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KAR - Q4 2013 KAR AUCTION SERVICES INC Earnings Conference Call

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**Ryan Brinkman** *JPMorgan - Analyst*

**John Lovallo** *BofA Merrill Lynch - Analyst*

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## PRESENTATION

**Operator**

Good day, everyone, and welcome to the KAR Auction Services Incorporated fourth-quarter and year-end 2013 earnings call.

Today's conference is being recorded.

At this time I am pleased to turn the conference over to Mr. Jon Peisner, Treasurer and Vice President of Investor Relations. Please go ahead, sir.

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

Thanks, Jennifer.

Good morning and thank you for joining us today for the KAR Auction Services fourth-quarter and year-end 2013 earnings conference call. Today we will discuss the financial performance of KAR Auction Services for the quarter and year ended December 31, 2013. After concluding our commentary, we will take questions from participants.

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

Lastly, let me mention that throughout this conference call we will be referencing both GAAP non-GAAP financial measures. Reconciliation 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 the call over to KAR Auction Services, CEO, Jim Hallett. Jim?

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

Great, thank you, Jon. Good morning, ladies and gentlemen, and welcome to our call. We have much to discuss, so I will get right to it.

That's reflect back a little bit on 2013, where we had adjusted EBITDA of $538.2 million, which was an 8% increase. Out net revenue was up 11% to over $2.1 billion. Our adjusted earnings per share was $1.19, which was also up 11%. We continue to focus on generating free cash flow in all of our businesses and in 2013 we produced free cash flow of $309 million. All in all, I feel very good about our financial performance for the year.

There's no question that 2013 was an interesting year. As you will recall, we started the year dealing with Superstorm Sandy. We were also looking forward to the cyclical recovery that we were expecting to take place in the second half of the year at ADESA.

As we think about that Sandy cars, we were able to sell the Sandy cars very quickly. In fact we sold over 50,000 Sandy cars by the end of the first quarter. This was a tremendous effort by the entire team at Insurance Auto Auctions.

I believe that this strong performance was recognized by our customers in we were able to achieve market share gains with several of our top US auto insurers. I would say that IAA's financial performance following the first quarter, I would describe it is being exceptional.

Turning to the whole KAR business. We expected that the industry would sell approximately 8.7 million vehicles and that this increase would be driven primarily by commercial vehicles, especially with the off-lease segment. We believe that this has happened as we expected. This increase in off-lease supply has led to strong growth in our online-only sales at ADESA.com, which is powered by are OPENLANE technology.

Maybe just to provide you with a little additional color that we haven't provided in the past is, our online-only sales at ADESA was $410,000 in 2013 and that compared to $310,000 in 2012. No question that with the 2013 online-only sales were heavily weighted to the Private Label Closed program. As we looked at the online-only sales mix, it did lead to a reduction in revenue per vehicle sold, which Eric is going to provide more color on in his detail.

Turning to the holding company, we did see increased costs. We had significant non-cash compensation costs related to the profit interest. We experienced much higher costs for our medical benefit plans. Again, I will leave the details to Eric, here in a few moments.

Enough looking back, let's look forward. In looking forward we continue to see the cyclical recovery in the whole car industry. I had mentioned to you that the industry achieved what we believe is 8.7 million cars sold in 2013, as we expected. We would expect that that number will grow to 9.1 million vehicle sold in 2014. Then, furthermore, we would expect that the volumes will grow to at least 9.7 million vehicles sold by 2016.

We are seeing some very positive trends that you may be aware of. As you know, the SAAR came in at approximately 15.6 million vehicles for 2013. That number is expected to increase to 16 million in 2014. Lease penetration rates continue to grow and we're seeing looser credit standards beginning to show up in the increased number of repossessions. As you think about some of the major drivers of our business is the SAAR, lease penetration and, obviously, repossessions.

If I can turn a little bit to technology. We continue to invest in technology. As you know, our Private Label Closed Sales, we believe will continue to increase our market share.

We have approximately 90% of the private label programs in the industry. As I've said in the past, that allows us to get the car at the top of the funnel, and we think that will continue to increase our opportunities going forward.

I also think it is important to note that we're going to continue to support every channel that we can to possibly sell a car. Our goal is to sell as many cars as we possibly can in as many channels as our customers demand.

As you think about this increase in off-lease vehicles over the course of the next three years, we do expect that more of these cars will get to physical auction. As these vehicles get to physical auctions, we do expect that we will see an increased utilization of her ancillary services for a couple reasons.

Number one, I believe that these sellers are going to need to enhance the condition of their vehicles just to drive the resale values and the residuals. From a competitive standpoint, I believe this is going to be the differentiator for the sellers in terms of the increased competition that there's going to be at the physical auctions, as well as the physical online. Definitely expecting that we will see an increased use in these ancillary services.

A big area of focus for ADESA in 2014 is going to be in our online-only open environment. We've talked about the closed environment, and then we've talked about what happens when the vehicle goes from the closed environment to the open online environment. We know that the economics get considerably better.

