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KAR - Q3 2012 KAR AUCTION SERVICES INC Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the KAR Auction Services, Inc. third-quarter 2012 earnings conference call. Today's call is being recorded. Today's host will be Jim Hallett, Chief Executive Officer of KAR Auction Services; Eric Loughmiller, CFO of KAR Auction Services; and Jonathan Peisner, Vice President and Treasurer of KAR Auction Services. I would like to now turn the conference over to Mr. Peisner. Please go ahead, sir.

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

Thanks, Jim. Good morning and thank you for joining us today for the KAR Auction Services third-quarter earnings conference call. Today we will discuss the financial performance of KAR Auction Services for the quarter ended September 30, 2012. 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, prospect, 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. I'll move right into our third-quarter performance. And we did fall short of our expectations in the quarter. Adjusted EBITDA was $117 million. This was only slightly better than the prior year and, at

ADESA and Insurance Auto Auctions, volumes continued to be challenged. But with that said, I believe that there is a positive outlook for 2013. We've had very good feedback from our customers on both the whole car side and the salvage side of our business, which I will talk more about in my comments here in a few minutes. But the tough years are behind us. 2011 and 2012 have been the toughest years that we have seen in our industry and I'm very pleased and very proud of how our employees and how our managers have managed through this period of time. We've been able to stay very focused on our business, still producing very strong gross profit, and as we will talk more about, exceptional free cash flow that this business is able to produce. And as I think of the toughest times being behind us, I believe and I'm excited to say that KAR is ideally positioned for a cyclical recovery.

As I think about ADESA in the quarter, we saw volumes increase 14%. All this volume was attributable to the inclusion of OPENLANE; no question OPENLANE has had a positive impact on ADESA. The OPENLANE customer mix is heavily weighted to the off-lease vehicles and we knew that these off-lease vehicles were going to be declining in 2012 and it certainly impacted OPENLANE as we expected it would when we made the acquisition in 2011. We did see a slight decline at ADESA's physical auctions; however, we also see an 11% increase in dealer consignment volumes. Now these dealer consignment volumes were offset by the declines in commercial volumes, but I think what is really more important, what I would like to really highlight here is the initiatives that we've taken on dealer consignment over the last two or three years have really exceeded my expectations. The amount of training that we have done with both our employees and with our dealers, I feel that we created some real stickiness with this business and I'm confident that we can retain our share of the dealer consignment business as these commercial volumes recover in 2013. So, the outlook for ADESA is very positive from a top down view of the industry.

And speaking with our economist, Tom Kontos, and with other economists who cover our industry, they all project improved commercial volumes in 2013. As well, we've taken the opportunity to check in with most of our commercial sellers and confirm what their lease return expectations returns are for 2013 and going forward. And they have all indicated that their lease returns will be increased in 2013 with even greater increases coming in 2014 and 2015. And while we are not in a position to discuss any individual customers, I can tell you that the feedback that we've had from our customers increases our projections that we've had and that we continue to share for 2013. In fact, there are a number of articles that have been written in the industry where they have been quoted as saying that they expect hundreds of thousands of additional off-lease vehicles to be returned in 2013. Also supported by the recent trends in new car sales as we continue to see the SAAR improve throughout 2012.

We have seen looser credit standards, which will only add more loan delinquencies, increasing the opportunity for repossessions. In two of our businesses, PAR and RDN, are two businesses that we have that work very closely with managing the repossession process with many of these financial institutions, and this gives us some early insight into the trends that are taking place in the repossession portion of the business. In Canada, it's a little bit of a different story. The Canadian market is lagging the US market. As you know, ADESA has a dominant share of business and Canada has not yet hit rock bottom. The recovery in Canada is likely to take at least a year longer than it has in the US. But, again, in Canada, ADESA has done a very good job in growing its dealer consignment business and we are hopeful that the dealer consignment business in Canada will offset the declines that we are going to experience on the commercial side of the business.

So, moving to AFC, what can I say. Just an absolutely outstanding performance. We saw an increase in the number of loan transactions up by 16%. Revenue per loan transaction was at $161. That is the highest level that we have seen this year. In the portfolio -- continues to be 99% current and I just want to take a minute and maybe just talk a little bit about how AFC differentiates itself in the marketplace. We consciously made the decision not to centralize our operations at AFC and maintain 104 what we call loan production offices in the field. Many of these offices are located in an ADESA auction or an independent auction or possibly a storefront and AFC does more than just loan money. They are providing services to these independent dealers that the dealers aren't necessarily able to provide for themselves. Many of these services are administrative services or as we would say back-office services and I think just done a phenomenal job of being able to really build the relationship and established a long-term relationship with the independent dealers. And again we've spoken to you about how AFC has been leveraging its core competency and its national footprint to grow new markets. We have moved into the salvage space. We are now financing more motorcycles, more recreational vehicles, and powersports. So AFC just continues to be a very, very good story for KAR.

