Corrected Transcript

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KAR Auction Services, Inc. (KAR)

Q2 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Please stand by. We're about to begin. Good day, and welcome to the KAR Auction Services Incorporated Q2 2014 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Jonathan Peisner. Please go ahead, sir.

Jonathan L. Peisner
Treasurer, VP & Head-Investor Relations, KAR Auction Services, Inc.

Thanks, Lauren. Good morning, and thank you for joining us today for the KAR Auction Services second quarter 2014 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended June 30, 2014. After concluding our commentary, we will take questions from participants.

Before Jim kicks off our discussion, I would like to remind you that this conference call contains forward-looking statements within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties that may affect KAR's business prospects and results of operations and such risks are fully detailed in our SEC filings. In providing forward-looking statements, the company expressly disclaims any obligation to update these statements. Lastly, let me mention that throughout this conference call, we will be referencing both GAAP and non-GAAP financial measures. Reconciliations of the non-GAAP financial measures to the applicable GAAP financial measures can be found in the press release that we issued yesterday, which is also available in the Investor Relations section of our website.

Now, I'd like to turn this conference call over to KAR Auction Services' CEO, Jim Hallett. Jim?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

Great. Thank you, Jon, and good morning, ladies and gentlemen, and welcome to our call. Let me start with some overall comments on KAR's second quarter performance. We had adjusted EBITDA of $154 million which was a 10% increase, adjusted earnings per share of $0.42 which was a 24% increase, and adjusted EBITDA margin of 26.3%, up from 25.9% the prior year. Consolidated revenue grew 8% to $586 million. The mix of vehicles at ADESA caused slightly lower revenues and we expect it. However, Insurance Auto Auctions and AFC both had strong growth. For the first six months of 2014, I feel the things were very much in line with our expectations.

Our free cash flow generation continues to stand out for KAR. Our board has approved the $0.25 per share dividend payable on October 2 and KAR generated $231 million in cash from operations in the first six months which was an $8 million increase over the prior year. We recognize that we must continually find opportunities to deploy capital for growth beyond the return provided by our dividend, which currently provides the yield in excess of 3%. And yesterday, we announced that we invested $30 million in the Canadian technology company called TradeRev. We acquired a 50% interest in the company and a significant portion of this investment will remain in the business to supply working capital as we continue to support the rollout of the business model in the new geographic markets in Canada and United States.

I believe that the combination of TradeRev and ADESA will create opportunities to expand our buyer base throughout the entire organization. TradeRev creates private, customized network of buyers and sellers to move fresh trades. TradeRev is a solution that addresses the $20 million to $22 million dealer-to-dealer transactions that don't currently come to a physical auction. We estimate that as many as half of these vehicles are sold on a dealer-to-dealer basis and what TradeRev will do, is TradeRev will stand in the middle of these transactions much like we do in our online and physical auctions.

And just a little further color on TradeRev is I would tell you the franchise dealers are very, very good at appraising their own brands. But when it comes to appraising our brands, they have to rely normally on some of the guide books, auction data; in many cases, they're still phoning wholesalers to get a bid on these vehicles. With TradeRev, it's quite simple. You're going to go out. You're going to scan the serial number or the VIN I should say, take a couple of pictures of the car, then you're going to push that information out to buyers and immediately start an auction process.

Couple things are going to happen. Dealers are going to have the ability to close more sales because they're going to have stronger appraisals on these cars. And they're also going to reduce the risk of loss at the time when comes to selling those trade-ins. And I can tell you that, as a former franchise dealer, I would absolutely love to have a tool like this. When I think about my time and the efficiency that I spent calling wholesalers and trying to get bids and trying to get appraisal on cars, and then when I think about the lost opportunities, the number of deals that I wasn't able to close, because I wasn't able to get a, what I would call, accurate appraisal on the car, certainly it prevented me from getting some deals done. So, with TradeRev, I think this is a good example of the type of strategic growth that we are pursuing.

We do have other deals in the pipeline in our other businesses as well, nothing that we're in a position to discuss today, but as I turn to the business units, and I look at Insurance Auto Auctions, I would say that Insurance Auto Auctions is hitting on all cylinders. Revenue is up 10%. Adjusted EBITDA, up 13% and our adjusted EBITDA margin is up to 28.5%. And inventory levels at June 30 were up over 10% compared to the prior year. We continue to invest in both technology and our physical footprint at Insurance Auto Auctions and I believe that we're very well positioned as we continue to move forward.