If I could, just for a minute, give you an illustration. If you're talking about a closed private label program, you're talking about a buyer base of roughly 2,000 to 3,000 dealers. I could go furthermore and say how many of those dealers would be within a 500-mile radius, where it would make sense to actually buy and ship a car?

When you go to open online, not only do you increase the economics but you dramatically increase your buyer base. You now pick up 17,000 or 18,000 franchised dealers. As well, you pick up approximately 37,000 independent dealers, so you've dramatically increased your buyer base.

This is going to be the area of focus for ADESA in 2014 is getting more and more of these buyers familiar with our open platform in buying these cars in the open platform before they go to physical auctions. With that more focus on line, better economics, a great platform at ADESA.com powered by OPENLANE, a great physical footprint across the country, we feel puts us in a great position to increase our market share in 2014 and going forward.

With that, I will turn to at Insurance Auto Auctions and say that there has been some recent RFP activity with the largest insurance companies in the US. We have increased our market share with many of these companies. Interesting enough, we have increased -- our strongest market share has come with some of the fastest growing auto insurance carriers in the US.

We did experience double-digit volume growth in 2013. We expect growth to continue at IAA, but perhaps not quite at the same level. There continues to be strong demand for aftermarket recycle parts. Activity in the collision repair industry supports the demand for salvaged vehicles. The number of auto insurance claims that are resulting in a total loss has now exceeded 14%, which all bodes well for things at Insurance Auto Auctions.

Turning to AFC, again AFC continues to be a leader in the floor plan lending to independent dealers. As you know our securitization provides a low cost to capital. We feel we have plenty of room to grow our customer base within AFC.

Our growth rate over the past three years at AFC has exceeded the industry growth. We do expect that that growth may moderate somewhat, but we also feel confident that we can still outperform the market. Perhaps not the same level, as we are seeing increased competition as there is easier access to capital.

Our focus at AFC has been and will continue to be about the total service that we provide to these independent dealers, and it goes way beyond just loaning them money. It's providing them with other back-office services and other products that can make it easier for them to do business.

I think a good example of that is Preferred Warranties, which you seen us acquire in 2013. We will continue to look for products and services at AFC that fit that customer set that we can continue to grow that business as we go forward.

In terms of looking at our guidance, we expect to increase our revenue and our adjusted EBITDA and our earnings per share over the next several years. Our 2014 guidance, we expect adjusted EBITDA of $580 million to $600 million of adjusted EBITDA. Our adjusted earnings per share of $1.31 to $1.42. Again, we expect a free cash flow to exceed $300 million.

Our dividend, our Board recently approved the first quarter dividend payment of $0.25 per share, which will be payable on April 3 to shareholders of record on March 26. We are in the process of refinancing our existing credit facilities. We expect to launch that process in the next several days. Again, I'll allow Eric to give you the color on that.

Weather is always in the news. I can say that we probably have experienced a pretty harsh winter across the country, certainly a record here in the Midwest. Investors ask me often is, how does weather affect our business? I would tell you that we expect to face some weather challenges every year. The real affect may come more so on a week-to-week basis; the weather can have an impact.

Obviously, it can affect our labor costs. It can affect our conversion rate, our attendance at auction, and ultimately our volumes sold. Over the course of a year, I would tell you that weather will not have a material effect on our performance unless there's some catastrophic event like the Superstorm Sandy that I hope we never have to experience again. I think everybody understands what the upside is here at Insurance Auto Auctions with the additional volumes that would come to Insurance Auto Auctions through the course of the weather that we have been experiencing.

With that, to wrap up my comments, I would say couple things. Number one, I'm proud to tell you that we have reached our leverage target of 3 times. We will continue to focus on growth opportunities going forward, as well as returning to our shareholders will remain a priority. I believe that KAR is well positioned in 2014 and beyond.

I absolutely believe that we are now a leader in technology and I as well believe that technology is going to be the differentiator for us going forward. It's this combination of technology along with our physical footprint that really creates the value for customers. The fact that we're going to allow our customers to choose to transact business through any channel that they decide that they want to do business in, we're going to make sure that we provide them the best venue and we are providing them with the best service that we possibly can.

With that, I'm going to turn it to Eric. Then, we will come back to you for some Q&A. Eric?

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

Thank you, Jim.

I will start by summarizing our 2013 financial performance and identifying the significant non-cash charges that were recorded in 2013. KAR reported revenue of $2.173 billion in 2013. All three of our business segments reported increases in revenue with ADESA up 6%, IAA up 16% and AFC up 16%.

Consolidated gross profit as a percent of revenue was down in 2013 as compared to 2012 at 43.3%. However, if we excluded the revenue and related costs associated with Superstorm Sandy vehicles processed, our gross profit was consistent year over year at about 44.5%.

As Jim mentioned, we are providing enhanced disclosure of revenue per vehicle sold for ADESA. We are now providing the revenue per vehicle sold for online-only sales and the revenue per vehicle sold for cars sold from our physical auction locations. For online-only sales, average revenue per vehicle sold was $118 in 2013 compared to $126 in 2012. The increased sales in the private label closed venues, which make up the largest purchase of our online-only sales, is the reason for this decline.