Insurance Auto Auctions had its challenges in the third quarter. Proceeds have been under pressure where we have seen selling prices moderate somewhat. Revenue per vehicle declined slightly in the quarter and declining proceeds also reduced gross profit on vehicles sold. But from a positive standpoint we also seen volumes increased 5%. Now some of this increase in volume has been made up by purchase vehicles. Purchase vehicles for the quarter were at 8% in 2012 and that number was 5% for the same period in 2011. So continuing on a positive note, we have seen our number of assignments continue to improve. We have had market share gains that have offset the impact of the mild weather that we've seen in 2012. And although we've continued to say that we do not talk about specific customers and specific wins and losses, there has been a lot of talk recently about national RFPs and where they are going directionally. And we are pleased to share with you that a major insurance carrier recently announced the results of a national RFP. And Insurance Auto Auctions was the largest provider to this insurance company going into the RFP and they are the largest provider for this company coming out of the RFP. In fact, they increased their market share with this provider. So, that will serve us well.

And then there's the whole Hurricane Sandy impact and many of you on the phone would understand that impact much better than what we would here in Carmel, Indiana but let me talk about how it has impacted our business. The truth of the matter is we don't quite fully understand the magnitude of how the storm has impacted us at this point in time, thinking it's just a little over a week old. But the storm did have an impact on our whole car business as well as our salvage business. We did experience some delays. We experienced reduced consignment volumes and weaker attendance, dealers just weren't able to get to the sales. And we experienced incremental costs. At ADESA, we were moving vehicles to high ground. We were preparing our sites in advance of the storm and we had temporary power outages and the network access going down on us. Insurance Auto Auctions increased towing. Additional temporary rents and rents in the Northeast can be very expensive. Additional labor and additional travel cost in terms of getting our employees to the site to be able to survey the damage caused by the storm. So with this, we are going to incur all these expenses in the fourth quarter. And we are not going to sell the vehicles until 2013. So, it will be a little tough on the expenses in fourth quarter, but it will be a good thing for 2013 and going forward.

The other thing that has come out just recently in articles yesterday and in another article this morning is the storm is also going to have an impact on used car prices and this is going to serve ADESA well. There's going to be demand for used cars to replace all these vehicles that have been lost in the storm. And it is going to provide us an opportunity not only to sell more used cars -- prices will likely increase and we will probably need to move cars in from other regions. It will be an opportunity for OPENLANE to reach more customers through its national platform. And then there will be an opportunity for CarsArrive; transportation is at an all-time high in terms of demand and our CarsArrive network will be able to provide more service there. So all of these things will continue to serve our business well. But I would say right now, we are focused on responding to the needs of our salvage suppliers. We want to assist our customers with efficient processing of the total loss claims and then we want to try and provide dealers with as much inventory -- access to as much inventory as we possibly can. So the true cost to our business is not known, but we will look forward to quantifying it and updating you as we come into our fourth-quarter call at the end of the year.

But as I think about this and the conversation I've just had with you, I've talked about whole car; I've talked about salvage finance; I've talked about OPENLANE; I've talked about CarsArrive; I've talked about PAR; I've talked about RDN; and what I'm really saying is I'm talking to you about what I call this end-to-end re-marketing solution and I continue to remind you that KAR is the only Company that has been able to put all of these services together in a full end-to-end solution both from a physical and a virtual standpoint. So with that, as we think about our 2012 expectations, going into the year, we told you that 2012 was going to be a transition year. 2012 would look very much like 2011 and it certainly did. And I will remind you that through the first nine months of this year, we have generated over $200 million in free cash flow and with that, I will say that we are going to adjust our guidance to between $500 million and $510 million for 2012.

And this is based on a couple of things. First and foremost, as we look at the first nine months of the year and especially the third quarter and how challenging that has been, and then as we think about the impact of Hurricane Sandy and many of the unknowns that we are going to have to deal with as we go forward here in the fourth quarter. So, with that said, I can say that, as I, to repeat, 2012 and 2011 have been tough years. And not that I've been wishing my life away, but I'm very pleased to see the end of 2012 coming about here. I'm excited about 2013. I'm excited about the business. This is a great business and again, I think that we are ideally positioned as we go forward. The outlook is very, very positive. We are in the stages of finalizing our internal budgets and I am very excited to not only come back to you and report to you our fourth-quarter results, but to come back and report to you our outlook as we move into 2013. I think that not only am myself and the Management team excited but I think our employees are excited knowing that we've been able to manage through these difficult times. So with that, I'm going to turn it over to Eric. Eric is going to provide further comment on our financial performance as well as maybe add some color to many of the things that I've addressed. Eric?