AFC had a good quarter as well. Revenue was up 13%, adjusted EBITDA increased 8%, and we believe that we continue to have the premier offerings for our independent used car dealers. As you know, floorplan lending is our primary source of revenue at AFC. However, we do provide other offerings that enhance th e back-office operation of the independent used car dealers. In fact, we're seeing some success with Preferred Warranties that we'd now began to roll it to other markets in the United States.

Turning to ADESA, ADESA revenue grew 6%, as well the volumes grew 6%. And I would tell you that I'm very pleased with this level of growth. We've spent a lot of time talking about off-lease cars over the past several months, and we expected more off-lease cars to get through the top of the funnel to the physical auction. I can tell you that we have not seen this happen yet. A large number of off-lease cars listed on our private label sites are selling to the franchise dealers, and that's not necessarily a bad thing for ADESA. However, I would tell you that it is creating a headwind on revenue growth but we're growing our adjusted EBITDA at a greater rate than our revenue.

When we look at the lease terminations that are coming, leases terminating in 2015 will be 700,000 greater than in 2014, and leases terminating in 2016 will be 500,000 greater than that in 2015. So, the volume of cars that are returning to the market, I believe, it will be difficult for the franchise dealers to continue to absorb all this volume, but I can tell you I'm absolutely [ph] not (07:34) predicting when that's going to happen.

I think also we're seeing the market values are declining below the residual values as the lease market gets more and more competitive, and these OEMs fight for market share. And I would say that this trend on declining residual values is expected to – market value is expected to continue. So when you think about the volume that coming at us in the used car values, I think these should prove to be a positive for ADESA and we will keep you informed of the mix of online versus physical of these off-lease vehicles going forward.

With that said, we have seen a very nice growth in the dealer consignment area. With the franchise dealers buying all of these off-lease cars, our dealer consignment at the physical auctions is up 4% year-over-year. And again, we continue to see a strong start in the U.S. It's expected that, again, will be over 16 million in 2014. I believe the most current estimate is 16.4 million. Recent articles have indicated that 2015 new car sales will be at 16. 8 million and some expect that that number will continue to grow in 2016 and beyond. So, when you think about new car sales, the retail financing of vehicles and lease originations, there are all positive events for all of our businesses especially those at ADESA.

At ADESA, we continue to focus on profitability. We are matching our cost to the sources of revenue in both the online and the physical. We've increased our adjusted EBITDA margin for ADESA to 25% from 24.5% last year. And the ADESA leadership team is focused on keeping costs in line with our volumes especially at the physical auctions. The mix of online and physical vehicle sold should not impact our ability to continue growing the top line and the bottom line performance. In terms of our guidance for 2014, there are no changes. We expected adjusted EBITDA of $580 million to $600 million and free cash flow between $309 million to $319 million of which Eric will provide more details on his comments in a few moments.

So in conclusion, I would tell you that I think KAR is in a great position in all three of our business segments. And I believe it's the combination of our businesses that give us confidence that we can continue to improve our earnings and continue to grow our free cash flow.

So, with that I'm going to turn it over to Eric, and then we'll be back for some Q&A. Thank you.

Eric M. Loughmiller

Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

Thank you, Jim. I would like to add just a few comments to Jim's overview today. Jim gave a nice overview of the second quarter performance of the business units. I would like to address one topic for ADESA.

Our revenue per vehicle sold at ADESA for the second quarter was $543 consistent with the prior year. We had an increase in revenue per vehicles sold at physical auction to $680 compared to $652 for the prior year. This is a positive trend given the mix of vehicles remains more heavily weighted to dealer consignment vehicles than commercial vehicles. The revenue per vehicle sold in our online-only venues declined in the second quarter to $99. This is down sequentially from the first quarter 2014 revenue per vehicle of $114. The volumes sold in the online-only offerings at ADESA totaled 132,000 in the second quarter similar to the 128,000 vehicles sold in the first quarter. What drove the average revenue per vehicle sold was an unusually high number of grounding dealer sales processed through the private label closed sites for two original equipment manufacturers. These transactions have the lowest fees of any of the online-only transactions.

I would also like to supplement the discussion of our investment in TradeRev. We do not expect to consolidate the results of TradeRev in the KAR financial statements. TradeRev will be accounted for under the equity method of accounting until such time that KAR's ownership, voting rights or board representation meets the definition of control in the accounting literature. We did utilize available cash to fund this investment in TradeRev.

Let me also speak a little more detail about one aspect of AFC's performance. As disclosed in our financial information for the second quarter, AFC experienced an increase in the provision for credit losses. This is not representative of a decline in credit quality. In fact, we continue to have over 99% of the portfolio current.

