KAR AUCTION SERVICES, INC.

Q3 2014 Earnings Call
November 5, 2014
11:00 am Eastern

Operator: Please standby. We are about to begin. Good day and welcome to the KAR Auction Services Third Quarter 2014 Earnings conference call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Jonathan Peisner, Treasurer and Vice President of Investor Relations. Please go ahead, sir.

Jonathan Peisner: Thanks, Randy. Good morning and thank you for joining us today for the KAR Auction Services Third Quarter 2014 Earnings conference call. Today we will discuss the financial performance of KAR Auction Services for the quarter ended September 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 Web site.

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

Jim Hallett: Great. Thank you, Jon, and good morning ladies and gentlemen, and welcome to our call. Last night we announced our third quarter earnings as well we announced an increase in our dividend and the share repurchase authorization.

But before I discuss the capital allocation topics -- that I know many of you are interested -- I would like to highlight our excellent performance in the third quarter -- which is really what we're focused on, on a day-to-day basis.

So as we look at the third quarter, net revenue increased 10%, adjusted EBITDA increased 14%, and -- as you will see in the comments to follow -- we had a very strong performance in each of our business segments.

At ADESA, revenue increased 12%, adjusted EBITDA was up 16%, and volume was up 6%. Revenue per vehicle sold was up 6%. And physical auction revenue per vehicle sold was at $697 -- this represents a 9% increase over the prior year. This increase was primarily driven by the increase ancillary and other services revenue.

In terms of our online only volumes, they increased 11%. And revenue per vehicle sold online was just under $100. This was similar to what we reported to you in the last quarter. And again, this is being driven by the grounding dealers continue to buy off lease vehicles at the residual value.

Volume sold at physical auctions increased 4% over the prior year. And our performance in dealer consignment segment continues to be strong representing 53% of our overall volume in the third quarter. We have also seen an increase in repossessions.

So with that, we would say the cyclical recovery at ADESA is in the early stages. As many of you know, the SAR continues to be strong at over 16 million vehicles sold.

Leased penetration rates are holding strong and may continue to increase. Sub prime lending continues in the new and used vehicle markets. And while used car pricing may be down year-over-year, these declines are fairly modest and much in line with what I reported to you in the previous quarter.

All in all, ADESA is well positioned as we look forward to the next few years. And I can say that I'm extremely pleased with the results at ADESA.

Turning to insurance auto auctions, another strong quarter for our salvage business. Revenue grew 9%, adjusted EBITDA increased 18% over the prior year, and volume was up 7%. Revenue per vehicle sold was up 2%, and the gross profit at insurance auto auctions continued to improve. And maybe more importantly we are well positioned as we enter the fourth quarter with a 15% increase in inventory levels over the prior year. Insurance auto auctions is clearly demonstrating that they're a leader in the salvage industry.

And I would point to a couple things. I believe that insurance auto auctions is leading in the area of technology. I also believe they're leading in the area of service to their customers on both the buyer's and the consigner's side.

And then when you look at performance -- whether you want to measure it by net proceeds for their consigners or the ability to grow profitability for our shareholders -- insurance auto auctions is doing a very good job.

In looking at AFC, revenue increased 7%, adjusted EBITDA increased 6%, and loan transactions grew by 5%. Revenue per loan transaction was roughly the same as last year. And I would say that this is a very strong performance given the market conditions.

Retail used car sales by independent dealers did decline by about 2%. And I would remind you that AFC is more than just loaning money to the independent used car dealer. We provide value added services to each of our customers, and we've consciously made the decision to invest in over 100 local branches in order to stay close to our customers.

And while there's a real advantage to be able to stay close to your customers and to serve your customers and touch your customers on a weekly basis, it's also an excellent way to monitor risk.

The portfolio has continued to grow, and we're experiencing minimal credit losses. And again, this just continues to be a great business and another great performance by AFC.

Changing gears, now let me speak to free cash flow, which I believe is the strongest attribute of our performance. Our Board approved an increase in our quarterly dividend to 27 cents per share. And in addition to the increase in our dividend, the Board of Directors has authorized a share buyback of up to $300 million over the next two years.

As I had mentioned before, strategic investments are our priority for KAR. Each of our businesses continued to evaluate a number of targets -- and believe me there are no shortage of opportunities in the pipeline. In the meantime, we have the option of using our available cash for share repurchases when other capital deployment alternatives are not imminent.

The most important point that I would want to make is that strategic investment and share repurchases are not mutually exclusive. We intend to maintain leverage near three times adjusted EBITDA for the foreseeable future.