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

Thank you, Jim. I would like to expand a little on our financial performance for the third quarter. KAR net revenue increased 5.7% in Q3 and gross profit was 44.4% of revenue, down from 44.9% in the prior year. Selling, general, and administrative expenses increased approximately $22 million in Q3. However, approximately $16 million of this increase is due to non-cash stock-based compensation. In the third quarter of 2011, our stock-based compensation was a credit or reduction during the quarter in expense of a $8.5 million, as a result of the stock price declining during that period. For Q3 2012, SG&A includes stock-based compensation of $7.6 million -- that is an expense, not a credit -- as we saw our stock price increase during the quarter.

In addition, we have added approximately $8 million in SG&A for OPENLANE that is now included in the ADESA segment. KAR generated $117.3 million of adjusted EBITDA for the third quarter. This was only slightly better than the $115.7 million of adjusted EBITDA for the third quarter of 2011. Our Q3 2012 performance was below our expectations and reflects the mix of vehicles sold at ADESA and Insurance Auto Auctions. At both ADESA and Insurance Auto Auctions, our adjusted EBITDA for the third quarter was below the prior year. This was offset by increased adjusted EBITDA from AFC and lower adjusted holding company costs for Q3. The ADESA segment continued to experience pressure on its performance due to the supply of vehicles in the marketplace. We will wait for the year-end NAAA survey to assess our market share position but I feel confident we have outperformed the industry in the United States and in particular in the dealer consignment segment.

I mentioned earlier that mix was causing our performance to be below our expectations for 2012. Let me explain. As we have seen our ADESA volumes grow year-over-year with the addition of OPENLANE, we are also seeing lower auction revenue per vehicle due to the unusually high level of our sales that are being completed in the closed environment. When I refer to closed sales, these represent commercial sales by OEMs and their captive or independent finance providers to their franchised dealers. The auction revenue from a closed sale is lower than the auction revenue from an open sale. To take this even one step further, if the vehicle is sold in a closed upstream environment, our auction revenue is lower and because upstream mean sold before arriving at a physical auction site, we do not have the opportunity to generate ancillary services revenue prior to the sale.

I would like to point out that the nature of the revenue has not impacted our gross profit levels at ADESA. Gross profit at ADESA for Q3 was 42.7%, only slightly below the 42.9% gross profit for Q3 2011. I would also like to comment on ADESA's SG&A in Q3. The increases in SG&A reflect the $8 million of OPENLANE SG&A; increased accruals for bonuses in 2012 compared to the prior year; and a loss of about $1 million on the sale of an idle property. We have controlled our expenses over the past two years and this positions us quite well as we look forward to increased commercial volumes. I also would like to point out that our SG&A costs for OPENLANE are in line and in fact even a little better than what was expected.

Insurance Auto Auctions was able to increase its volume year-over-year but also felt the effect of softer proceeds paid at auction versus 2011. As we have discussed in the past, we have a strategy to bring more noninsurance vehicles into the salvage auction network. One of the methods used to bring these noninsurance vehicles is to purchase inoperable or low value vehicles from consumers. For purchase vehicles, we are required to recognize the sale price of the vehicle as revenue and our acquisition cost of the vehicle as cost of services. As you can see in our financial statements, IAA gross profit for the third quarter of 2012 was 36.7%. If I were to adjust our gross revenue to net revenue on purchase vehicles, which is how we manage the business, our gross profit was actually 40.6%. We are still experiencing year-over-year declines in gross profit as proceeds have moderated but our GAAP financial statements do not tell the whole story. SG&A for Insurance Auto Auctions declined to $14.8 million for the quarter from $20.3 million in the prior year. This decline reflects lower accruals for an annual incentive compensation, reduced stock-based compensation at IAA, and the recording of a gain, which reduced the expenses, on the sale of excess property of over $2 million that is recorded in SG&A.

