur - ***JPMorgan - Analyst***

Okay. Just touching on the average revenue per unit in the LSR business, that came in quite a bit what we you expecting despite the year-on-year decline. Noticed there was an increase in the average revenue per unit in physical auctions, so can you help us think about what's driving that, and is there more increased costs over there, and how should we think about it going forward?

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

Good question. A couple of things. First, with the addition of High Tech Locksmith, we're penetrating the key cutting business even further than we were before. We've been in that business, but this is giving us, I think the real advantage in the marketplace. Jim, do you want to add anything to that?

High Tech is what it is, it's cutting these fancy keys that are quite expensive

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

No. It's a nice business, and it's a business that we ran into a few years ago, I will say, by accident. And we were able to grow it into a nice business, and then we saw the opportunity to make an acquisition and really take it in a more serious way, and it's been a nice contributor for us.

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

And that's an important part of ancillary services. What do the dealers need, and then the second part I mentioned in my commentary, is we're seeing nice gains in the repossession processing businesses, which we have PAR, and I didn't mention this, but also RDN, which is more of a subscription-based service, but both of those are positive signs, as we're starting, and I think we're all reading about, we're starting to see more defaults on car loans and more repossessions occurring, and so I think that's a positive trend, but in the current quarter, contributed revenue, as we're beginning the processing of a lot of that repossession activity

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Samit Kur *- JPMorgan - Analyst*

So the last thing I want to touch upon is, thanks for discussing the priorities regarding the use of your free cash flow, but wanted to approach it from the leverage angle, and will this spill really into the whole car recovery? Is there an opportunity you can be more flexible on deleverage as you evaluate strategic investments and buybacks?

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

Let's not talk about the specifics. We do have the flexibility to increase our leverage and utilize that. At this point our focus is really not to repay debt, but with the refinancing, we increase our flexibility to consider all capital allocation opportunities equally. And again, there is some flexibility if the situation were appropriate, where we could increase leverage if that were part of the strategy.

Samit Kur *- JPMorgan - Analyst*

Okay. That's all my questions. Thank you

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

Great. Thank you.

Operator

Matthew Fassler, Goldman Sachs

Matthew Fassler - ***Goldman Sachs - Analyst***

So a couple of questions. First of all, just a quick housekeeping question, is the locksmith, High Tech Locksmiths revenue counted in revenue per vehicle, or is that separate from that number?

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

No, it's counted, Matt, in revenue per vehicle.

Matthew Fassler - ***Goldman Sachs - Analyst***

Got it. And I guess the second question on ADESA, as we think about the sequential revenue per vehicle numbers, we did see a pickup in revenue per vehicle sold from Q4 to Q1, which I think is the first time that's happened in a while, so is that a function of the more favorable pricing trends at physical? Is it a function of some of the pricing pressure abating online, and it's a little tough to tell from the disclosures, or is there a exogenous factor like perhaps High Tech Locksmiths contributing to that move?

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

Well, unfortunately, Matt, it's probably all of the above. You got a benefit from the additional ancillary services, which High Tech Locksmith was a major contributor, but I would like to point out, we're putting keys for existing clients. This didn't bring -- we're not in the retail key cutting business. This is all done wholesale, and the customer base is the dealers.

Second, I would add it's what we call other related services such as the repossession agency fees we get for PAR, the subscription fees at RDN, as they are assigning those things. I would also point out, without specifics, there are things that declined during the quarter, that were very similar in nature, so they were offsets, but those two were contributors.

The strong performance in dealer consignment should not be underestimated, as helping us maintain this very high revenue per vehicle in the physical auction. While they don't use ancillary services at the same pace as the commercial cars, they give us very strong auction fees per car sold, which helps keep that number growing, and it's a big part at 50% dealer consignment, without ancillary services, to maintain that number and keep a strong revenue per vehicle, I think is quite an accomplishment.