For the first six months of 2014, KAR has generated $1.169 billion in revenue, an increase of 6% over the prior year. Our gross profit as a percent of sales increased to 44.7% for this period from 42.6% in the prior year. We have also improved our adjusted EBITDA margin for the first six months to 25.8% from 25.2% in the prior year. Our improved performance results in adjusted net income per share of $0.83 for the first six months of 2014, an increase of 28% over the prior year. All in all, a very solid financial performance for KAR.

As Jim mentioned and you saw last night in our earnings release, we have no changes to our previously issued guidance. We expect adjusted EBITDA of $580 million to $600 million for 2014. We anticipate $105 million in capital expenditures with $47.3 million already expended in the first six months. Cash taxes are expected to be $105 million to $115 million. Cash interest on corporate debt is expected to be $61 million.

Because I am often asked why cash interest paid on our statement of cash flows differs from this number, I would like to review this using our June 30 financial statements. Through the first six months of 2014, our cash paid for interest disclosed in our financial statements is $38.5 million. This includes $6.8 million of AFC interest expense related to the securitized receivables which we do not consider interest on corporate debt and subtract from EBITDA to determine adjusted EBITDA. So through the first six months, the interest paid on our corporate debt was $31.7 million. This is the $38.5 million less the $6.8 million. So, I think that gives a summary for you to understand that. The net of all these items I've just discussed is the free cash flow of $309 million to $319 million expected in 2014. This represents $2.17 to $2.24 per share.

So, I thank you for joining us today. And I will now turn the call back to Lauren, our operator, for the questions. Thank you, everybody.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question comes from John Lovallo with Bank of America Merrill Lynch.

John D. Lovallo
Analyst, Bank of America Merrill Lynch

Q

Hey, guys. Thanks for taking the call.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Good morning, John.

John D. Lovallo
Analyst, Bank of America Merrill Lynch

Q

Good morning.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Hi, John.

John D. Lovallo
Analyst, Bank of America Merrill Lynch

Q

The first question is, have you seen any uptick in repo volume and if so, I mean, what are the factors you would attribute that to? I mean, is it a loosening in credit terms or there are other things going on?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. I would say, John, that we've seen a slight uptick in – in repos, excuse me, and I would attribute it to just losing your credit standards. I think as you know the credit markets are back and more availability and more competitive, and we're seeing that repo segment grows somewhat, although modest at this point in time.

John D. Lovallo
Analyst, Bank of America Merrill Lynch

Q

Okay. That's helpful. And then, if we think about the kind of capacity utilization at physical auction sites particularly, the reconditioning shops and paint body shops, etcetera. What is your ability to, kind of, flex labor and potentially mothball some of these operations if necessary?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. There is capacity, there's no question about that, and we – our labor is variable. And we've often spoke in the past about our price initiative where we're very focused on matching our labor with our volumes at the physical auction. So, it's like this based on how inventory ebbs and flows. So, as I mentioned in my comments at

ADESA, that's one of the areas that ADESA is very focused on as we see more vehicle selling online. We're focused on how we match that labor up at the physical auction as well.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And John, let me add to that. In some cases, we've outsourced some of those labor functions, because of the volatility in volumes. And in other cases, we pay on piece parts. So, the more productive they are, the more they get paid, which motivates the people to do that job fast; again, always matching up to the volume running through the shops.

John D. Lovallo
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks very much, guys.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Operator: Our next question comes from Ryan Brinkman with JPMorgan.

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Congrats on the quarter. Thanks for taking my question.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Good morning, Ryan.

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Good morning. I'd like to ask several on IAA. First of all, looked like the volume growth accelerated again in the second quarter [ph] at 59% (17:27), can you kind of just remind us of what the residual [indiscernible] (17:31) volumes were a year ago? Not too much, I don't think. And then also, can you kind of help us, I know you don't want to talk about market share and whatnot, but I had thought that you're going to like cycle past some of the step change in share. And so maybe you wouldn't have been posting the stronger results, can you just kind of help us understand what's driving the results and impacting the [ph] care ability (17:51)?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

So, I want to make sure I repeat the question that we got it right. The first is what type of [indiscernible] (17:58) volume would have been in the second quarter last year? Before I turn it to Jim, I'll answer that one. It was just a few thousand vehicles were left in the second quarter. We have sold substantially all of them in the fourth quarter and first quarter of 2013. And your second question is you thought we'd be lacking kind of some of the market share gains we had a year ago, and you'd like to know more information on the strong volume growth, how are we accomplishing that against tough comparables. Did I get that right?