AFC's performance in the third quarter reflects the continued improvement in performance for this segment of our business as Jim mentioned. Revenues have increased, gross profit has increased, SG&A has declined, and credit quality remains extremely strong. Our revenue per loan transaction of $161 is not only the highest this year, it is the highest in the last five years, and perhaps in the history of AFC. It is obvious that a lack of credit losses is a key driver of their performance. You may have noted that the allowance for credit losses on our AFC portfolio was reduced to $8 million at September 30, 2012 from $9 million the previous quarter. This reflects the write-off of delinquent accounts which had previously been reserved. The portfolio continues to be over 99% current and on average is turning in less than 60 days. Our holding company SG&A expenses increased to $20.9 million in Q3 from $4.4 million the prior year. This difference relates solely to an increase in non-cash stock-based compensation.

Now let me speak briefly about our cash. Our available cash at September 30, 2012 was $130.5 million. Our consolidated net leverage ratio is at 3.5 times and we have generated $203 million of free cash flow in the first nine months of 2012. We are very proud of this performance. As Jim mentioned, we are updating our 2012 guidance. Adjusted EBITDA of $500 million to $510 million with capital expenditures of $90 million, cash taxes of $70 million, and cash interest paid of $95 million for the year will result in free cash flow of $245 million to $255 million in 2012. We continue to be pleased with our cash generation, which has been consistently improving over the last several years. In terms of our updated guidance, we have contemplated the impact on individual sales in the areas affected by Sandy last week.

In the ADESA locations that were able to recover and have sales last week throughout the Northeast, we saw lower volume sold. This is not surprising and we believe is just a timing issue. Unfortunately, it is hard to predict at this stage how quickly we can get back to normal at these locations. We also have the impact of additional costs for temporary land, increased labor cost, increased operating cost, that will impact the Insurance Auto Auctions business. We have over 30 IAA locations responding to the needs of customers in the areas affected by Sandy. It is only been one week since the hurricane hit the Northeast and even less time since power and basic services were restored in some locations. Our first priority is to serve our customers and the communities in which we do business. This will come with some increased cost in our fourth quarter. Any total [lost] vehicles sold will likely be in 2013 and not provide an offset to the increased costs we will incur in the near-term. I think that is enough for my formal remarks and I'll now turn it back to Jim and Jim we can start the Q&A section.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

John Lovallo, BofA Merrill Lynch.

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

Hello. John, I can't hear you?

Operator

Please go ahead, sir, your line is open.

John Murphy - *BofA Merrill Lynch - Analyst*

This is John Murphy on for John Lovallo. I just had some confusion there on the operator there. As we look at the conversion rate, it starkly is at a low point in the range down year-over-year. And I understand the mix impact here. I was just wondering if you could talk about what is going on with the conversion rate at the dealer level and the institutional level and I know you don't disclose the exact numbers there but I was just curious what you're seeing considering that pricing is so strong I would expect the dealer conversion rate to actually be a little bit higher as well as the institutional. I was just curious if you could break those two out directionally for us?

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

Yes, John, I think that you mentioned it. It's mix and it is historically low and that is the result of us selling more dealer cars and a high percentage of dealer cars. Even though our dealer business has grown and continues to be at a higher percentage of our overall business, it still does convert at a lower rate which, at the end of the day does drag the conversion rate down. So it's just a question of the mix and I think that you will see that change and go back on the north side as these commercial volumes come in 2013.

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

And John, you will see in our Q, which we expect we will probably file tonight, 45% of the cars sold at ADESA were dealer consignment cars and that is the highest level we have ever had as a Company.

John Murphy - *BofA Merrill Lynch - Analyst*

Okay, that is great. And within that channel, there has been no material swing one way or the other in the conversion rate for the dealer specifically, it is just the mix? Got you. And then as we look at this fleet business coming back and the backlog is definitely out there in the market, there's a lot of concern that some of these institutional sellers will go through their own channels or other channels other than the physical or your online auctions. I'm just curious what trends you're seeing there as far as your contracts with some of these institutional guys. Have they changed anything specifically that would really hamper this recovery or are we really just looking at something that is just more cyclical and not secular here?

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

Yes, John, I think that we don't see any change. Obviously, are OPENLANE platform serves 90% of the OEMs and we have certainly checked in and we feel that they will continue to sell on the OPENLANE platform. At the end of the day it is about the money and you are going to go with the channel that is going to produce the best results and between the physical auctions and the online platforms that are available, I think that those brands have been well established and that is where dealers go to buy vehicles.

John Murphy - *BofA Merrill Lynch - Analyst*

Okay and then just lastly as we look at AFC, you mentioned that you're growing your business into the Insurance Auto Auctions dealers. I'm just curious how the go-to-market strategy works relative to what you are doing at ADESA because obviously it's a little bit different of a buyer base or financing base there. And just really curious how that impacts your revenue per loan transactions and your margins there? Because there seems like there might be a much richer mix within Insurance Auto Auctions and what you're able to get out of your customers. I'm just trying to understand the difference there between the two?