Matthew Fassler - ***Goldman Sachs - Analyst***

Great. Another question I'd like to ask about AFC, so the decline in revenue per loan transaction was a bit of a directional change from what we had seen through the quarters last year. As you think about the prospects for that business in 2014, is that a run rate that you would expect to maintain, or would you expect to see smaller declines or flattish numbers in that metric?

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

Well without getting into specific predictions for the future, I will tell you the first quarter has the highest level of write-offs every year with one exception, and that was the fourth quarter of 2008, which I think we all understand was a unique period. So Matt, about half of that decline, which we haven't experienced was provision for loan losses, and you'll also see that we have, again, when you get the Q, average loan balances are starting to moderate a little bit down, so that takes a little interest spread out a bit.

I don't see that there's going to be a negative trend. Perhaps we won't sustain the $160 we were having for some period of time last year in certain quarters, but I think it will be fairly stable.

Again, be consistent with what we see in the prior year, also down just a little bit, perhaps, depending on how things come together on average loan balance, what's the loss rates, used car prices. How long is it taking them to pay off if we get more curtailment, that would actually take that up a little bit.

Matthew Fassler - ***Goldman Sachs - Analyst***

And then one final question, if you would. To the extent that off-lease is sort of the dominant factor driving supply, can you talk about the seasonality of off lease supply, typically, versus the broader marketplace?

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

Well let me start with just telling you that I'm sitting here looking at the lease origination schedule that we get from third parties, and if you go back to 2011, the great news is, and this is what we've been talking about, it was a steady higher penetration rate through the year, month by month. That's 2011, on a SAAR that was 12.7 up from 11.6, which generated an absolute number higher of leases written. Now Jim, this is a normal trend, as you're going back into the cycle, where we began growing SAAR, and lease penetration rates starting to recover.

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

So I guess the bottom line here Matt is as these leases come to maturity, the real bulk of the leases will start to mature later in this year, as they were written during the course of 2011.

Matthew Fassler - ***Goldman Sachs - Analyst***

Understood. Thank you so much.

Operator

Bret Jordan, BB&T Capital Markets.

David Kelley - ***BB&T Capital Markets - Analyst***

This is actually David Kelley in for Bret this morning. Just a couple of quick questions. And first on IAA, really strong growth and certainly solid unit expansion, even off of the tough comp. Can you talk about or provide some color in what you were seeing, as far as weather trends, vehicle utilization trends, and also maybe some commentary on the current quarter as well, would be great.

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

Well there's no question we have spoken about the weather, and is the weather being a good guide for Insurance Auto Auctions, just the amount of accidents and collisions are obviously up, and as that goes up, you're obviously getting more vehicles coming our way. I think that overall, it's just the volume has been driven by the weather, plus although we don't get into necessarily talking about specific wins and losses, we had some very nice pickups last year. During the course of last year we won a number of RFPs, without mentioning names that we chatted about.

I think that those RFPs and those customers have now fully kicked in, if you will. I think our market share has continued to grow. And I think, with all that, I think that all the stars and planets are pretty much aligned for IAA. As you know, we talked about the 15% increase at the end of March 31, we also know it takes about 70, 75 days to process an insurance car, so we absolutely know what the first half of the year is going to look like, and then obviously, we have our projections for the balance of the year as well. And David, I'll just add a little color, while again, I don't want to predict volumes in that, there has been quite a bit of spring weather, especially last weekend at the end of last week, we had typical weather related spring so this volume doesn't just stop when the snow stops. It continues. I think all of us in the industry are experiencing a more normal weather pattern where is a steady volume creation as these accidents or these total loss vehicles come to the market.

David Kelley - ***BB&T Capital Markets - Analyst***

All right. Great. Thank you for the color there. And then a quick question on ADESA, as well. If we are looking at the quality of the vehicles that are trickling down to physical auction, how would you compare what we're seeing in this cycle versus previous cycles, when we're starting to see off-lease vehicles coming back maybe in the early 2000s or so.