At our physical auction sites we saw an increase in average revenue per vehicle sold to $651 for 2013 from $644 in 2012. These two components blend to an average revenue per vehicle sold of approximately $545 in 2013 compared to approximately $560 in 2012. I hope this additional disclosure is helpful in your understanding of our performance at ADESA.

I would also like to comment on the gross profit at Insurance Auto Auctions. We have seen our gross profit as a percent of revenue decline since the peak in 2011 and the first half of 2012. This decline is expected as we were experiencing record levels of proceeds at the salvage auctions, which contributed to increases in revenue per vehicle.

We knew this level of proceeds would not be sustained, and since the second quarter of 2012, have seen proceeds moderate. In addition, we sourced approximately 7% of the vehicle sold by IAA by purchasing the vehicle. As I've described before, this requires us to recognize the sale price of the vehicle as revenue and the purchase price of the vehicle as cost of services.

Prior to 2012, purchased vehicles represented 5% or less of our volume sold. Purchased vehicles represented 7% of vehicle sold in both 2012 and 2013. This accounting treatment reduces our gross profit as a percent of revenue. In addition, we have seen tow cost increase in 2013.

This has also contributed to a very modest decrease in our gross profit percent. As I look forward, I expect our gross margin to improve from the 2013 levels as long as the revenue per purchased vehicles does not become a greater portion of our total IAA revenue.

KAR's selling, general and administrative expenses for the year include $67.2 million of non-cash stock compensation expense. The profit interest components of this charge, totaling $52.1 million, is not deductible for tax purposes. This reduced our net income per share for the year by $0.43 and for the fourth quarter by $0.33.

The profit interest expense is now behind us, as all of the stock held by KAR Holdings II, LLC has been sold. We will have an additional $23 million of expense related to the exit options held by a broad group of KAR Management. These options are currently not vested and will vest when KAR meets the performance criteria.

Generally, KAR stock must close at $30 and $35 for a minimum of 20 consecutive trading days in order for any of the shares to vest. The expense related to the exit options is deductible for tax purposes, but only when the options are exercised by the holder.

The increase in our medical benefit costs also accounts for substantially the remainder of our increase in SG&A for 2013. As Jim mentioned, we had negative experience in the plan in 2013. As a result, our medical costs have exceeded our expectations. In total, our medical costs increased by approximately $9 million over the prior year and the Company had to absorb all of this additional costs.

Let me walk through the calculation of free cash flow for 2013 with you now. We had adjusted EBITDA $538 million. Our cash interest expense on corporate debt totaled $75 million. Cash tax payments were $57 million. Capital expenditures aggregated $97 million.

This nets to free cash flow of $309 million for 2013, which represents $2.19 per share. From this free cash flow, we used $46 million to acquire businesses in 2013. We retired $53 million in long-term debt, and returned $79 million to shareholders in the form of dividends.

Now, let me turn to our guidance for 2014. Jim has mentioned our adjusted EBITDA is expected to be $580 million to $600 million. Our cash interest expense on our corporate debt is expected to be $68 million. We expect our capital expenditures to be about $105 million, and our cash taxes are expected to be $105 million to $115 million for the year.

I would like to take a few minutes to talk about the significant increase in our cash taxes. We had cash taxes of only $57 million in 2013 and now that number will nearly double. As we mentioned in our earlier conference calls this year, we have benefited from some tax planning strategies that were implemented in 2013 that allowed us to deduct certain capitalized IT costs. This reduced our cash taxes in 2013 by approximately $20 million that will not recur in 2014.

In addition, we have been utilizing net operating losses and will have less NOLs available to us in 2014. Last, we had a substantial savings from deduction of debt issuance costs in 2013 as we increased our borrowings on term loan B and use the proceeds to extinguish the floating rate notes that remained outstanding.

In summary, our free cash flow for 2014 is expected to be $302 million to $312 million. This will be $2.12 to $2.19 per fully diluted share. We are working on a couple of initiatives that could result in improving our free cash flow in 2014. First, Jim mentioned our intent to launch the refinancing of our term loan B facility. The current credit markets may offer the opportunity to generate cash interest savings in 2014.

As part of pursuing this refinancing, we are also seeking to provide the Company with greater flexibility for making capital expenditures and for making restricted payments. We plan to launch the refinancing process in the next few days and there can be no assurance that we will successfully complete this refinancing. Our guidance on cash interest on corporate debt does not include any potential savings from this proposed refinancing.

We also pursuing a number of tax planning strategies that may offer an opportunity to reduce our cash taxes. As we develop the strategies, I will keep you posted on the impact on our cash tax position throughout the year.

Now let me finish with some commentary on where we are spending our capital expenditure dollars. In 2013, just over $50 million of our capital expenditures was for technology, either software or hardware utilized in our various businesses. We expect this trend to continue with over half of our capital expenditure dollars being directed to technology projects. This is consistent with the trend for technology to be of increasing performance to our buyers and sellers.