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Yes, exactly. Thank you.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. Sorry, Ryan, we're having a little bit of a difficulty hearing you on that, but thank you for repeating. As I think is well documented, there's no question much of it can be attributed to the weather. We had a very, very difficult winter in terms of ice and snow and sleet. Some would say that continue to be difficult spring as well where we had lot of rain, a lot of flooding, tornadoes, storms, things of that nature. And some would say that continue right in to the summer as well. So, much of it is attributed to the weather. And then maybe you already did mention, we did pick up some nice market share gains last year, and we're seeing the full effect of those new gains kick in here in the first six months of this year as well.

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Okay. And then just last question and a bit of a follow-up on IAA, looks like the inventories were quite high. So, I mean strong volume and strong inventory that – you want that, that's good. Is there anything you can say about is this still related to – I mean that would suggest that there are incremental share gains or does it relate to you haven't sold off all of the harsh winter month inventory, whether some of it relate to – one of your competitors been calling out an increase in cycle time? Is that part of the situation, too?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Ryan, I think you just answered the question. That is the case. And we do have one large customer that has changed their processes or they're in the process of changing their processes. That was a double. And what it has caused, it has caused a delay in selling those volumes. And so, those volumes are backed up for that one particular customer that will flow through the third and fourth quarter. Hopefully, we'll see that start to pick up. And then I would just say that there's been a portion of those vehicles that are as a result of the hail and the flood vehicles as well.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And Ryan, it's been a pretty weather-oriented second quarter. So, some of that inventory is just – we probably have had more damage than most people contribute because we haven't had hurricanes. Right, Jim?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Right.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

But there's been other weather events.

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Great. And final, final question, now you're out of the business of predicting the cadence, right, of when the vehicle fall further down into the funnel when the franchise dealers are [indiscernible] (21:17). Is there anything you can say and you talked to the reference for KAR in the online-only side, is there anything you can say about your conversations with OEMs to allow it to suggest that they consider marketing more aggressively in the online-only, opening that up to not just franchise dealers after a shorter period of time. Is there any shift there because obviously the economics are so much better in online-only...?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Ryan, I think you've been sitting in some of our management meetings. That's exactly – number one, I think the – many of the OEMs are surprised a lot by the take rate in the closed environment. But one of the things that we're working on is we're working on that open sale environment through analytics, through working with Tom Kontos, our economist and our management team.

We're working to try and demonstrate to many of the OEMs that the pricing that they're leaving at the open sale or they're asking at the open sale is more than the receiving when the car eventually gets to an auction. So through the use of analytics, we're able to go back and maybe suggest to the OEMs that if we get priced these cars lower closer to what the actual value is that they're receiving, then we can sell more of those cars in the open online sale which as you know get much better economics for us.

Ryan J. Brinkman
Analyst, JPMorgan Securities LLC

Q

Great. Thanks for all the color.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Operator: Our next question comes from Bret Jordan with BB&T Capital Markets.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

Hi. Good morning.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Good morning, Bret.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

A quick question on TradeRev and I guess given that there are the 22 million units that are going dealer-to-dealer, would that number grow? Would this sort of drive more product online as you make it easier for these dealers to sell to each other through your system as opposed to putting it to physical auction, or are there just reasons that you can gain share of that 22 million but the number will not sort of eat into your sort of physical?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

Bret, there could be some cannibalization if you think about it. Some of these cars could get sold through TradeRev and may not get to a physical auction. There's two things that I would point out and I think, again, you've answered it, it's a very large market and if we could get a slice of that very large market, it would more than offset what we would give up in cannibalization. And then the second point I would make, although some of these cars may get transacted on TradeRev initially, if they're going to a wholesaler then they could eventually end up at physical auctions as well, which would be a win-win.

Bret D. Jordan
Analyst, BB&T Capital Markets
Q

Okay. And then on average revenue in the quarter, you closed your own vehicle business early in the year, right? So you should have seen a headwind in revenues, because you weren't selling as many equity vehicles this quarter. So, I guess on those vehicles, was your ARPU actually better than it looked in the quarter because you had the non-comparable against those equity vehicles?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.
A

Bret, the ARPU is what it is. You are correct that we deemphasize but we still – there was inventory when we close down that car buying business at the end of February. There was still inventory to be sold. It's not something I called out, because it was not a major variation. Perhaps in the future quarter, it could be a little more significant. It was never a big part of our business that it was bit of a headwind in the comp, so yes, one might argue that $26 or $28 improvement that we had would look a little better if you hadn't had the gross up with the cars, but I don't think it would have been that significantly different.