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

Yes, John, I don't know that I know what you mean by richer mix but I will tell you the average loan balance is significantly lower. So, it actually probably can at times be a slight drag on that gross revenue per loan transaction of $161 and it is still a very small portion of the portfolio, but a fast-growing small portion. So, again, as we look at that business, we are not focused on $161 as revenue per loan transaction. We are really focused on the profitability and so if that number were to come down slightly because our mix -- motorcycles our average lower balance, recreational vehicles can be higher. So the mix will impact that. The key is you are really the strength of the performance overall on the EBITDA line and I think that is outstanding at AFC. But it hasn't drug it down yet. It could because the revenue on those salvage vehicles would be a little less.

John Murphy - *BofA Merrill Lynch - Analyst*

But ultimately your profits and returns on that side of the business are just as good as they would be on a whole car side?

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

Yes, yes they are and generally, again, it is a salvage vehicle, turns a little faster.

John Murphy - *BofA Merrill Lynch - Analyst*

Got you. So it's just incremental business. Thank you very much, guys.

Operator

Gary Prestopino, Barrington Research Associates.

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

Just real quickly, would you have had to lower your EBITDA guidance if Sandy hadn't occurred? Given the volume trends you are seeing?

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

Well, I don't think we need to dissect our guidance, Gary, but we made a comment that one of the impacts was our performance in Q3. So, I'll let you conclude what that means. It is not entirely related to Sandy, no, it is not.

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

Okay, that is fine. And then, Jim, are you still seeing that you're going to do about -- the market is going to do about 7.7 million units this year and then going up to 8.4 million next year and 9 million by 2015? Are those still good numbers to work with here?

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

Yes, Gary, they are. And we feel confident in those of those numbers.

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

Okay and then is the majority of what is driving this, is this going to be just lease returns or is it just a mixture of lease, rental, and factory?

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

It is a combination. A huge part of it is going to be lease returns, then add in the repos, and then we are going to see an increase in rental car returns as well.

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

Okay.

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

And then if you can, you're going to maintain this dealer business that we spoke about, especially as we see the SAAR increase. I read in The Wall Street last week they confirmed that sales were up $2 million, new car sales were up $2 million in 2012, and that is expected to rise again in 2013. So when you combine all those factors, that gets you to the $8.4 million in the $9 million that we talk about in 2015.

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

Okay, and then just to be clear, because I've been getting this question a lot, with a car that is damaged by saltwater due to the hurricane, is that salvageable for parts or does that generally have to be a [crushed] car because of the saltwater getting on the car itself?

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

Gary, let's let the insurance regulators and the insurance companies decide that. We all recognize saltwater damage is different than fresh water damage, but I don't want to speculate what anybody is going to require or do, it is too early, and I'm going to have to pass on giving specifics on that because I think it may vary by carrier, in may vary by jurisdiction.

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

Okay, thanks guys.

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

Gary, before you go, you said 7.7 million. I wanted to clarify in case others misunderstand that, that excludes the online sales of OPENLANE, which in 2011 were about 300,000 units and this year are expected to be just under that number somewhere. I just want to be clear, it is not growth in the industry from 7.7 million to 8.4 million because the 8.4 million does include OPENLANE as well.

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

Thank you.

Operator

Chris Ceraso, Credit Suisse.

Chris Ceraso - *Credit Suisse - Analyst*

It looked like revenue per unit in IAA was a little bit light. How much of that would you attribute to mix or commodity prices or something else?

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

Chris, as I dissect it, I highlighted the one item. When we calculate revenue per unit, we consider the net margin on purchased vehicles to be comparable to a provider fee or a sell fee and that is where we saw the biggest deterioration and it was actually in that component as opposed to -- I would tell you, relative to year-over-year performance, while the proceeds were softer, they aren't drastically different. There is a seasonality to the year. And I would tell you it is more probably on provider fees if anything it was a very slight impact on buy fees and I would argue probably not much at all, down just maybe $1 or $2 at most.

Chris Ceraso - *Credit Suisse - Analyst*

Okay. And then that weighed on margin to some degree, too, because it looked like you had a deeper than normal seasonal decline from Q2 to Q3 in the margin in that business?

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

That is exactly right, Chris. Because of that tighter margin, which is again the pricing difference between when you buy the car and when you sell it, which is only a few weeks, but we saw that -- that cause, that 36.7% but on a net basis you are still over 40%. I think that is a very strong performance for IAA.