We still need to maintain our facilities for the cars that get to the physical auction sites, but we clearly see technology as an important component of our offering. Much of this capital investment is directed to projects that enhance the technology utilized in our online-only venues, but we are also enhancing of the services offered from our physical auction sites, our condition reporting, and the availability of analytics for our customers.

With that, let me conclude my remarks. I will now return the call to Jennifer. Jennifer, we'll take questions from the investors.

## QUESTIONS AND ANSWERS

**Operator**

Yes. Absolutely.

(Operator Instructions )

Our first question will come from Goldman Sachs. If you could you please announce your name?

**Matt Fassler** - *Goldman Sachs - Analyst*

Good morning, it's Matt Fassler. A couple questions for you. First of all, if you could just give us a little more color on your conviction that the mix of the incremental vehicles will skew more towards fiscal option or certainly away from the dealer-centric online-only auctions? Obviously, it looks like those cars represented the bulk of the growth that you saw in cars sold in 2013. What dynamics do you see playing out in your favor in that regard in 2014?

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

Matt, this is Jim. Thank you for your question. I think it just comes down purely as simple case of volume. The franchised dealers are the dealers that by these vehicles in closed environments. There have been a shortage of volume leading up to 2014. We feel, and certainly others in the industry have the opinion, that these franchised dealers are not going to be able to continue to absorb this kind of volume that is coming at us. There will be more of these vehicles get to the open platform and eventually trickle to the physical sales. Just purely a case of more vehicles to choose from, and they're going to maybe pass over some vehicles that they may have kept in the past.

**Matt Fassler** - *Goldman Sachs - Analyst*

Is it your sense that their inventories are somewhat full right now, or is that perhaps a mix shift to CPO maybe has run its course? Any news on the ground that would incrementally support that view?

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

The opinion would be, Matt, that I think their inventory can reach the levels that they can absorb at this point in time. Whether it be through this CPO programs or just through having inventory on the ground, they are able to buy all the inventory they want. At some point in time, just not going to be the demand there.

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**Matt Fassler** - *Goldman Sachs - Analyst*

Got it. One quick follow up for Eric. Eric, as you contemplate the new financing deal that you hope to complete, it sounds like in the next few weeks, are you also looking for any incremental flexibility in capital allocation including perhaps stock buyback? Would that be part of your part of your goal or is that secondary to lower cost of funds?

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

No, as I mentioned we are going to increase the flexibility for both capital expenditures, which means we can do greenfields and other things that might have been more limited, and restricted payments, which would include all the potential uses of capital for return to shareholders.

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**Matt Fassler** - *Goldman Sachs - Analyst*

Great. Thank you so much guys.

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**Operator**

Next, we'll hear from JPMorgan. If you could please announce your name?

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**Ryan Brinkman** - *JPMorgan - Analyst*

It's Ryan Brinkman. Another capital allocation question, it looks like you finished the year with nearly $200 million. You're forecasting to generate over $300 million of free cash in 2014, half of which roughly goes to dividends. That would leave you with a potential, I think, just a lot more cash than you've had historically. Can you remind us of what the minimum cash is you would like to run the business? You are at the leverage ratio you previously targeted. How would you balance the prospect for dividends versus repurchases versus potential acquisitions going forward?

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

Okay. First, let me deal with the cash balances, Ryan. Of that $200 million, you will see in the 10-K that we expect to file tonight, that about $148 million is available cash. The rest of that is cash that actually is, call it, earmarked for customers for the sale of their cars. It's called flow cash. That's always the case. We always have a little bit less available cash than the balance sheet cash. The rest of your analysis is accurate that it will generate substantial cash. Generally speaking, we will just look at the best way to deploy that cash. Jim might speak to what our priorities are.

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

I think really our priorities remain unchanged. We continue to look for acquisitions for growth in all of our businesses. That is always ongoing, whether it be a strategic fit or whether it be just be from a geographic presence, just a good opportunity to grow through acquisitions, continue to provide a return to our shareholders. Then obviously, there's always the opportunity to continue to pay down debt.

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**Ryan Brinkman** - *JPMorgan - Analyst*

Okay. That's very helpful, thanks. The 11% rise in ADESA volumes, can you just put that in the context of maybe the industry? How much share there do you think you're gaining? I know attributed IAA market share gains to you're having helped out your customers during Hurricane Sandy. What do you attribute the ADESA market share gain to? Is it because of the stronger mix toward institutional, or is OPENLANE helping you? What do you attribute that to?

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

I think it is coming from several segments, Ryan. If you take it -- we went into the year with about a 23% share and we are now, I believe, at a 24% share. With my commentary, I mentioned I would expect that we feel confident we have the opportunity to continue to grow that.

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

Ryan, I will add a little more color. We really believe that our online venues provides us an opportunity to continue growing that share, because we get a shot at those cars. As Jim mentioned, we have 90% of programs, right Jim?

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

Right.