Bret D. Jordan
Analyst, BB&T Capital Markets
Q

Okay, great. And one last question on the channel ARPU. The online that was at 99%, is that a temporary impact, you said two OEs had particularly high volume. Was there a plug of their product that came through for some reason that does not continue?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

I think it was just the case that we were handling more vehicles that were being sold to the grounding dealer. And as those vehicles were being sold to the grounding dealer, they were showing up as an online closed sale, which again came out and affected the ARPU being at $99.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.
A

And, Bret, I pointed out in my commentary; it wasn't like there was a big increase in volumes. So, this was something new, a very similar volume to the first quarter where that was – that's the case. I can't tell you what will happen in the future. And it was two particular brands. So, one would think there were something causing them to buy such a large number that they hadn't bought in the previous quarter. But I didn't – I can't really tell you whether it'll continue or not continue.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

Okay, great. Appreciate it. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Thank you.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Operator: Our next question comes from Matt Fassler with Goldman Sachs.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thanks a lot. Good morning.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Hey, good morning, Matt.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Hi, Matt.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Hi. How are you? First question, on the acquisition, if you look out to the long run and you think about how the economics of owning 50% of this business or perhaps more over time will ultimately enhance your P&L, I know there's a strategic value, it's an interesting element of the market, but can you map out for us sort of what the map to pay off this year? But, perhaps, in terms of time, and also how you think that might ultimately evolve?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, essentially, using the equity method, we'll get credit for half of their profitability in our P&L. And with our assistance in the roll out, we think we can accelerate the pace at which they attacked the various markets they're going to pursue as they spread that platform over a broader geography. How that'll play out, essentially, there's a lot of leverage in these technology platforms and we think it can be very successful on a relatively short period of time.

If at any point in time we choose to gain control as defined by accounting, whether that be through increased ownership or having a bigger impact on the governance of the organization, we would begin consolidating that and would have a bigger impact on our financial statements, Matt. But again, right now I would tell you, we think this is going to be successful. They are very small business today that has reached breakeven and slightly profitable and that's good news because they've done it in a limited number of markets. So, that gives us optimism that we can go at this thing hard and fast. Right, Jim?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Absolutely.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thanks for the color on profitability. And as a quick follow-up, to this part of my question, are there any contingencies in terms of options to buy more or puts or anything like that as part of your purchase agreement?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Yeah. We have some rights at the right time to perhaps increase our ownership. And we'll see how that plays out. And at any point in time, you can always buy the rest of it if they're willing to sell it at the right price, right? But being part of this it's really important to us in keeping the management team in place, the founders and their technology skills and their knowledge of the market. Jim might want to speak more of that.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. I think that was really critical in this acquisition. And these guys first got started in 2009, so, this is technology that they've been working on and developing and have learned a lot of lessons as they've developed it. And it was really critical for us to keep them in the deal. Keep the founder in the deal and he kept his entire management team in place. And I think that's what they bring to the table, and I think Eric said from the ADESA side is when you think about our locations and our people and our resources, we can really pour the gasoline on this thing and get it to the market and hurry.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

That's great. And then just a second question. So, your leverage has come down. You have a new [ph] brake (29:27) agreement that gives you more flexibility to return capital to shareholders. I know that this has been one of the questions on the table now for a couple of quarters ever since that you've obtained that flexibility. What's the board's thought process on either a buyback or a higher dividend?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. Matt, I would tell you that as we've said always, all options are on the table, but I can tell you right now we are very much focused on strategic initiatives in all of our businesses, much like what you've seen with TradeRev here. We do have targets and we do have opportunities in our other business segments, as well as others at ADESA, and we will continue to pursue those and keep you posted as we go forward.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Are those two mutually exclusive, the return of capital to shareholders and strategic acquisitions, or do you feel like you could perhaps meet your strategic goals while buying back from stock or something like that?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

No. I don't think they're exclusive of each other. I think that it will be a decision as to what path we go down and the deals that we pursue, and what the requirements are on each deal as we go forward. We're currently returning 45% of our free cash flow through our dividend. We think, the dividend is pretty healthy dividend at this point in time. But again, I would say that there's nothing off the table.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thank you.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome, Matt.

Operator: Our next question comes from John Lawrence with Stephens.

John R. Lawrence
Analyst, Stephens, Inc.