Chris Ceraso - *Credit Suisse - Analyst*

Okay. And just coming back to the hurricane, you were pretty clear that it's going to have a negative effect in Q4, but judging from prior episodes, similar episodes, do you have any early expectations of what kind of increase in business it might produce for you as we get into 2013?

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

Chris, good question and it is just unfortunately too early, because the assignments are just beginning. People are just getting back to their homes and finding their cars damaged. And it will take a little bit longer. And I don't want to speculate based on media publications how this compares to Katrina or Irene, which is what they are doing. We'll just have to wait to answer that. It is a highly populated area, though, so there should be a lot of damaged vehicles.

Chris Ceraso - *Credit Suisse - Analyst*

Yes, okay. Thanks.

Operator

Craig Kennison, Baird.

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

Jim, you mentioned better stickiness with some of your dealer consignments. Could you talk about what is driving your stickiness, there?

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

As we go back probably three years now and we've seen this decline coming in off-lease volumes, and we were going to have to manage this period of time, quite frankly, our dealer business was as low as 25% of our overall business. And we knew that that was the opportunity for us to offset these declines. And we have put a national team together and the national team is probably close to 300 people now working on this national dealer consignment team that went out and daily called on dealers, trained dealers on how to use our services, how to use our technology, how to log onto our site, how to use the different services. I could go on and on but it was just getting dealers more and more comfortable with all the services that the auctions have been able to offer and I think at the end of the day, dealers have learned the true value of an auction. And they have needed to learn the true value of an auction just based on that tight supplies that we have been experiencing here over the last couple of years and so as we go forward, I believe that the good habits that we've created both online and in the lanes, I believe that those dealers will stay with it because it has been a good experience and a good result for them.

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

That's helpful and then with respect to the salvage business and I apologize if I missed this, but we know that scrap metal prices declined materially during the quarter. Since you took on more risk on some of those deals, did you actually take a loss and is that part of the margin issue you saw in the salvage business?

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

No, we still generated a net margin on the sales of the vehicles. We did not take a loss.

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

I'm sorry did you actually -- did the decline in salvage metal prices, did that actually influence at all your profitability so to speak?

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

Again, Craig, it is a good question. There are so many variables that affect the proceeds. I would again tell you that -- I would say the percentage decline in commodities prices might have been even greater than what we saw in proceeds. So used car prices is another influencer, especially at the high-end on the low-end, lesser so. I probably couldn't dissect it to that level and I don't think it created a loss during the quarter of any sort.

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

Okay, thank you guys.

Operator

Bob Labick, CJS Securities

Bob Labick - *CJS Securities - Analyst*

On the salvage side, I know you don't like to speak about specific gains, but you've mentioned on last call and then again today, broadly speaking, some RFP wins. Can you tell us if those volumes are fully reflected in the current volumes at IAA or roughly how much we should expect in terms of future gains in volumes from these wins?

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

Bob, that is a level of granularity we don't get into. We have been feeling very good about our business on an ongoing basis. The recent national RFP that Jim mentioned, though, none of that activity has been reflected in the marketplace yet. It was just recently announced.

Bob Labick - *CJS Securities - Analyst*

Okay, great. And then sticking with IAA. IAA, I believe, has a tough comp in Q4, meaning 52 weeks versus 53 a year ago. Is that the same for ADESA and AFC or is that just for IAA?

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

That is just IAA. They are the only segment on that calendar. Everyone else is on calendar month, calendar year.

Bob Labick - *CJS Securities - Analyst*

Okay great and then just switching to the balance sheet. You are likely to reach your goal of three times levered early next year. Could you just tell us the available options with your free cash flow once you've reached that and how you'd prioritize them?

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

Well, Bob, no, I don't think, other than the fact that we are focused on generating free cash flow and evaluating the options that we see in front of us, at this point in time I don't think there is anything specific to discuss. And we have not protected when we will hit that three times but we are very comfortable that we are generating strong cash flow.

Bob Labick - *CJS Securities - Analyst*

Okay, thanks very much.

Operator

Bill Armstrong, CL King & Associates.

Bill Armstrong - *CL King & Associates - Analyst*

Most of mine have been answered, but I just have a couple quick ones. The AFC penetration in the salvage side, is it your plan to start opening some offices on-site or in or near your IAA auction? Similar to what you have at ADESA?

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

Again, we don't want to talk about specific numbers but we do have on-site representation at some of those auctions whether it be on sale day or even all during the week if there's enough activity. They will respond to the market, so if there's enough activity I'm sure they will be on-site.