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

Again, we get an opportunity to continue growing share. As you know from following us for quite a few years, our commercial representation has always been stronger than dealer. As this recovery, even back to the 2016, is heavily weighted towards commercial, we would expect to perform at a very high level because of our concentration in commercial business over the history of ADESA.

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**Ryan Brinkman** - *JPMorgan - Analyst*

Thanks. Last question then, you mentioned the weather benefiting IAA, I'm guessing more in the back half of 1Q or kind of Q2. Are there any metrics you can help us to think about how great that benefit could be? For example, the number of cars that you've been towing and processing, how's that been trending? Would you expect this to potentially pressure 1Q earnings at IAA if the weather remains bad, benefiting you in 2Q? Or, should most of the vehicles that you took in, in January and the first part of February potentially be auctioned off by March end?

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

I would say, Ryan, that we would, as this inventory is building now, this is inventory that would actually get sold primarily in the second quarter.

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**Ryan Brinkman** - *JPMorgan - Analyst*

Okay. Very helpful. Thanks, guys.

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

Ryan, I will tell you we gave you a inventory number in the supplement that we sent out, inventory year-over-year at December 31 was up, excluding Sandy from the prior year, 10%. I think that's been a pretty good leading indicator of how that business has done over the last three quarters of last year when we were giving that same number, and it was quite strong as well.

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**Ryan Brinkman** - *JPMorgan - Analyst*

Right. Presumably it would increase even more ex Sandy in January and February, I would imagine, right?

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

We clearly know there's been a lot of cars that have been off to the side of the road getting picked up by tow trucks. We will benefit from that activity without a doubt. We're not going to quantify it right now, but yes. It's been a very difficult winter, which makes for strong supply of total-loss vehicles, typically.

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**Ryan Brinkman** - *JPMorgan - Analyst*

Great. Good to hear. Thanks, again.

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**Operator**

We'll now take a question from Bank of America. If you could please announce your name?

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**John Lovallo** - *BofA Merrill Lynch - Analyst*

It's John Lovallo from Bank of America. First question would be, looking at some the public dealers Lithia, AutoNation, and Sonic. They appear to be making a pretty concerted effort to push more into used vehicles. This dovetails off of Matt's earlier question. Do you think that this is more of a public dealer phenomenon, or are you seeing this on the private side as well? Along with that, do you have any feel for what you think these dealers might view as the appropriate mix between new and used vehicles?

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

John, that really comes down to the individual group or the individual dealers as to how they look at their mix of business and what their selling mix and history has been. I think it's a little bit different with everyone, but generally speaking I can say that over the last several years the franchised dealers became much better used car merchandisers because they had to. Again, I can't quantify it, but I would say that there is a continued focus on selling more used cars.

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**John Lovallo** - *BofA Merrill Lynch - Analyst*

Okay. That's helpful. Looking at your view that more vehicles are going to move down the funnel, if you will, if you look at lease residual values, would you say that they're now close enough to wholesale values where there is really no opportunity for consumers or dealers to buy the vehicle in the money, if you will?

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

Yes, I would say that we have short memories when it comes to residual values. I would say that the residual values are creeping back up, getting more aggressive just from a market share standpoint, being more competitive. As those values creep, that will be another indicator of these cars possibly getting to open and beyond to physical sales.

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**John Lovallo** - *BofA Merrill Lynch - Analyst*

Very helpful. If I could finish with just one question with Eric, just kind of a modeling question here. If I remember correctly, I think the first-quarter conversion rate at ADESA was 61.3%. The second quarter was 57.1%. Third quarter 56.6%, and I believe the full year we're saying 56.8%. Would that imply that the fourth quarter conversion rate was somewhere in the low 50% range?

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

I don't know what your numbers imply, but I'm showing a little bit different numbers for you. No, we weren't that low in the fourth quarter. It's been pretty consistent through the year in that just above the mid 50%s. That's because of the mix of dealer cars, John. In that number we are excluding the online-only sales. If you go back three or four years when it was much higher, our online-only sales were in there at 100% conversion. We talked about it back in 2011.

Now, we are separating that, and so it's down a little bit. The conversion rate will historically be higher in the first quarter because of the nature of the cars and it's the tax season and there's a lot of buying activity. I think it's been fairly steady through the last three quarters and remains in that upper 50%s. Again, the first quarter typically will have a little bit higher conversion rate. I would, perhaps, expect the same thing this year as well.

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**John Lovallo** - *BofA Merrill Lynch - Analyst*

Okay. Very helpful, guys. Thank you.

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**Operator**

John Lawrence, Stephens.

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**John Lawrence** - *Stephens Inc. - Analyst*

Just a follow up on a previous question. Can you talk a little bit about when you say that you want to open up, from the private sales to the open, and that's what you are going to attack in 2014. What is really the tactical things that need to be done? Is some of that technology? Can you walk us through those strategic tactics that need to be done in 2014 to enhance the business?

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

Yes. Thank you for your question. I think the biggest thing is getting out to these dealers one on one, and getting them, number one, familiar with the platform, marketing the platform. In some cases sitting down and demonstrating to them how to use the technology. I can tell you that we have put compensation programs in place for our general managers and many of our commercial managers at the physical auction sites to focus on online buyers.