So with that, I'd like to turn to our latest acquisition that we announced last quarter, which is TradeRev and give you an update on our first 90 days. There's nothing meaningful to report in terms of financial statements, however, we have made some significant progress.

We focused on enabling three key enhancements to the TradeRev application. We have now integrated AFC and we're funding purchases on TradeRev with AFC. And we've actually had a number of transactions take place in the early stages.

We've also been able to integrate our transportation quotes and fulfillment through CarsArrive. And again, we've actually been able to ship cars through TradeRev with the CarsArrive network.

And then finally we've integrated ADESA so that we can stand in the middle of the transaction -- which is what I talked about previously. It's in terms of handling the flow of funds, processing the titles, providing the arbitrations, and the other services that we provide at physical auctions and even at our online auctions.

So we're now in a position that we're ready to launch TradeRev in the major U.S. markets. And we've actually accelerated the growth in the Canadian markets. I continue to be very excited about this product offering as we go forward.

So before I conclude, a couple of things that I want to speak to. Number one being our guidance. Adjusted EBITDA 580 to $600 million is unchanged. Our results in free cash flow of approximately $309 to $319 million -- which Eric will speak to in a little bit more detail here in a few moments.

So in conclusion, a number of comments that I'd want to make. Our three businesses are performing extremely well. Cash flow is very strong. Our adjusted EBITDA guidance is unchanged. We've increased our dividend. We have a full pipeline of acquisitions and opportunities.

We have authorized a share repurchase program. But maybe most importantly we've just reported on a great quarter. And this is not only great for our shareholders, but it creates a lot of energy and a lot of enthusiasm for our employees and for the culture at KAR.

So with that, I'd now like to turn it over to Eric for some additional color on our financial performance. And we'll be back with Q and A. Eric?

Eric Loughmiller: Thank you, Jim. I only have a few things to add to your comments this morning. First, on a consolidated basis, our gross margin of 44.3% of revenue is in line with the prior year.

I believe this is important to point out as we have seen an increase in ancillary services and other revenue at ADESA, which often has a lower gross profit profile. We also experienced growth in preferred warranties revenue at AFC, which also has a lower gross profit characteristic.

Overall, this demonstrates we realized some operating leverage as we saw our revenues grow on a consolidated basis.

We're also maintaining our discipline in controlling SG&A. The absolute dollar value of selling general and administrative expenses declined in the quarter. This decrease was primarily driven by reduced stock based compensation.

Excluding stock based compensation expense our SG&A increased by less than $3 million in the third quarter. Our strong year-to-date performance is the reason for this increase. We have accrued annual incentive pay in all of our reported segments at a rate greater than the prior year in the third quarter.

Our incentive pay programs are based on financial performance at the consolidated, business segment, or local operating level. Our pay for performance compensation design rewards our employees when results are strong and provides a lower cost structure when the business is under pressure.

The ability to leverage our SG&A costs is a primary driver of our improved adjusted EBITDA margin for the third quarter and year-to-date. On a consolidated basis, our adjusted EBITDA margin was 25.3% for the third quarter and 25.6% for the nine months ended September 30, 2014.

In terms of business segment performance, I believe Jim's comments combined with the financial supplement we made available last night provided good explanation of the strong performance in each of our business segments.

Overall, all of our businesses are performing well and the combination of these businesses provides KAR the operating leverage to increase our adjusted EBITDA margin over time.

Our overall liquidity continues to improve. Our senior leverage ratio -- including capital leases -- is 2.8 times adjusted EBITDA at September 30, 2014. Our available cash at September 30, 2014, was $148.6 million.

As you may have noted, we have been increasing our finance receivables at AFC, and this results in the use of some working capital for the portion we do not securitize. This is not unusual for the third quarter, and is a combination of the seasonal trends and our success in growing in the AFC business.

Our capital expenditures are in line with our expectations for the year. Through the first nine months of the year, we have expended $70 million in capital expenditures. Just over a half of the capital expenditures have been for technology investments in all of our business segments. We will continue to prioritize technology investments going forward.

At the same time, our physical infrastructure is a key to having these strong technology offerings. So as Jim has said many times, the physical auction locations are not going away and remain an important element of our technology-based service offerings.

Now let me speak to our guidance in a little more detail. As indicated in our earning release last night, there are no changes to our adjusted EBITDA, cash taxes, cash interest on corporate debt and capital expenditures expectations. As a result, we continue to expect $309 to $319 million of free cash flow -- or $2.17 to $2.24 per share.

We have updated our net income per share and adjusted net income per share guidance for the year. Our effective tax rate for the first nine months of the year has been below 40% and we expect this to continue through the end of the year. As a result, we have lowered our expected effective tax rate to 38% from 40%.