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

I think what you're going to see here, what we're seeing and what we will continue to see, is we'll see the dealers being a little bit more selective. In the past, where there is very tight supply, a dealer may have gone outside his parameters, perhaps buying a car with a little bit higher mileage, or buying a car that needed a little bit more reconditioning, and willing to do that reconditioning. Now, with the increased volume coming, he can be a little bit more selective and basically that franchise dealer is now looking to buy a car that he can basically buy that day, take it home and get it on the front line and ready for sale tomorrow.

David Kelley - ***BB&T Capital Markets - Analyst***

All right. Great. Thank you.

Operator

Gary Prestopino, Barrington Research.

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

Jim, one of the comments you made about this off-lease volume is that you feel the franchised dealers will be unable to handle the volumes coming through. Do we assume then that pipeline gets filled up, that some of these leased cars are actually going to the independents? Or are you just talking in terms of the franchised dealers can't handle the volume in terms of the grounded cars that come back to the dealers?

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

Yes, Gary. Good question. First of all I think that the franchised dealers, that population isn't growing, there's only so many franchised dealers in the country, and I believe that they can only handle so much volume, and at some point they reach capacity. As you know, those cars go into the closed environment first, and that's where the franchised dealer primarily buys these vehicles.

Then I think what will happen is those cars are going to go through the open online sales we talk about. When you go to the open online sale, you go from just those franchised dealers, you add 37,000, 38,000 independent dealers, who are now eligible to buy those cars in an open online sale, and then obviously, when you get to the physical auction again, that vehicle is now available to all of those independent dealers as well. So that's a long way of confirming what you said, that yes, I see more independent dealers getting to more of these off lease vehicles.

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

Has that started to happen as of yet, or is that something you are anticipating?

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

I wouldn't say that we could say there's any strong signs of that, but I believe it's more -- we're maybe seeing a little bit, but I think it's more on the anticipation side.

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

So in the past when this has happened, because everything goes in cycles, at what point -- what percentage do you see in that shift of these leased cars coming back, and being sold to the independents? Does it hit maybe 20% 30%, 40% at the peak?

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

Gary, I don't know if I'm in a position to speculate what that percentage may look like. I think as I said in my commentary, we have to wait and see how this plays out.

I think we're going to get a very early indication. I think the indication is going to come here in the next 60 days or so, that we'll start to see what percentage eventually makes their way to physical, and what percentage are being bought by independents. I do believe that once these vehicles do get to the physical auctions, there will be a higher percentage of those vehicles being bought at the physical auctions by the independent dealer.

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

And Gary, the evidence of this is, again, we won't get into too many specifics, but in 2009, OPENLANE, they published articles, they were not a public company, but OPENLANE sold about 390,000 units and the number of units sold in relation to those listed was substantially lower as a percent than it is today. And we talked about that openly, so there were more calls going into that channel, but a lower conversion percent.

That's the history that we are expecting to recur. We don't know what the exact numbers will be, but as there's more cars listed, they aren't going to buy as many more as there are cars listed. And we did confirm, and we've said this in previous calls, if it doesn't sell in the online only venue, they end up in the physical auction space, they don't go other places. Right, Jim?

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

Right.

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

Okay. Just curious, you mentioned Eric, that usually Q1 is the highest addition or write off for loans with AFC, seasonally. Is that just a function of the fact that if you have a loss, it's going to come from the dealer side, and you would get dealers that just try and hang on, and they get through Christmas and they can't make it?

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

I think that's a very, basically, if they took chances on their inventory, those come to light as you near the end of the year, and then they find themselves behind the eight ball going into the first quarter. The other thing to point out for seasonality, our portfolio tends to be at its peak in that late January to middle February, and then we have what we call the February thaw, where the tax season, as it's known in the used car business, then you start selling your inventory, paying us back. Actually, the portfolio balance starts to decline and then begins building again in the fall to early winter. So that's actually the seasonality and the pattern of the portfolio size.

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

Okay. Thank you.

Operator

Bill Armstrong, CL King & Associates

Bill Armstrong *- CL King & Associates - Analyst*

Can you talk about pricing trends at the salvage auctions, what are you seeing there in terms of supply and demand, and where are vehicle prices going?