It's just an overall marketing program, much like what we did with dealer consignment back four or five years ago. As you remember, our dealer consignment had reached a low of 25% and we got busy with that when we knew the off-lease cars we're going away. We took that percentage up to 50% just through focus. It's the same thing with the online buyers. We have, now, brought our online and our physical buyers all under the leadership of one of our vice presidents, who leads up all of our dealer activity.

Going forward, he's got a network of somewhere in the neighborhood of 250 to 300 actual, what we call, dealer consignment people on the road that work out of the physical auctions where they are out calling on dealers and going through much of the things that I've talked about here. Again, it's just one dealer, one day at a time, bringing them to the platform and then helping them understand it. Then, in sending our people to -- really see the online buyer, really is no different than the physical buyer. Just seeing them all as buyers.

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

John, I would like to add, we integrated the OPENLANE site with the ADESA site and now it's ADESA.com powered by OPENLANE technology. In doing that, the ADESA customer might have been more comfortable buying on LiveBlock, and he now needs to be educated. Hey, you can go on to the open environment of these other sites, that they are not accustomed to going to. Part of it was integrating the sites, right, Jim?

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

Right.

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

And getting the customers used to the access to all of that inventory as opposed to waiting till it got to physical auction. That open environment is before it gets to physical auction but after it's done with the closed private label sale. Right, Jim?

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

Yes. If you would ask me what the utopian situation is? I would say it would be to do a personal visit with all 57,000 dealers in the country. You would visit every single franchised dealer and you'd visit every independent dealer and give them a personal presentation on our platform and all that goes with it.

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**John Lawrence** - *Stephens Inc. - Analyst*

Right. To follow that, just a quick dive into what technology you're going to employ new in 2014?

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

That's complicated question because basically you want to enhance mobile, you really want to get more access to the PDAs in the mobile phones and the devices, so it's a new technology. It's a new way to address or get into our technology. That would be one. You're constantly dealing with network speeds and storage and things like that, again, to make everything quicker, to make it a more efficient transaction. Those would be examples that I would give you. Again, just enhancing the various platforms that we have. Is that a fair way to say it, Jim?

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

I think a lot of it is enhancement and definitely big movement towards mobile. I think someone told me the other day that there's going to be 1 billion of these phones shipped this year and more and more people are going to be doing business from a mobile device. We have been working on mobile. As you know, we've absolutely clearly a leader at Insurance Auto Auctions. We are now incorporating more and more mobile into things that are happening at ADESA. I think it's overall just making it easier, being where the customers want us to be and letting them buy the vehicles the way they want to see them and the way they want to buy them.

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

John, I just thought of something from my comments. I mentioned condition reporting. Jim, you might talk about the importance of condition reporting as the buyers become more comfortable with online buying.

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

The most critical thing in buying a car online is the condition report. That is what really creates the confidence in the buyer is being able to get a clearly understandable, easily read condition report. As an industry, we are about to introduce an auto grade that we call, where we actually have a standard grading system for vehicles within the industry. This is not just an ADESA initiative, this is an industry initiative. As we introduce this grading system, then there will be a push to get a more standardized condition report.

Today, we might be writing 35 condition reports differently for 35 different customers and eventually this industry has to get down with a more standardized condition report that people don't really have to stop and figure out who the seller is and what the condition report differences are. It just makes it more standardized and easier for buyers. It's an ever evolving process, but this auto grade is going to be a great start for us.

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**John Lawrence** - *Stephens Inc. - Analyst*

Great. Thanks for taking the question. Good luck.

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**Operator**

Bill Armstrong, CL King and Associates.

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**Bill Armstrong** - *CL King & Associates - Analyst*

You mentioned earlier in your opening comments that repossession volume is now increasing. I was wondering if you could expand upon that a little bit? How big a piece of the pie is that for you? What percentage increases are you seeing at this point?

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

I would just say that I don't think we get into that level of detail.

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

Let me give you some industry stats. At the peak, which was what? Probably back in 2010, the repos in the industry were about 1.9 million units sold out of about 9.4 million, as I recall. That number has dropped down to more like 1.1 million to 1.2 million. What we're saying is, we are going to probably see that number grow again. Jim, that's I think the numbers. Those are industry numbers, Bill.

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**Bill Armstrong** - *CL King & Associates - Analyst*

Okay. So at the peak was 1.9 million out of how many?

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

Out of 9.4 million sold by the industry in, roughly --

**Bill Armstrong** - *CL King & Associates - Analyst*

Okay. Yes, that's helpful. We're starting to see that coming back in.

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

I think it was 1.9 million out of 9.1 million. I just looked up the numbers.

**Bill Armstrong** - *CL King & Associates - Analyst*

Okay. On the salvage side of revenue per vehicle, I think it started to moderate. Is that actually -- are we in negative territory in terms of the year-over-year comparisons when you exclude Sandy, or are we just looking low single-digit increases?