In addition, we have experienced lower depreciation and amortization expense than originally anticipated in our guidance. As a result, we are increasing our guidance for net income per share to $1.05 to $1.15 per share. We now expect adjusted net income per share for 2014 of $1.45 to $1.55.

So that concludes my remarks. Thanks for joining us today and I will now turn the call back to our Operator, Randy, to facilitate questions. Randy?

Operator: Thank you. If you would like to ask a question, please signal by pressing star 1 on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, it's star 1 to ask a question. We'll pause just for a moment to allow everyone an opportunity to signal for questions.

And we'll now take our first question from Matthew Fassler from Goldman Sachs.

Matthew Fassler: Good morning.

Jim Hallett: Good morning, Matt.

Matthew Fassler: Congratulations on a nice quarter here.

Jim Hallett: Thank you.

Matthew Fassler: I'd like to dig a little bit deeper into the composition of ADESA, and Eric, you alluded to the (margin) profile of ancillary, etc. But what do you think changed this quarter in terms of that revenue per vehicle at physical auction? Because the move was pretty dramatic and obviously flowed through to the overall revenue per vehicle.

And I know we've all been waiting for a physical auction to pick up. But it seems like the pace was rather sudden and dramatic.

Jim Hallett: Yes, I'll let Eric get into the details, Matt, but obviously, these cars get to physical auction. We did experience the growth in our ancillary services and other revenues. So maybe, Eric, if you want to break it down a little bit.

Eric Loughmiller: Yes sure, Matt. As we look at it, it's really being driven by the fact that as more cars get to physical auction, we can do more work on the cars. One aspect is transportation. But it gets into mechanic work, body work, inspections -- cutting keys is an element of it -- the repossession activities of our PAR and RDN. So it's across the board.

And, you know, that's what makes -- what I think was -- an excellent quarter for ADESA is getting that RPU up to $697 -- I think -- is something we've all been waiting on -- and now we've seen it in the third quarter. But it really ties -- I would tell you -- it really ties into the ancillary services at the physical auction locations as much as any of the other revenue sources that we have.

Matthew Fassler: And do you feel like those trends are directionally sustainable in terms of the growth in cars at physical auction and the revenue per car sold?

Jim Hallett: Well, Matt, I've told you in the past I've gotten out of the predicting business. But I think we'll just stand by and see what happens here going forward.

Eric Loughmiller: But the color I'd add for you, Matt, is -- with this type of mix -- I do expect this is the type of revenue per vehicle we have. What we can't tell you is what the mix will be the next quarter or the quarter after. But with this strong, you know, physical auction volume -- we've been telling you -- they tend to use service at the auction lanes.

Matthew Fassler: If I could ask one follow-up. I know that we expected this to happen for a while and we're grateful that it finally did. To the extent that you can now look back and see -- if you can see -- kind of where the volume came from. Was it off lease? Was it repossession? You know, did the

CPO vehicles seem to back up a bit in the channel leading them to spill over into physical? Any sense of what finally gave way to enable this trend to start to kick in?

Jim Hallett: You know, Matt, I think it was a combination of a number of things. There's no question that the lease cars are having an impact. Whether we're getting the lease car directly to the physical auctions, as we say, through the funnel or whether the lease car is displacing a dealer car and we're getting the dealer car.

But, you know, I don’t want to lose sight of the fact that, yes, there are the lease cars. But we also did a very good job on dealer consignment. We are seeing more repossessions. So I think it's a combination of a number of things.

Matthew Fassler: Great and one very final quick -- just a kind of between the lines question -- you give us a great breakout in the ((inaudible)) last night of the different components of online only. And you have the downstream piece of that and, you know, upstream and midstream continue to grow to at a very rapid rate -- over 30% in units. The downstream is coming down. We're not concerned about that, but just want to understand the moving pieces within that online only business.

Eric Loughmiller: And Matt, I want to be careful. You're using terms that we use in the business. When you say, "Downstream," like, online only was up 11% year over year.

Matthew Fassler: Yes.

Eric Loughmiller: That's...

Matthew Fassler: I'm talking about the ((inaudible)).

Eric Loughmiller: We can only call that, "Upstream."

Matthew Fassler: I'm talking about the 79,000 cars down from 91,000 -- that piece of the mix.

Eric Loughmiller: Well, again, those are your numbers. Generally speaking, I think it's more seasonal than anything -- again, the third quarter volumes -- as opposed - and again, you look at it. The online sales remain quite strong -- in the high 30s -- for us so - and that's online total -- not online only.