Bill Armstrong - *CL King & Associates - Analyst*

So you have individuals there, you are talking it up or making their services available?

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

That is correct.

Bill Armstrong - *CL King & Associates - Analyst*

Okay. Interest expense, what should we be modeling for Q4? Approximately?

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

Well our cost of funds is at about 5% other than the floaters which is a little lower. The variable that is a little tougher is the securitization interest and I don't know what your assumptions are there, but it tends to have a little bit lower cost of funds than the 5%. So that's about the level of guidance I'm comfortable with. Our cash interest paid excludes the interest on the securitization because we consider that for EBITDA purpose to be an offset to revenue and not corporate interest expense.

Bill Armstrong - *CL King & Associates - Analyst*

Right, so on the P&L, you've had a run rate of about $30 million per quarter, in that neighborhood for the last year. Should we expect it to continue to be in that neighborhood on a GAAP reporting basis?

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

I don't want to speculate, I don't know that that is a bad assumption, though.

Bill Armstrong - *CL King & Associates - Analyst*

Okay.

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

And I don't think any of us are expecting interest rates to go up based on policy and it is just a function of what's the balances at AFC, which I'm not going to protect right now.

Bill Armstrong - *CL King & Associates - Analyst*

Understood. Okay, thanks.

Operator

John Healy, Northcoast Research.

John Healy - *Northcoast Research - Analyst*

Wanted to ask about a comment you made about the storm. Potentially helping used car values go higher -- I was wondering if, I don't know if Tom's on the call, but maybe you could give some perspective in terms of how long he thinks maybe another step-up in the used car market values could last for and maybe just revisit any updates you guys have on what you think the used car market could do in 2013?

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

Yes, the comment was that we don't know the actual numbers, haven't been able to quantify the actual numbers, but we know as Eric spoke that this was a extremely heavy populated area that we are dealing with. We expect that there is going to be a high number of vehicles that are going to need to be replaced and when you have that kind of demand, although it could be short term, when have that kind of demand, it is going to drive used car prices in those markets and will probably affect used car prices in other markets as well because they're going to have to reach further to get vehicles to fill the void that is being created. I'm looking at an article as we speak here and it says that the National Automobile Dealers

Association is predicting that as a result of the storm, December prices of used vehicles up to eight years old will end up being anywhere from 0.5% to 1.5% higher than earlier projections. So that is quoting the NADA.

John Healy - *Northcoast Research - Analyst*

That is helpful. And I wondering if you guys could remind us and I don't want to draw a direct comparison to Katrina or Irene to what it could do for the IAA business, but how much of a lift in volume did you guys get at IAA from Katrina? Do you remember?

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

That was '06 so it is a long time ago, so when we were selling the cars. I don't have that number in front of me, John, and the Irene was totally different last year and at no point did we disclose that at that level of detail, we just said it was a contributor our increases last year, which were for the year in 2011, we were over the prior year by 9% and that was one of the contributors.

John Healy - *Northcoast Research - Analyst*

Okay and just last question, I know you stepped up the purchases on the IAA side yourself a little bit is that something that we should expect you guys to continue to do in the fourth quarter and into 2013 to maybe be a little bit more aggressive out there in terms of buying cars and then selling them through yourself?

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

It comes down to we don't have any specific goals or targets that we are trying to achieve in that area. It comes down to the demand and with the tightness of supply, there was the opportunity to buy these vehicles and the folks at IAA did a good job in buying the vehicles and we will continue to buy the vehicles as the market continues to demand them. And the other thing to keep in mind is with our effort to support the insurance carriers in the Northeast, it is highly unlikely we will buy vehicles in the Northeast, because we will be working through a large supply of vehicles and that will take some time. So, but yet on the West Coast, you may meet demand there in a different way. It varies region to region.

John Healy - *Northcoast Research - Analyst*

Very helpful, thank you.

Operator

Bret Jordan, BB&T Capital Markets.

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

A quick question talking about the RFP business for national insurance accounts, what is the profitability trend been there. If you looked at this insurance company you mentioned, is the go-forward productivities from on a per car basis comparable to the trailing productivity or is pricing playing a role on the RFP side?

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

We are not going to comment about any details other than what we gave you. But we see the IAA business continuing to perform at a very strong level and I have mentioned before, as proceed start to moderate, there could be some declines in margin, but that is because we've been at unusually high levels, not because the business is going to perform at a lower level and on a net basis being about 40% for the third quarter I think speaks to that point. I don't see anything really hurting that business materially.

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

Okay so that competitive level in the RFP doesn't change materially?

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

All our fees are competitive, but I don't think it has an impact on our outlook for the business.