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

Low single-digit increases. Again, I gave you the annual numbers that you'll see in the supplement that will be in K tonight. The good news is revenue was up by more than the volume year-over-year in the quarter and Sandy was not a big impact on the fourth quarter when you break those numbers out. So, we did see some improvement in revenue per vehicle in the last several months of the year. Again, the way we achieve that, Bill, as you know, is through buy fees. The seller fees are pretty much static.

**Bill Armstrong** - *CL King & Associates - Analyst*

Right. How about the overall selling prices of these vehicles at the auctions? I imagine that must be starting to come down a little bit?

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

It is slightly moderating. I would say that we look at it maybe 2%, maybe a little bit less, but it's moderate.

**Bill Armstrong** - *CL King & Associates - Analyst*

Got it. Okay, thank you very much.

**Operator**

Colin Daddino, Gabelli & Company.

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

A few questions. First one, talking about ADESA, I wanted to hear your thoughts on what the supply channels look like, maybe five years from now? We understand the leasing coming back, but maybe specifically the dealer and then the rental companies?

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

Our vision, we've limited to three years, Colin, just to keep that in perspective because we kind of look at the SAAR, the average three-year lease, as a key driver of factual information, so maybe we will limit our visibility to three years. If that's okay?

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

Works for me.

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

As you look at three years, again, it's commercial is growing. Historically, you might see that caused dealers to look for alternatives to retail their car wholesale differently. Again, I will go back to where we were through the 2004 through 2009, about half the industry was dealer and half the industry was commercial. Jim, would you consider that a fair kind of balance?

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

Right.

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

Within that, we're going to see these off-lease cars continue to drive because leasing seems to be the sales tool du jour of the cap-to-finance companies and the OEMs.

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

If you think about three years, I think, well I mentioned in my commentary that 2016 gets the industry to at least 9.7 million units. All those segments are going to contribute somewhat, but again I would repeat what Eric said. The major driver will be these off-lease cars and if you look at leasing penetration now as a percentage of new car sales, it's at record highs. We mentioned during many calls that we expect that leasing will even get to a higher level of penetration as we start to move towards 2015 and 2016. I think the bulk of the cars are going to come to that, but as you think about repos, just with the credit standards, the more credit your write, obviously, the more repos you're going to have. Just the fact of simple math.

Then, you mentioned rental cars. Rental cars has always been rather a small segment for us. I would not expect it to get dramatically different, but either way I wouldn't expect it to go much lower or necessarily much higher. I think it will remain pretty much stable. We're hopeful with the increase in supply that we can maintain our dealer consignment levels. Quite frankly, the dealer consignment was a pleasant result in 2013, and we're hopeful that we can maintain those levels.

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

Great. Sounds good. My other question relates to if there's any changing land needs? If you're focusing on the online and the upstream open buying lanes, does this change how you think about the amount of land you might need at a physical auction or is it still needed for ancillary service items?

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

Yes. That's a question that we get challenged with often, even internally. I think we are -- absolutely, I believe that there is still a place for brick-and-mortar here. I don't believe brick-and-mortar is going away, but I believe that as we look forward and as we assess brick-and-mortar we may determine that we may need less of it. We're definitely going to need to pick these cars up. We're going to need to marshall these cars up. In many cases, we're going to need to provide reconditioning and the mechanical and the other services that go along with it that we provide through our ancillary services. We're going to need brick-and-mortar. To your point, where we may have gone out to a market and looked at maybe, as an example, looked at 100-acre site, while maybe that site becomes something more like 50 acres, just by way of example.

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

Okay. For land you might already have, is there -- what kind of flexibility do have there to either do other things with it or sell it? I think it's mostly leased, or break the leases, that kind of stuff?

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

We own 38 of the ADESA properties, which is a good place to be. Here is the really good news. Land is always in demand in one of our businesses. We've had a number of situations recently where if we are not using the full complement of ADESA property, Insurance Auto Auctions is constantly looking for temporary locations as store, especially with the weather we've been happening. When we have idle land, Colin, we sell it. Our goal is to get rid of it and not worry. We are not land speculators, so get rid of it, turn it into cash. We don't sit on a lot of excess land. To the extent that we might have capacity available, we -- Jim, you might talk about -- specialty sales is a good use of land, right?

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

Yes. One of the things that we recently announced is we recently announced that Tom Caruso has become our Chief Client Officer at the KAR level. What Tom's focus is really going to be is taking a look at all of our businesses and how we can better utilize and work together. I know one of the assessments that we have been doing is we are assessing the opportunity to bring more salvage sales into some of our existing Whole Car sales.

Now, that's not always that easy because there are different permitting and different licenses and requirements, but one of the things we're looking at is how do we better utilize some of these facilities. There's a salvage opportunity, but then there's also the specialty sales. As you've heard me talk about in the past, we're looking at other opportunities, whether it be in heavy duty equipment, or whether it be in boats and RVs and motorcycles and water craft and those types of things. We're creating some specialty sales in selective spots around the country. Again, I think Eric said it. Maximize it, and don't sit on it if it's not producing any results.