So I really think - you know, you saw the upstream -- or the online only -- dropped sequentially. It went 128,000, 132,000, 120,000 -- the three sequential quarters. That's a seasonal trend, not a change in the marketplace.

Matthew Fassler: Thank you.

Jim Hallett: You're welcome, Matt.

Operator: And we'll now take our next question from Bret Jordan from BB&T Capital Markets.

Jim Hallett: Good morning, Bret.

Bret Jordan: Good morning, guys. Question on (IAA) -- and one of your competitors recently sort of was talking about some structural increases in expenses related to the insurance contracts. Were you pushing against headwinds in that category? Were there offsets that allowed you to grow the business? Or are you seeing less structural impacts?

Jim Hallett: You know, I can't speak for what they had to say, but I can tell you that I think we're just doing a good job of managing our business, first of all. I think there's a couple things that point to that. I think we're demonstrated that we're leading with technology in terms of the way that we're servicing our customers, mobile applications, the way we're integrating with our customers.

And then I think the thing that we've talked about for years -- the fact that we offer every car online and we offer that car physical as well -- continues to play out. And the way it continues to play out is demonstrating that we are driving higher proceeds and getting better results. And I think customers are taking notice of it. And at the end of the day, I think it's allowing us to win business.

Bret Jordan: Great. Thank you.

Jim Hallett: You're welcome.

Operator: And we'll now take our next question from Ryan Brinkman from JPMorgan.

Ryan Brinkman: Hi.

Jim Hallett: Good morning, Ryan.

Ryan Brinkman: Good morning, yes. And congrats on the quarter.

Jim Hallett: Thank you.

Ryan Brinkman: Regarding the decline in used car prices during the quarter, that's starting to get some increased attention in other circles, too. Do you think that the decline is simply a function of increased supply of cars at whole car auctions? Is that the primary drive? Or do you think it relates to, you know, other things happening in the broader economy impacting demand or the trend in new car price?

My sense is it's a function of supply. But because you guys have, you know, some unique insight here, I thought to ask you.

Jim Hallett: Yes, Ryan, I think I would. In terms of supply, the declines are modest. I think we pointed out to you last quarter that we expected those declines would be somewhere in the 2 to 3% range. Overall -- on a year to date basis -- that's kind of the numbers that we're seeing.

Ryan Brinkman: Okay. You know, and then I think investors are pretty pleased with the 4% increase in physical auctions today. In your prepared remarks, though, you talked about cyclical recovery ((inaudible)) of being, like, in the early stages. And, you know, I know you described yourself in recent quarters as being out of the prediction business in terms of when those volumes would inflect.

But now that they seem to actually have inflected -- or started to inflect -- I'm curious if you feel more comfortable in commenting further on the expected trend there.

Jim Hallett: Well, I can point to a couple things. I know we've said a number of times that, you know, there's an additional 700,000 off lease vehicles coming in 2015 and another 500,000 coming in 2016. And -- at some point in time -- we have said that we thought more vehicles would get to the physical auction.

I don’t want to jump all over 4% here in one quarter. But, you know, I will say -- over the long term -- I've always maintained that they cannot absorb all of these cars at the top of the funnel. And these cars will eventually -- at some point in time -- make their way to physical auction.

Eric Loughmiller: And let me add to that, Ryan, in Jim's comments, he commented, "We have a strong SAR. We have the average credit score in the new car transaction declining. All of that is actually good for the supply of vehicles in the wholesale marketplace." It isn't just one factor; right, Jim?

Jim Hallett: Very true.

Ryan Brinkman: Okay. You know, I think there's been a lot of focus -- or there has been -- on sort of the mix of your volume between, you know, high RPU physical, sort of medium RPU online only, open and -- I guess -- low RPU online only closed.

And maybe you've got some ability to try to influence that mix, but not a whole lot. What about the effort, though, to increase RPU in each of these channels -- which it seems that you might be in a better position to impact? You know -- for example -- charging a higher fee in online only closed where you've got some dominant share in technology. Is there any progress there?

Jim Hallett: Well again, what you see is really the progresses in providing more services to the consigner in advance of selling the car drives RPU up at the physical auction. At this point, you know, you look at a mix, we're waiting for more cars. Ultimately, we hope more cars will be selling in the online only open channel. And when that happens, there's a natural pickup in revenue per unit in the online only channel.

But again, most of it is really driven by the nature of the car -- not by pure price increases for common services that we provide.

Ryan Brinkman: Okay. That's helpful. Last question on the 15% increase in inventory at ((inaudible)) total auction ((inaudible)). Just trying to think about the model and implications to that strong increase, you know, co-parts talked about some of the increase in their inventory level relating more to just a rising cycle times and has tried to parse out the impact of cycle times versus underlying gain -

I'm just curious if you're influenced at all by the same phenomena? Or whether the underlying gain really is that strong?