Q

Good morning, guys.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Good morning, John.

John R. Lawrence
Analyst, Stephens, Inc.

Q

Would you – to follow Matt's question on TradeRev, would you comment a little bit about it? If you looked at where in the sequence of margins does a TradeRev transaction take place? I would assume it's as high as anything you have on an online platform?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. I would say that we're looking at high margins, lower revenue. Lower revenue compared to physical auction.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Compared to physical auction.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

But certainly, I would say above what you would see in a closed online environment.

John R. Lawrence
Analyst, Stephens, Inc.
Q

Right. Secondly, if you look at the second half for the year, when you guys look at your guidance going forward, how much of a mix are you expecting to see for that guidance in this physical auction, more of those cars getting to the bottom of the funnel?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

Well, we talked about that a little bit earlier, and I said that I'm getting out of predicting. I would have thought – as I said on our last call, I would have thought that we would have seen more cars getting there at the end of the second quarter, and quite frankly, that didn't happen. But, again, as these volumes continue to come and increase – we talked about 700,000 and 500,000 over the next – that's 1.2 million over the next couple years. At some point in time, I would think that simple math tells you that eventually, they can't absorb all these cars and that they will eventually get to auctions at some point in time. But at what point in time that is, I've been wrong so far. So I'm going to reserve that comment.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.
A

And John, while we don't give guidance quarter-by-quarter, Jim did comment during his remarks we don't think the mix is going to impact our ability to grow the bottom-line performance of KAR. I mean, it's something that our cost structure is lined up properly. If it's more online or more physical, we can perform under either environment.

John R. Lawrence
Analyst, Stephens, Inc.
Q

Right. Thanks. And just the last point there, is it just as simple of a fact that as SAAR continues to grow, there's more trade-ins, and therefore the dealerships are not getting full of that inventory because they continue to get that trade?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

There's no question on that. There's more trade-ins, and I think, the dealers are in a position to be a little bit more selective. They can decide do they want to focus more on some of these off-lease cars, do they want to focus on keeping more trade-ins, and has their profile of the used car inventory that they focused on, has it shifted, whereas when inventory was really tight, dealers were stretching to keep more and more cars that might have been a little bit older, a little bit higher mileage. Now we would expect to see maybe more of those cars getting to the auction, and that's why we're seeing the 4% less that I talked about in the dealer transactions and why we're seeing a high-take rate in the closed environment on the private label sites.

John R. Lawrence
Analyst, Stephens, Inc.
Q

Great. Thanks. Good luck.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

You're welcome. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Thanks, John.

Operator: Our next question comes from Bob Labick with CJS Securities.

Robert J. Labick
Senior Managing Director of Research, CJS Securities, Inc.

Q

Good morning.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Good morning, Bob.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Good morning, Bob.

Robert J. Labick
Senior Managing Director of Research, CJS Securities, Inc.

Q

Hi. I wanted to ask about acquisitions and the tuck-ins, could you first maybe give us a little background on the TradeRev acquisition, was this an auction process, has this been a company you've looked at for a long time? How did it come about? And then just as a kind of corollary, could you give us your criteria for your tuck-ins? You've made a bunch of neat ones in the last year or so, it seems like the activity has sped us. Give us the criteria on how you look for them.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Well, I think, in terms of answering your question on TradeRev, this was a company that we identified that was operating in Canada. We thought it was a unique business model, and saw that it was focused on what I would call an addressable market that we currently weren't – didn't feel that we were getting a slice of. So it was just opportunistic that we got involved in conversations and we ended up acquiring 50% of the business. But it wasn't an auction process to answer your question. And it was really the strategic rationale of bringing this component of the business into the KAR family.

And then in terms of other acquisitions, I think, we're always looking at different businesses, how they fit both from a strategic standpoint, as well as how they might fit from a technology standpoint, and then perhaps the geographic standpoint, and we're evaluating these businesses. And as I say, they are one at a time, we prioritize them, they don't always go down as we think they're going to go down. But at the end of the day, there are a number of businesses that we continue to focus on that would tuck-in very nicely.

Robert J. Labick
Senior Managing Director of Research, CJS Securities, Inc.

Q

Great. Thanks very much.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

You're welcome.

