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KAR Auction Services, Inc. (KAR)

Q2 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to this KAR Auction Services Incorporated Q2 2015 Earnings Conference Call. Today's conference is being recorded.

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

Jonathan L. Peisner

Treasurer, Vice President-Investor Relations

Thanks, Shannon. Good morning and thank you for joining us today for the KAR Auction Services second quarter 2015 earnings conference call. Today we will discuss the financial performance of KAR Auction Services for the quarter ended June 30, 2015. After concluding our commentary, we will take questions from participants.

Before Jim kicks off our discussion, I would like to remind you that this conference call contains forward-looking statements within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995.

Investors are cautioned that such forward-looking statements involve risks and uncertainties that may affect KAR's business prospects and results of operations and such risks are fully detailed in our SEC filings. In providing forward-looking statements, the company expressly disclaims any obligation to update these statements.

Lastly, let me mention that throughout this conference call we will be referencing both GAAP and non-GAAP financial measures. Reconciliations of the non-GAAP financial measures to the applicable GAAP financial measures can be found in the press release that we issued yesterday, which is also available in the Investor Relations section of our website.

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

James P. Hallett

Chairman & Chief Executive Officer

Great. Thank you, Jon, and good morning, ladies and gentlemen. Welcome to our call. I'm very pleased to report on our second quarter results with all of our business units performing well.

My agenda for today is to really speak to five topics. I'd like to cover the highlights of our financial performance, speak to a couple trends in the used car supply for online only and physical auctions, give you an update on our acquisition activity for the first six months of 2015, discuss capital allocation, and then end up with a update on our guidance for 2015.

Starting with our financial performance, we had consolidated results where we saw our revenue grow 12% and adjusted EBITDA increase 10%. Turning to ADESA, overall volume grew 14%. Volumes at the physical auction increased 13%, and online only volumes increased 16%. I'll speak to the supply trends in just a few minutes.

At the physical auction, revenue per unit sold for the second quarter was $686, up from $680 last year; and after digging into the details, I realized couple of key factors contributed to the ARPU not increasing even more. And that was the Canadian exchange rate was a drag on our revenue. And dealer consignment volumes were up 7%. And as many of you may know, the dealer consignment vehicles have a lower revenue per unit than the commercial vehicles. But overall, a strong performance on volume and an increase in ARPU drove 17% increase in adjusted EBITDA at ADESA.

At Insurance Auto Auctions, volume continues to be the headline story up 14% over last year, and revenue increased a solid 11%. There were really two factors that negatively impacted the revenue at IAA during the second quarter. First was commodity prices have continued to be depressed, impacting the lowest value vehicles sold there, and therefore affecting our buy fees. And secondly the Canadian exchange rate has negatively impacted Insurance Auto Auctions second quarter results as well. That's twice here I've mentioned the Canadian exchange rate, and Eric is going to provide more detail for that in his comments in just a few moments.

With that said, Insurance Auto Auctions had an increase in adjusted EBITDA of 8%. The adjusted EBITDA did not keep pace with the revenue growth due to a lower gross profit from purchased vehicles, which led to a 1% decline in overall gross profit. SG&A increased less than $1 million, excluding expenses related to compensation and the acquisition of HBC. So, the volume story at IAA continues to be strong going into the third quarter.

Inventory is up 18% over the prior year at June 30. The outlook for IAA is positive due to the strong supply of vehicles. However, this will be somewhat offset with the depressed commodity prices and the Canadian exchange rate, which I've already spoken to.

At AFC, we've seen a very strong performance in what I would call a highly competitive environment. Loan transactions grew 13%, revenue grew 8%, and managed receivables at June 30 have grown 26% over June 30 last year. Growth in other services revenue which is our preferred warranty business was up 9% and we're now in the process of rolling preferred warranties out to other geographies across the U.S.

In fact we're looking for our preferred warranties to grow at a faster pace than the floorplan lending business. And this positions AFC well for growth as we continue to see the supply of vehicles at auctions increase over the next few years.

A couple trends in used vehicle supply that I want to speak to is we're seeing growth in the physical and the online only auction volumes. And I believe this is representative of the trends that we expect to see as we go forward. Our customers have told us that off-lease supplies in the second half of 2015 will be stronger than what they were in the first half of the year. And the number of cars selling online only is growing, but not as fast as the supply of off-lease vehicles. The good news is, this is driving strong physical auction volumes.