Jim Hallett: No, we clearly -- and again we've seen this, in particular with certain customers, the cycle times have increased as they've changed their title processing,. We think that'll come back over time.

But there's a real increase in the absolute number of cars on the lot as well unrelated to cycle times. Again our representation with our customer base and it's really been a good season in terms of collisions and total losses relative to our business.

And while the number of insurance claims may have declined slightly this year compared to the prior year, severity is up. And that has typically been good for the supply in the collision repair industry needs these parts.

So we're in a pretty good spot. And sitting again with a lot of that inventory is really related to accident rates more than cycle times.

Ryan Brinkman: Okay. Very helpful. Thanks for the color.

Jim Hallett: Thank you.

Operator: And we'll now take our next question from Craig Kennison from Robert W. Baird.

Jim Hallett: Morning, Craig.

Craig Kennison: Good morning. Thanks for taking my question.

It's nice to see the progress you've made integrating trade revenues so far. I'm wondering how you would frame the volume opportunity in 2015.

I know you don't like to predict. But we're trying to figure out what kind of metrics we should hold you to see if we're gaining traction in that new business model.

Jim Hallett: Well, more so, Craig, I would maybe speak to what the addressable market is. If you take a look at vehicles that are being sold dealer to dealer there's approximately 20 million to 22 million vehicles in that space.

And if you would think that, you know, the dealer is going to keep a number of those vehicles for their own inventory requirements and then they're going to sell off other inventory -- if you think of that maybe as keep9ing half of it and selling off half of it that gets your market to about 10 million units, 10 million, 11 million units.

We would be looking for some slice of that as we go forward on an increasing basis. So other than that that's about as much of a prediction as you're going to get from me.

Craig Kennison: Okay. I thought I'd try. And then with respect to the repo market, you know, I know that your market share does depend on category.

You have a different share of institutional volume versus dealer volume. You have a high share of the off lease volume.

What does your share look like in the repo space? Is that volume stressed to pick up?

Jim Hallett: Yes, I'll let you quote the numbers there. But I can just tell you that, you know, this is a space that we've tended to do very, very well in.

We have a large number of customers with a large share in the repo space. Eric, can you?

Eric Loughmiller: Yes, I mean the commercial vehicles we've said we're overrepresented, you know, in probably more in that 30% range as opposed to that 24% to 25% where our total market share is. And Craig like anything we actually evaluate the customer, not the nature of the car and why it's with us.

So I would just point to that's kind of our share of that commercial space. You know, it's in the low 30s.

Craig Kennison: Got it. Thank you.

Jim Hallett: You're welcome, Craig.

Operator: And we'll now take our next question from John Lovallo from Bank of America Merrill Lynch.

Jim Hallett: Morning, John.

John Lovallo: Good morning. Thanks for taking my call.

First question, just following up on Craig's question on the repo volume. The increase there, can you attribute this - is it looser financing terms which could have some, you know, economic implications here?

Or is this just something that's a little bit spotty and kind of bounces around from quarter to quarter?

Jim Hallett: I would say to you that, you know, it's just - there's more credit availability. And I think that many of these lenders are just taking on more paper. Eric?

Eric Loughmiller: Yes. And I'm looking at a chart that's published in the industry. This is not our data.

There's an absolute reduction in the average FICO score on a new car transaction. And that is one of the leading indicators, John of increased credit risk being taken by the lenders.

And when you take more risk in the retail transaction in particular you are going to have more repossessions.

John Lovallo: That's very helpful guys. Next question is on AFC.

There was a slight decline. And I'm not trying to beat you up on this but a slight decline in revenue per loan if you strip out the other services.

What were the main drivers there?

Jim Hallett: Well the driver of that was a very slight but relative to portfolio it's really modest increase in provision for loan losses which is a negative on our revenue per unit. Revenue per loan transaction.

John Lovallo: Okay perfect. And then final question is...

Jim Hallett: However, I...

John Lovallo: Sorry. Go ahead.

Jim Hallett: No, I was just going to add with that said this portfolio continues to perform at a very high level. We're still over 99% current and the portfolio has continued to grow.

So I would say it's very, very modest. Eric?

Eric Loughmiller: Exactly. And that slight increase is more seasonal than something related to the portfolio. That third quarter is oftentimes where dealers and maybe took some chances in their tax season inventory have to pay the piper.

And, you know, we end up with some loan losses every year during the third quarter.