Operator: Our next question comes from Gary Prestopino with Barrington Research.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.
Q

Hey. Good morning, everyone.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

Hey, Gary.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.
Q

Couple of questions here. Number one on TradeRev, can you tell us how big their network is of both franchise and independent dealers?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

Well, I'd just tell you that the market, right, I think, they're – if I am correct, I think, there's somewhere in the neighborhood of 17,000 or 18,000 franchise dealers here in United States. That's really what we're focused on, and as well as the franchise dealers in Canada. It really focuses on the franchise dealers, and the franchise dealers being able to get instant bids on their vehicles and instant liquidity on their wholesale units. So, we will be focused – as we roll this out in the various markets, we will be focused on getting the franchise dealer signed up to be on this platform, and that's the target audience, so some slice of that.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.
A

And, Gary, to-date, their focus has been in Canada, in the major markets in Canada. And to be honest, they're beginning to roll out into the United States, and we're really going to help support that and give them – as Jim put, pour some gasoline on that capability as they've begun to address the U.S. market.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.
Q

And the dealer just will strictly pay a fee if a car is sold, the seller will pay a fee or the buyer or both?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.
A

Yeah. Well, there is a – the business model, as it currently exists, there's a subscription fee for the buyer to receive the information and then there's a fee for the selling dealer based on a per-bid system.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.
Q

Fee for selling dealer. Okay. Great. And then shifting to Insurance Auto Auctions, can you give us a breakdown of what their percentage of cars sold are insurance versus non-insurance, and how that has shifted year-over-year?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

It's been pretty consistent. It's still pretty much in that 80%-20% range. We're seeing a few – we're seeing a little bit more in what we call the VRD category of non-insurance vehicles. So – but I would say that 80%-20% rule probably works.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And, Gary, if anything, the insurance has been so strong because of the weather. It's naturally going to be a little bit higher than the non. And you see that by the fact that we're not purchasing as many cars. We're not going to third parties because we're able to meet the demand in the marketplace with the vehicles coming through total losses and the VRD program.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thank you.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Welcome.

Operator: [Operator Instructions] We'll take our next question from Majid with Tourbillon Capital.

Majid Khan
Principal, Tourbillon Capital Partners LP

Q

Hi, guys. Congratulations, and good performance and good results.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Thank you.

Majid Khan
Principal, Tourbillon Capital Partners LP

Q

Most of my questions unfortunately have been asked, and the one really important one was really about the buyback and some capital allocation, but sounds like you guys have given your thoughts. I just want to echo, and I think probably not alone as a shareholder that given that you guys have created a lot of flexibility on the credit side and given the valuation of your stock, you guys can do the math as well as anybody, and given your bullish outlook on your company it's not inappropriate to have a buyback authorization whether you tap it or not. So I'm just wondering outside of the thought that you already gave, what might be the timing of you guys deciding whether – how you guys are going to go about allocating your capital, which you – between the debt capacity and free cash flow there is a significant amount to be allocated?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Majid, I said previously I think that I continue to say there's nothing off the table, and we continue to look at all options and when you think about timing, where – we monitor every aspect of capital allocation on a daily, weekly, monthly basis. And there's nothing that's out of consideration, and it's just taking these things one at a time, and doing what we think is best for the businesses.

Majid Khan
Principal, Tourbillon Capital Partners LP

Q

Enough. And is there any pushback from the new board, or is that just the board is too young to make these determinations at this point?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You know what, I don't think it's a question of the board, I think it's a question of management, and what management is really representing in terms of where we think we should be going with these businesses and their vision – our vision for the different businesses, and where we think we should be making investments to continue to grow the business.

Majid Khan
Principal, Tourbillon Capital Partners LP

Q

Fair enough. Well, you guys have done a great job so far. So, congratulations again.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Great. I appreciate it. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Thanks.

Operator: Our next question comes from Colin Daddino with Gabelli & Company.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Morning, Colin.

Operator: Colin, your line is open. We have a follow-up question from Gary Prestopino with Barrington Research.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Yeah. Just getting back to this whole issue of the dealers taking a lot of cars on a closed auction sales initially; do you have any stats on just what age, year, models, things like that, they've been taking in term of – what we're really looking for, are they – have they – do you think they've hit a peak in terms of the age of the cars that they're buying on these closed sales as you're getting more new sales coming into the market?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yes, Gary, you know, typically what you're looking at here is you're looking at a three-year-old leased car, probably with less than 65,000, 75,000 miles on it. The – so they are primarily all off-lease cars. So, to your point that we're not getting into the older cars there.

Gary F. Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thanks.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Operator: Our next question comes from Colin Daddino with Gabelli & Company.

Colin Daddino
Analyst, Gabelli & Co., Inc.

Q

Can you guys hear me now?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Yeah.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Hi, Colin.