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

Bill, I'd say that we're seeing prices pretty much flat in the salvage industry, maybe moderating down slightly. But, certainly nothing material.

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

And Bill we would describe it as very strong, while maybe down slightly, very strong pricing given the supply that we have. Many times, you'll see this supply result in lower pricing. There's a lot of demand out there, and pricing is holding quite strong, in relative terms.

Bill Armstrong - *CL King & Associates - Analyst*

Is that demand coming from international buyers, or is it more parts dismantlers [at your home], do you think?

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

I think it's all of the above, Bill. There's no question, our international buyer base remains very strong. But again, as we reported in the past, the demand for aftermarket recycled parts continues to be driving prices as well.

Bill Armstrong - *CL King & Associates - Analyst*

Got it. And a question on ADESA, the repo volume, you've mentioned now for a couple of quarters that you're seeing increases in repo volumes. Are these cars mostly older cars, and maybe subprime buyers, or is it more across the board, in terms of the mix in mileage and age?

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

Yes, Gary I would say that some of these financial institutions have very short memories. And lots of these repos are very late-model vehicles. If the vehicle is going to be repossessed, and I'm not sure exactly what the stat is, but it's normally repossessed within the first 18 to 24 months. So these are relatively new vehicles, or nearly new vehicles. Once a vehicle gets past the three, four, five year stage, there's not as many of those vehicles being repossessed.

Bill Armstrong - *CL King & Associates - Analyst*

Interesting. Okay. Thank you.

Operator

Bob Labick, CJS Securities

Robert Magic - *CJS Securities - Analyst*

This is [Robert Magic] filling in for Bob. In IAA last quarter, inventory was up 10% year-over-year, and this quarter volume growth was up 3%. Can you please help us understand the disparity between inventory growth and subsequent quarter volume growth?

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

Yes, it's actually the dynamic of Superstorm Sandy on a year-over-year basis, that is causing that disparity. Again, you talk about we're up at 10%, and then we're only up 3%.

Last year's first quarter had over 40,000 Superstorm Sandy cars in it, that weren't in this sequential measure, that you're talking about, Robert. If you exclude Sandy, we were up 15% in revenue and 14% in volume, as I mentioned in the commentary, which -- a year ago, so I think you're seeing kind of the dynamic of that. Our inventory levels and growth have been a good, not a precise, but a good moving indicator of the volumes processed in the subsequent quarter.

Robert Magic - *CJS Securities - Analyst*

That's helpful, thank you.

Operator

Colin Daddino, Gabelli & Company.

Colin Daddino - *Gabelli & Company - Analyst*

Following up on the last question, the 15% year-over-year growth in the Insurance Auto Auctions volume, that's not adjusting last year for the excess backlog after Sandy, correct?

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

No, the 15% merely takes out the Sandy vehicles.

Colin Daddino - *Gabelli & Company - Analyst*

Okay. Got it. And then so you clearly have pretty good visibility for the upcoming institutional volume for ADESA. I was hoping you could speak a little bit to visibility on the dealer consignment volumes?

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

Yes, Colin. As I said, I'm very pleased with how our dealer consignment is performing, and I talked about that in the commentary. I also think that the dealer consignment will continue, and I believe that dealer consignment is going to be supported by the SAAR as we get up over 16 million units. Obviously this is a great creator of transactions of used car trade-ins, which ultimately make their way to auctions, hopefully.

But at 50% this has been a real focus for us, and a year ago, I believe that I was asked if I thought the dealer business could be sticky with the commercial volumes coming back, and I said I believed that it could. We could remain relatively at a high percentage on dealer consignment, and I can tell you quite frankly, it's exceeded my expectations. I think we've done a great job of attracting and retaining that dealer business.

Colin Daddino - *Gabelli & Company - Analyst*

That's great. And then another one on ADESA. So as I understand it, the vehicle mix and the revenue per vehicle is being dragged down a little bit, because of the institutional online sales. Do you expect this to maybe soften or reverse in the next 60 days or so, where you said you may begin seeing some volume spill into the physical auctions?