John Lovallo: Helpful. And last question -- there's a large British auction company that just filed an S-1. I guess I'm curious is this something that you guys took a look at?

And I'm just wondering if the buyback being put in place now is due to the fact that these guys look like they're pursuing the IPO route?

Jim Hallett: Yes, you know, we really don't have any comment on that at this point in time.

John Lovallo: okay.

Eric Loughmiller: And again the buyback is independent of any discussions in the marketplace right? We said they're mutually exclusive of our strategic priorities.

We'll do what's right with capital allocation as the opportunities are in front of us.

John Lovallo: Very helpful guys. Thank you.

Jim Hallett: You're welcome.

Operator: And we'll now take our next question from Gary Prestopino from Barrington Research.

Jim Hallett: Good morning, Gary.

Gary Prestopino: Couple of questions on trade revenue, which is - I find intriguing. First of all in doing your analysis pre buying this and all that and what you're going to do with it, how many of the dealers domestically right now, the franchise dealers have some kind of technology driven system to do dealer to dealer trades?

Jim Hallett: You know, I'm not sure of what kind of products are in the marketplace. I can tell you that there are some products in the marketplace, Gary.

But trade revenue was the one that stood out to us as having the best technology and the best platform that we thought would be most appealing to dealers. Eric do you have any thoughts on that?

Eric Loughmiller: And, Gary, I'd add most of the products that we see would be like our dealer block or smart auction that really were focused on aged inventory; wouldn't you say, Jim?

Jim Hallett: Right.

Eric Loughmiller: More than fresh trades. Is that a fair way to say it?

Jim Hallett: Yes.

Gary Prestopino: So they key differentiator there is their focus on fixed trades and their technology to do the transaction or to facilitate the transaction?

Jim Hallett: Very much so, Gary. You know, you're really starting an auction process as we say with traderev while the customer's sitting in your showroom.

You're basically going out and you're taking a couple photos of that vehicle and taking a shot at the VIN plate. And you're immediately sending that out to a network of buyers.

And you're instantaneously starting to receive bids on that vehicle. So we're really talking about fresh trades even before the new car deal gets transacted.

Gary Prestopino: Okay. That's okay. And then in terms of this increase in physical auction revenue driven by services can you - do you even measure this in terms of what has been the more prevalent service that you're seeing right up front?

Is it detailing minor body work, painting, some mechanical repair? Can - I'm just trying to get an idea of what kind of car is coming in right now that would be, you know, facilitating this increase in revenue per vehicle.

Jim Hallett: Yes. Gary, I would say again it's all of the above as well as transportation being another one. And these consignors are going to do whatever work is required.

If it's body, if it's paint, if it's mechanical, reconditioning. Cutting keys, whatever.

And they're doing what they need to do to make sure that they're getting the car in a competitive spot in the lane so that they're going to attract the most buyers and achieve the highest resale price. And again it's going to be different work.

But most of this work tends to - a lot of this work tends to focus on appearance type items.

Gary Prestopino: Okay.

Jim Hallett: Those being paint and tires and detailing and things of that nature.

Gary Prestopino: Is there any statistics you can share with us that as you get deeper into the cycle how many of these -- like you're saying about 700,000 off lease vehicles next year. How many of those, you know, as the inventory pipeline gets filled what's the shift going from closed to just down to the physical auction?

Jim Hallett: I wish I could...

Gary Prestopino: Go ahead. I'm sorry.

Jim Hallett: No.

Eric Loughmiller: The one thing we've said in the past, Gary, that is still true -- the off lease car is the biggest user of ancillary services historically.

Gary Prestopino: Okay.

Eric Loughmiller: Every captive finance company does something. It at a minimum reconditions the car.

But they'll do more work on the car than probably any other segment in the industry.

Jim Hallett: And I think, Gary, as far as - Okay. Sorry. Go ahead.

Gary Prestopino: Go ahead. I'm sorry. Go ahead.

Jim Hallett: No I was just going to say as far as the shift I think we just have to wait and let it play out. You know, then, you know, we've seen a little bit of that this quarter and I think it's too early to get into forecasting what that shift's going to look like.

Gary Prestopino: Okay. And these leases coming next year I mean it kind of dovetails with the seasonality with car sales, correct? In terms of being spread out across the year?

Jim Hallett: Yes I would think, you know, it's - if you take a look we know the number's 700,000. There could be some seasonality based on when the lease was written.

But I think it is spread across 12 months without looking at it in detail here.

Eric Loughmiller: And keep in mind Gary we were coming three years ago -- we were coming off the bottom in new car sales. So there was a more steady increase than there probably was in a typical seasonal pattern of new car sales.