New car sales continue to be strong. Interest rates continue to be low. And lease origination rates remain about 30%. And as I've mentioned before, the cyclical recovery will continue for the next few years.

Turning to our acquisition activity in the first half of 2015, we spent about $115 million in the first half of the year. And I recognize that we have not provided a lot of detail on the individual transactions due to the terms of our purchase agreements and we're not going to discuss those individual transactions. However, we are providing information in aggregate for the first half of the year, and I'll let Eric cover this in more detail.

As I've previously mentioned, we are primarily acquiring businesses that can benefit from the cyclical recovery that we are enjoying in our whole car business at ADESA. As many of you know we also acquired HBC which is a salvage auction business operating in UK. HBC is the number two player in the UK market. And the business model is somewhat different than our North American salvage model, but this is a profitable business that we feel fits very nicely with KAR's – with KAR, excuse me. And we have opportunities to share technologies and processes, but we do not intend to convert them to the North American business model.

Turning to capital allocation plans, we continue to prioritize strategic growth as the best use of our capital. We've done a realistic assessment of the next two quarters to three quarters, which indicates we will not have the same pace of acquisitions as we had in the first half of 2015. And I do want to emphasize that this does not mean we will slow down on identifying and hopefully acquiring businesses that provide growth opportunities.

As we look at the next few quarters, it's clear that we will have some cash that we need to put to work. And we have announced our intent to initiate an accelerated repurchase program to acquire $200 million of KAR common stock. We intend to initiate this plan later this week. And upon completion of the accelerated repurchase plan, we will have acquired about $225 million in KAR stock out of our current authorization of $300 million.

So let me close my remarks with an update to our guidance. We are raising our guidance for 2015. We now expect adjusted EBITDA to be $635 million to $665 million. This increase reflects the impact of the acquisitions we completed in the first half of the year. I will let Eric cover the impact on our earnings per share expectations. And we've also updated our capital expenditure guidance to include capital for the ADESA Greenfield location that's being completed in the Chicago area. We now anticipate free cash flow in 2015 of $310 million to $335 million.

I'll now turn it over to Eric for some additional commentary on our financial performance, and we'll be back with some Q&A. Thank you. Eric?

Eric M. Loughmiller

Chief Financial Officer & Executive Vice President

Thank you, Jim. I would like to supplement Jim's remarks with additional details on a few items. I believe our strong performance on a consolidated basis is demonstrated by the 12% revenue growth and 10% adjusted EBITDA growth.

In addition, we saw adjusted earnings per share increase 10% to $0.46 for the second quarter. Operating adjusted earnings per share, which we believe is representative of our cash earnings per share increased 13% to $0.51 per share. For the first six months of 2015, our operating adjusted earnings per share has increased 17% to $0.98.

In Jim's comments he mentioned that the strong U.S. dollar negatively impacted revenue. To summarize this impact on a consolidated basis, consolidated revenue was negatively impacted in the second quarter by approximately $11 million. This foreign currency impact reduced adjusted EBITDA by approximately $4 million in the second quarter as compared to the prior-year when using a static Canadian conversion rate for both years. There was a similar impact on our pre-tax earnings.

One area we are monitoring carefully is our SG&A. We did see SG&A cost increase year-over-year in the second quarter at a little faster pace. SG&A was up 8% in the second quarter. This increase was driven by increased costs in IT and human resources, both areas we have chosen to invest to support our growth.

SG&A is only up 1.6% for the first six months, so I don't see this as an issue, but we are focused on controlling the growth in SG&A going forward. With that said, we are making some investments in IT and HR to support this growing business.

Jim mentioned that the exchange rate for the Canadian dollar negatively impacted revenue per unit sold at ADESA. As we disclosed in our financial supplement last night, the stronger U.S. dollar reduced ADESA revenue by $7.9 million. This represents about $12 per vehicle sold with most of this impact being realized in the revenue per unit at physical auction.

Jim also mentioned commodity prices have hurt salvage auction values, especially on the low value vehicles. Well, to provide some additional color on this, we analyzed selling prices for salvaged vehicles in the second quarter this year compared to last year. I found it interesting that we sold more than two times the number of cars in Q2 2015 than Q2 2014 at a value of $300 or less.

This clearly demonstrates the impact commodity prices are having on the value of salvaged vehicles, especially the lowest value vehicles. At AFC, we are seeing pressure on revenue per loan transaction as the strength of this business invites increased competition.