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

Okay. Great. Helpful. That's all for me. Thanks, guys.

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**Operator**

(Operator Instructions )

Now, we're going to go ahead and take a question from CJS Securities. If you could please announce your name?

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**Bob Labick** - *CJS Securities - Analyst*

It's Bob Labick from CJS Securities. Thank you for the very helpful color on the online only. I wanted to go back there for a second. I think you said, basically, now roughly 20% of your volume was on the online only. Could you give us a sense how much of that is closed versus open? Then, with the push towards the open, two, three years from now, where do you see A, online only and 20%, is it greater or smaller? Then, the mix between open and closed?

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

Bob, I'll start with that. The online only, it's really -- the recovery in the off-lease vehicles, we knew would start in the private label online only because they were starving for that inventory. We've gone through several years with a lack of supply of one- to three-year old used cars because of what happened in 2008, 2009 and the SAAR dropping and there's a lack in supply. Naturally, we expected there would be a heavy conversion in the private label environment and that's occurring. Jim, you might go on with that. As more cars come, there aren't more franchised dealers -- to be in a private label closed sale, you have to be a franchised dealer of the nameplate that the car is being sold. We will look at that.

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

Just the breakdown, though, if I got your question right. Last year we sold 34% of our vehicles, I think it was, online. It is right now 34%, 35% range. I think it's important to understand of that 34%, 35%, half of those were sold in an online closed venue or online open venue. The other half was actually sold at a physical auction where it was actually sold to a physical buyer or a buyer bidding online in the physical sale. So, there's a 50/50 slip there, I think was the question -- or the point you were getting to, I think

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**Bob Labick** - *CJS Securities - Analyst*

Right. I was thinking of the 410,000 number that you gave us for the online-line only closed and opened, trying to get a sense of is that 80% closed, 20% open? Then also, of that 410,000, that's 20% of your overall volume. Does that come 25%? It sounds like you're saying it's probably close to maxed out at 20%? That's what I'm trying to get a sense of.

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

That's a good point. It's a heavier concentration on closed than it was going back to the 2009 and prior period, when we looked at OPENLANE and some the numbers we've talked about before. We don't give that breakout at this time. I don't want to give new numbers right now and have to file an 8-K, but I will tell you it is heavier than it was historically. As I mentioned, it is, substantial majority is in the closed right now more than perhaps patterns prior to the significant decline in the off-lease vehicles, Bob. As we see that, we do think, and Jim mentioned this, we do think more will end up in the online only open, getting it out of the closed, changing the economics. More of those will even get through that part of the channel to the physical auctions. Overtime, we do think it diminishes.

I did some quick math, and you are correct. It's just under 20% of our volume. You can calculate those numbers with what we gave you, was in the online only, but not all of that is closed. We will disclose 35%. So, we are little bit more than half in 2013. It has been about half in 2012, and now we are little bit more than half is in the online only compared to that 35% that was sold to online buyers.

Again, Bob, I can't predict where it's going to go, but we do think that the close -- and that's why we began giving you this additional disclosure of what's the revenue per unit in online only. What's going to take that number from a decline to an increase will be more moving into the open environment. I think it will allow investors to track that.

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**Bob Labick** - *CJS Securities - Analyst*

Great. Those are very helpful numbers. Then just one more on ADESA, obviously volumes have been very strong. The gross margin sequentially appeared to be down a little bit versus Q3 on basically flat sales sequentially. Just curious, the driver of the change there? Where you expect gross margin -- you mentioned gross margins for IAA should be up next year. Where do you see them for ADESA next year?

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

Good question. Again, the gross profit, I don't consider the sequential move to be that significant. There's a little seasonality that gets into the labor utilization and the throughput in the auction in the fourth quarter. Then you get some mix issues that would influence it. I really continue to believe, over the long term, we have the opportunity to improve our margins in both of our businesses, ADESA, IAA, probably AFC is a more static margin business.

I look at the opportunity to improve it. You'd improve it at the gross profit line just by having more volume that increases the efficiency at the auction, so that's where you get that. The mix has worked in our favor a little bit. When we are little heavier online only and it's private label closed, and while it's lower revenue per vehicle, it does enhance the gross profit percentage for us. I would just tell you, Bob, I think we will be on the path for some steady improvement as the volumes increase. Again, to quantify it is hard to do.

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**Bob Labick** - *CJS Securities - Analyst*

That's great. Thank you very much.

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**Operator**

At this time that does conclude our question-and-answer session for today. I would like to turn the call back over to Mr. Jim Hallett for any additional or closing remarks. Please go ahead, sir.

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

Thank you, Jennifer. I will just wind up by saying thank you to everybody that's on the call this morning. We appreciate your time. We appreciate your interest in our Company. As a Management team, I can tell you that we feel very confident in the position of all of our businesses. More importantly, we feel confident and look forward to delivering the results that we've outlined here for you today. With that said, we will say thank you. We will look forward to following up with you all and talk to you in 90 days from now. Have a great day. Thanks.

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**Operator**

Thank you. That does conclude our call for today. We do thank you all for your participation.

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