Gary Prestopino: Okay. Thank you.

Jim Hallett: You're welcome.

Operator: We'll now take our next question from John Lawrence from Stephens.

John Lawrence: Good morning.

Jim Hallett: Morning, John.

Eric Loughmiller: John.

Jim Hallett: Morning.

John Lawrence: Yes, could you take on that - looking at that just a little further on those services and the margins that they represent, if you have more paint mix one quarter versus mechanical, does it really move the margin on those different services or are they all about the same?

Jim Hallett: Yes, no, no - those margins are - those services have varying margins and, you know, I'll let Eric break that down a little bit but I would tell you at the outset is my focus is more on (EBADA) dollars than it is margin, but Eric, maybe you want to speak to some of those margins on the various services.

Eric Loughmiller: Yes, John, we talked in the past, the lowest margin business is transportation and again, by just the competitive nature of transportation and moving the cars, and then after that they vary a little bit, you know, we do pretty well on reconditioning and aesthetic paint and body work, mechanical is good but not as good, it's a little lower. Post sale inspections, very strong - so it varies but I would tell you other than transportation, we generally would tell you it's a 30-40% margin on ancillary services. The high end might be more reconditioning and paint and body work and the low end might be more mechanical.

John Lawrence: And would you share on that range, would this be this mix for this quarter would be that total mix be toward the top, the stronger margin or toward the average?

Eric Loughmiller: Well, you can do all kinds of math and many have done it for me, it varies, what's going to put you at kind of the bottom of that range will be probably more transportation and nothing to do with whether it’s mechanical versus body. Transportation is what swings this margin up or down more than anything, it is our largest ancillary services revenue component.

Jim Hallett: Yes, I think I would go back to Eric’s point that we’re going to average somewhere on ancillary services in that 30-40% range with the exception of transportation and then you’d have to adjust for transportation volumes being - impacting that down.

Eric Loughmiller: Yes.

John Lawrence: Right. Thanks for that. Secondly, can you talk about the flow of the quarter? Did it - these increase really start July or was September a hockey stick month? Or had did it flow during the quarter?

Eric Loughmiller: That’s a low level of granularity but there is a seasonal aspect to the business as people finish their summer vacations, retail use car activity is a little lower than Labor Day and beyond it really picks up, so I would tell you as is normal in our business, it would tend to be the last half of the quarter over the first half but that has more to do with the calendar than the flow of vehicles.

John Lawrence: Okay. And last, regionally - pretty strong across all regions?

Eric Loughmiller: Yes, one thing with us, the U.S. is up course in the recovery and Canada is lagging, we have not begun to see the, you know, the recovery in Canada quite yet, although there is some very positive retail activity up there. It will take it a few years to get to our marketplace.

Jim Hallett: Yes, and I wouldn’t necessarily think of Canada as a region but if you’ve been following it, Canada is predicting perhaps a record in terms of new car sales and also with leasing being now fully back in vogue, we expect those leases to really - the impact here we really expect to see in 2017 on those vehicles - on those lease returns.

John Lawrence: Right. Thanks. Good luck.

Jim Hallett: Thank you.

Operator: And we'll take our next question from Bob Labick from CJS Securities.

Jim Hallett: Good morning Bob.

Bob Labick: Good morning. A lot of my questions have been answered but I just want to dig a little deeper, on IAAA, you know, fantastic results there and then the inventory build was up sequentially, you know, from 10% I guess at the end of June to 15%, didn't seem like there was unusual weather. Can you - and I know you don't want to comment specifically, but is there market share shifts or new account wins? Is industry volume growing that much or are - what do you attribute the sequential growth there to?

Jim Hallett: I think we did mention that we do have a customer or two that are in the process of changing their process in terms of the way they take these vehicles to market and that has backed up inventory a little bit.

And again, Bob, good point; although we look at whether in our local region it's been a very steady weather year - there's been a lot more activity in isolated pockets within the United States in particular then we might all relate to in our local market. It's been a steady stream and also keep in mind last year's third quarter, we've been coming off of Sandy and inventory levels might have just been a little bit lower too. I didn't look at that but, that could have been a cause of it as well.

Bob Labick: Okay. Great. No, I mean, your volume of 7% of a plus 10 seems like you passed through pretty well, right? So it didn't seem like that would be the sequential driver.

Jim Hallett: I'm referring to the inventory level not the pass through of a year ago.

Bob Labick: Right. Right. No. Exactly. I'm saying your volume was good off of a plus 10 inventory so I thought that, you know, something may have changed to continue to grow that but, you know, if the cycle time is just certainly understandable as well.