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

All right. Great, thank you.

Operator

(Operator Instructions)

David Melka, New York Life.

David Melka - *New York Life - Analyst*

Just wanted to ask you, you've been growing the AFC business very strongly and at the same time you've spoken about the fact that you're getting into different things in that business whether it is the IAA portion of it, whether it's motorcycles and RVs, and you've also talked about the fact that you manage that on a very decentralized basis because you think that's what help grow the business the best. But can you talk a little bit about the oversight you exercise over what happens in those fairly autonomous groups as it relates to what they are doing -- audits, credit quality, things like that, what metrics you look at?

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

And David let me clarify, the 104 loan origination offices are how we interact with the customer.

David Melka - *New York Life - Analyst*

Yes.

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

They have a very centralized underwriting process managed entirely at the corporate level and even collections, while again the feet on the ground or out in the street, we monitor and manage that business, it is really more of a hybrid than it is a decentralized portion. Now relative to the credit profile, yes, it they are very in tune to the differences in the type of product that they are floor planning, how it moves, what is the right length. But again it has so much similarity -- has title, you can track the ownership, those are the things they look at and I think they've done a great job. And so these new markets are really just an extension without changing their business processes substantially that they can just again leverage it into a different marketplace.

David Melka - *New York Life - Analyst*

Well is all of the credit analysis and monitoring and stuff like that, is that all centralized? What decisions are actually being made in those discreet regions besides marketing?

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

Yes, no, all the credit decisions are managed here at central office.

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

So if you think of the outlying locations, they are trying to get the customer to apply and then AFC has a centralized underwriting process that determines if we will extend credit.

David Melka - *New York Life - Analyst*

And the monitoring, is that also done and audited from the home office or is that something that you rely on the local people to do in a bigger way?

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

Well, again, we have a subsidiary of ADESA that does over 60,000 lot checks per year. They touch every customer. That is managed centrally. I just don't -- it a hybrid, though, because we also expect the managers of the field to be in regular contact with our customers and know what is happening in their business. But I would tell you the formal processes are all manage through the AFC corporate management team and the feet on the street are really contacts at the auctions and for the customer. And they have absolutely no influence over the processes.

David Melka - *New York Life - Analyst*

Okay. Thank you very much.

Operator

Colin Daddino, Gabelli & Co.

Colin Daddino - *Gabelli & Company - Analyst*

If I'm thinking about longer-term margins, what is the trade-off or dynamic on the gross EBITDA margins between maybe the ADESA commercial volume leveraging some of the fixed costs versus some of these volume initiatives like the higher dealer consignment or closed sales on ADESA which might be dilutive to margins?

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

We want to sell every car that comes to us and the real impact is the lower volumes. There is a fixed cost infrastructure. They have done a great job of keeping it at the lowest possible level with lower fixed costs. At the same time, what we are looking forward to is the total volumes to increase without seeing that SG&A grow is going to be the leverage on the EBITDA margin. In terms of differentiating, yes, if you had a commercial mix with a lot of ancillary services, the gross profit margin may decline, but the dollars will go up. So, we've always looked at that and it is within a fairly narrow band. And again, I think that is the strength of the ADESA business model right now and how we attack the marketplace.

Colin Daddino - *Gabelli & Company - Analyst*

Okay great and then just in terms of the winner of last night's election, it has caused some concern that maybe carried interest for hedge funds or private equity funds might be attacked so in light of that, with some of your larger shareholders, what are they thinking and where are you in the sales process?

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

I think it is best that they answer what they think happened in election last night and I'm going to pass on that one. Jim, are you?

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

I'll keep my political views to myself.

Colin Daddino - *Gabelli & Company - Analyst*

All right, thank you very much.

Operator

And at this time there are no further questions. We would like to turn it back over to our speakers for any additional or closing remarks.

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

Okay great. Thank you, Jim. And I just wind up with saying thank you for your interest in our Company and thank you for being on the call today. I am genuinely excited and enthused about this business. I feel very good. We know that all the tailwinds -- or all the headwinds are becoming tailwinds. We know the SAAR is going to increase. You know about the leasing returns coming back to the market. You know what we've done with dealer consignment and I think consumer confidence continues to improve. Hopefully the economy, we get past this election, although I won't speak to politics, we get past this election and hopefully things get settled down and I think it's all good as they say. And I can tell you the Management team is focused and excited and we'll will look forward to the coming year, closing out this year and to the year ahead of us and with that I'll wind it up and say thank you and goodbye.

Operator

Thank you that will continue today's conference. We thank you for your participation.