Colin Daddino
Analyst, Gabelli & Co., Inc.

Q

All right. So, given your comments around your strategic vision for the company and obviously focused on acquisitions at this point it sounds like. You did mention some possible geographic acquisitions. I was just kind of wondering maybe using the old baseball analogy, what inning might you be in for consolidation particularly in the IAA business, but also the ADESA business.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Colin, I would tell you in the core physical auction business, you're in the very late innings, right. That consolidation has occurred. There are still opportunities. Jim has mentioned them in multiple calls before. There are some players that have remained independent that would fit well. But they perhaps don't have an interest at this point in time becoming part of a bigger operation. But generally, I'd put us in the later innings in both – in the U.S. and Canadian markets.

Colin Daddino
Analyst, Gabelli & Co., Inc.

Q

Great. And then since that seems to be the case, what about international opportunities? Are you guys focused on that or is it still kind of technologies and new U.S. and Canadian markets like TradeRev?

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Yeah. I think that we've continued to be interested in the international markets. I've stated previously we've developed a number of relationships internationally. We certainly know who the players are. They know who we are. And I think that we continue to look at opportunities and especially focus on technology. I think that we have a number of technologies that are lacking in some of the markets. And we think some of our technologies like in OPENLANE, our GPS tracking technology, our inspection technology, perhaps this TradeRev technology, all these things, we think would play very well in some of these international markets.

Colin Daddino
Analyst, Gabelli & Co., Inc.

Q

Okay. Great. Well, TradeRev sounds interesting. So, good job. Thank you.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

Thank you.

Operator: We have a follow-up question from Matt Fassler with Goldman Sachs.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thanks. I'm sorry I didn't get to this before and if you addressed it earlier. But the interest expense number that you reported fell off a bit from Q1 to Q2 and was below our forecast. I'm not sure if there were one-time items that factored into that. But can you talk about just the [indiscernible] (45:51) and you spoke a bit about cash interest, et cetera, cash taxes too. Can you talk a bit about the number that we should look for going forward relative to the run rate – the Q1 run rate, the appropriate run rate or the Q2 number, and are there adjustments that we didn't see that would change the way those numbers look to the naked eye?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

No, Matt. The specifics on that, we had a new debt agreement reached in the first quarter, and what you're seeing as the Q2 run rate is pretty indicative of what it should be under the current agreement. In Q1, we had amortization of previously capitalized debt issuance cost that got written off, and you saw that add-back. But what it did it lowered the non-cash interest expense going forward.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Below 20s or at the mid-20s would be a better – more representative run rate of the quarterly interest?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Right, and it's the amortization went down because we wrote off – I think, the number was around $30 million, but I'm not – I didn't look it up of unamortized debt issuance costs. And the amount incurred in the new transactions were significantly less, so naturally that amortization number went down.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thank you for the clarification.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Thanks, Matt.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

A

You're welcome.

Operator: And we have a follow-up question from Bret Jordan with BB&T Capital Markets.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

Hi. Just to follow-up on the IAA conversion cycle, sort of the cadence through the quarter and whether or not the conversion cycle on a year-over-year basis is back to normal. And I guess, sort of some color as to what the [ph] lay (47:23) conversion, is it more processing these salvage vehicles at the insurance level or is it a state level where they need to transfer titles, maybe if we could sort of think about where we are currently on the conversion cycle versus we were at sort of peak crash levels.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

You know, Bret, the answer is, and I think our competition has said the same thing. It's a particular customer that's got a slower cycle, not a broad-based state by state issue. And it has more to do with changing process within the insurance company not within the salvage process or the state titling or anything like that.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

Okay. All right. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And I believe it'll work its way out in a relatively short period of time. This isn't something that we would expect to be a long-term impact.

Bret D. Jordan
Analyst, BB&T Capital Markets

Q

Okay.

Operator: At this time, I'd like to turn the conference back to Mr. Jim Hallett for any closing or additional remarks.

James P. Hallett
Chief Executive Officer & Director, KAR Auction Services, Inc.

Okay. Thank you, Lauren. And thank you, ladies and gentlemen, for being on our call this morning. We continue to appreciate your interest in our company and our stock, and as I've said in my comments earlier, I think the businesses are performing on whole as well as they have in many, many years. It feels good to be in this spot. And it feels good that the team continues to be focused and we continue to be focused on growing our business and growing our cash flow. And with that, we'll look forward to continued dialog and your continued support. So thank you for being on and we'll talk to you as we go forward.

Operator: This concludes today's conference. Thank you for your participation.