Jim Hallett: Well, you know, as we go back to Sandy and coming out of Sandy and a number of RFPs that took place last year, there was no question that we did well in gaining market share through some of those RFPs and perhaps some of that showing up in the volume as well.

Bob Labick: Yes, no complaints here, it's great. I was just trying to get a little more, you know, color there. And then, you know, one more in terms of just a little deeper, you spoke about it obviously on the call already, but on the on line only closed versus open auctions, obviously there's a big, you know, revenue difference to you, can you talk to the, you know, proceeds to the seller difference? Is there a significantly higher proceeds to the seller in an open versus closed auction and, you know, if that is the case, can you help influence, you know, more closed auctions to become open auctions on line?

Jim Hallett: I like the way you're thinking, Eric. I'll let you take that.

Eric Loughmiller: Yes, I mean, essentially it's the venue of which the buyer transaction, the price, the consigner is willing to take. What we are doing and Jim talked about in the last call is we're giving the analytics to our customers. We do think there's an opportunity in the on line only open for them to transact where when they let it get to physical auction, perhaps they're not getting a better result than they might have gotten without moving the car, right Jim?

Jim Hallett: Right.

Eric Loughmiller: So - but again - it's more data analytics than it is kind of what's the value - the question on the open is are they getting net more than they get at the physical because it's already gotten through that private label closed.

Jim Hallett: Yes, and one of the things that we've done to encourage more of those vehicles being able to be sold in the open on line sale - Eric's pointed to the analytics - but I would also point to a couple of policy changes we made in terms of we've kind of simplified the fee structure and we've made a little bit more of a - I would say - of a liberal arbitration policy where we've relaxed some of the arbitration rules a little bit and I think all this is an effort to drive more of those vehicles to be sold in the open sale.

Bob Labick: Okay. Great. Thanks very much.

Jim Hallett: You're welcome.

Operator: Once again it is star 1 to ask a question and if you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. We'll now take our next question from Bill Armstrong from CL King and Associates.

Bill Armstrong: Good morning, Jim and Eric.

Jim Hallett: Good morning.

Bill Armstrong: On the insurance auto auction side, your gross margins were very strong up over 200 basis points year over year and, you know, considering that the average selling price is - I would imagine - were a little bit lower than a year ago, just wonder if you could delve into maybe some of what the drivers were for the higher margin and are these, you know, sustainable drivers going forward?

Eric Loughmiller: Bill, good question, one of the things to your point that I would point to is we had 6% of our volume was purchased vehicles where last year that was a little bit higher percent. That does actually impact margin because of how we have to recognize the gross sale price in our revenue if we purchase the vehicle. So we pick up a little bit of margin improvement merely because we have to have a lower mix of purchased vehicles and then the rest of it is really just the ability to manage the business as Jim mentioned.

Bill Armstrong: Okay. Got it. And that actually was a follow up question, what - was there anything to call out that was behind the relative decline in the purchased vehicles percent versus 8% from a year ago?

Eric Loughmiller: No, other than that was the target we set. We felt we needed to reduce that as there’s been a healthy - again - we go back a few years where there was a shortage of total loss vehicles and we were supplementing by purchasing vehicles and things like that, you know, we have a healthy supply right now and so there’s less emphasis on that and also in this - the current pricing environment of cars, it’s a little bit riskier transaction so it’s not as beneficial for us.

Bill Armstrong: Okay. Got it. And on the guidance, so if we, you know, take your guidance and back into the fourth quarter, that would imply just an EPS of 23-33 cents which obviously is quite a wide range, what sort of assumptions or what sort of trends would you be looking for that would, you know, move that number either towards a higher end of the range or the lower end of the range?

In other words, I guess what are the opportunities and what are the risks in, you know, within that range of estimates?

Eric Loughmiller: Well, you know, Bill, we don't speak to individual quarters on our guidance, but it's like the whole - when we talk about the whole year - what creates a range for us is really the mix - the mix of the vehicles within our businesses. So that would be the primary driver that would allow the range for the year.

Bill Armstrong: Okay. Great. Thank you.

Eric Loughmiller: You're welcome, Bill.

Operator: And this concludes our question and answer portion. I would now like to turn the call back over to Mr. Jim Hallett for closing comments.

Jim Hallett: Thank you, Randy and thank you, ladies and gentlemen, for being on our call this morning. We appreciate your time and we appreciate your interest in our company and in our stock.

Obviously we're extremely pleased with the quarter we've been able to report to you, but I would say even more so, as we look forward to what lies ahead of us, we're feeling very good about how we're positioned and how we can continue to grow this company to the next level. So with that, I thank you and I look forward to talking with you next quarter.

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

END