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

Yes, I don't necessarily think there's going to be any fewer cars sold online. But I think, going back to my point, I think as more of these vehicles make their way to a physical auction or an open auction, that's where we're going to get obviously increased fees and increased revenue. So, I don't see that taking revenue per vehicle down, if that's what you are asking.

Colin Daddino - ***Gabelli & Company - Analyst***

Okay. So maybe a continuing $100 per vehicle sold in the online one, but then as more in physical auctions, that should balance it out, and get some more ancillary revenue?

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

Right. I think we've told you in the past the one that car goes from closed to open, it about triples the economics, and then when it gets to physical and physical online, than the economics grow again. There's no question as more cars make their way to physical, that average number will grow.

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

And within the online only Robert, as its moving to physical, it will get offered open online only, and that's why you're looking at $122 per car a year ago down to $114. Our mix has been unusually weighted towards the private label closed. It will start to get more open sales, which will even draw the online only revenue per vehicle up a little bit over time, that would be when they get through the open sale.

Colin Daddino - ***Gabelli & Company - Analyst***

Right. And the my final question is, have you had or has there been a Board meeting since the debt refi in March, and when is your next Board meeting?

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

Well we have quarterly board meetings, so yes there's been a quarterly meeting since the debt refi, and our next board meeting is held in conjunction with the annual meeting, which was announced for June 10.

Colin Daddino - ***Gabelli & Company - Analyst***

Okay. That's great. That's all I have. Thank you.

Operator

(Operator Instructions)

[Majid Khan], with Tourbillon Capital.

Majid Khan - ***Tourbillon Capital - Analyst***

Congratulations on the great results. Most of my questions have unfortunately been asked and answered, but while I have you here, I was wondering on the buyback or potential buyback, on your guidance, your stock is trading around a 7% yield, and if we share your enthusiasm on the off-lease vehicles going through the system, it's probably trading closer to a 10% free cash flow yield a few years out. So I'm just wondering how you are thinking about deploying your free cash flow or potentially raising debt at 5%, 5.5% and potentially buying an asset that's yielding 2X that? What other uses of cash do you have?

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

Again, I'll say something that was discussed in the year-end earnings call, the previous earnings call. We do believe that when you're considering all the alternatives, the free cash flow yield on the equity is a no number with very little execution risk, so when we look at strategic investments, they would be at a premium to that yield, to meet the standard as to the allocation of capital. And again, I'll turn it to Jim to repeat what he said about our priorities, they're all considered.

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

Yes, I think it's an everyday discussion, in terms of constantly analyzing these opportunities in all of our businesses. We absolutely have targets that we're discussing, and we're prioritizing. Some of our strategic focus is a little bit more long-term focused, and I think it's just a question of waiting to see how these priorities come to us. Oftentimes, they don't always come in the order that you might expect them to come in, so you're dealing with them as they come up, but I can tell you that all of our business units, we are having ongoing discussions, and I would say to you, stand by.

Majid Khan - ***Tourbillon Capital - Analyst***

Great. Thank you. That's very fair. Keep up the good work.

Operator

With no other questions in queue at this time, Mr. Peisner, I'll turn it back to you for closing remarks.

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

This is actually Jim. I'll close it out. First of all, I want to thank you for your interest in our company and our stock, and for being on the call today. But more importantly, I think I really want to share my enthusiasm and my outlook going forward.

There's no question that we have come through a very difficult period of time. We saw the cyclical recovery that we told you was going to take place in 2013. We are now well into the cyclical recovery, but by no means are we done, and I can tell you that we're feeling very good about our industry, and we're feeling very good about KAR's position in the industry, and I think that we're passionate and driven to continue to grow this business. I again thank you for your continued support and thank you for being on the call today, so with that, I'll sign off, and have a great day.

Operator

Ladies and gentlemen, thank you for your participation. This does conclude today's conference.