Revenue per loan transaction was down 5% in the second quarter as compared to last year. The primary driver of low revenue per loan transaction is lower fee income per loan transaction. The competitive pressures are being seen in the fees charged for originating and curtailing loans. Despite this modest pressure on revenue per loan transaction, the margins on the floorplan lending business remain outstanding.

In addition to the fee pressure, we saw a slight increase in bad debt in the second quarter. This is more a timing factor as we don't see any deterioration of the portfolio. In fact, the credit quality of the portfolio at June 30 is as strong as it has ever been.

In June we did complete the amendment and extension of our securitization facility. We were able to increase the size of the committed facility by $225 million and extend the term to June 2018. As part of this amendment, we were able to increase the advanced rate and amend certain definitions which will reduce the amount of loans not eligible for securitization.

Jim gave you a nice overview of our acquisition activity and let me supplement this with a few more financial details. We are acquiring businesses with actual EBITDA that we believe we can grow. The businesses acquired in the first six months of this year had $15 million of adjusted EBITDA for the last 12 months prior to acquisition.

We expect these businesses to contribute $5 million to $10 million of actual adjusted EBITDA for KAR in calendar 2015. We expect to have these businesses fully integrated with KAR within 12 months of the acquisition date. After integrating the businesses, we expect them to produce $20 million to $25 million per year in adjusted EBITDA with the opportunity to continue growing these businesses further.

While our acquisition activity has been focused on adding to the ADESA business, we also acquired HBC, the UK salvage operation. This business is being reported in the salvage segment at this time. We are not integrating the UK salvage business into our North American salvage businesses.

The salvage business model in the UK is somewhat different than North America. There are more cars purchased and then sold at auction. This will result in higher revenue per unit for the UK business, but much lower margins.

Now let me add some commentary on our guidance. We have updated our guidance to reflect the impact of businesses we have acquired in the first six months. In addition, we have estimated the impact of the accelerated share repurchase program we announced last night. This program will result in the use of our revolver and available cash to fund the $200 million share repurchase.

This will increase our cash interest expense on corporate debt for the year to about $61 million. We have also reduced the fully diluted shares outstanding used for computing net income per share and adjusted net income per share to reflect the execution of the accelerated share repurchase program.

Our revised guidance is net income per share of $1.43 to $1.58, and adjusted net income per share of $1.62 to $1.77. Our expected free cash flows of $310 million to $335 million will result in free cash flow per share of $2.17 to $2.35.

That concludes my remarks. So I'll turn the call back to Shannon to host our questions. Shannon?

QUESTION AND ANSWER SECTION

Operator: Yes, sir. [Operator Instructions] And we move to our first question from Matthew Fassler with Goldman Sachs.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Thanks a lot. Good morning, Jim.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Matt.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

A couple questions – good morning. Couple questions, if I could. First of all, as we think about capital allocation, and I presume this one is for Eric. How are you thinking about your target leverage ratios, particularly, now as you've gotten a bit more aggressive on the buyback, where do you want to see this on a sustained basis, if you can remind us so that we can model this out appropriately over time?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Sure, Matt. Our target still remains three times. So, three times or less, but closer to three times. Even with this though, given our current debt, and the available revolver that I could use on this, we won't get to three times as a result of this share repurchase program. But over time again as I look over the next year at the maturities of the term loan B1, and dealing with that, hopefully we'll put a structure in place that can keep us is in line with close to that three times again over time.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Got it. So if the business remains solid and the leverage drifts lower, you would probably remedy that to get closer to those targets?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Again, that will remain our target. We'll see what actions we can take to stay close to it.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Got it. Thank you. And then a quick follow-up, two very quick ones actually. One just related to the purchased vehicle piece within the salvage business, I think, it was a bit of a bigger impediment to the numbers this year or this quarter. What's – is it increased activity, or is it just sort of tougher luck if you will, as you cross those vehicles?

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah, Matt, as you know we have some commitments to purchase some of these vehicles. And there was just more volume and we purchased some additional vehicles in what I would describe is a declining market.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

And is that something that we'll need to learn to live with, or is this sort of a uniquely tough market to take principal risk?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, I think, it's just – it's month-to-month, quarter-to-quarter, as used car prices hold and as we see where they settle in, it will play itself out in terms of how we handle these cars.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Okay. And then finally, there was one new disclosure I think in the ADESA color, which was the number of cars that were sold to grounding dealers. I don't think you gave that at least last quarter and perhaps not in the past as well, can you talk about we have one quarter's worth of trend if I'm right on that, can you talk about the bigger picture trend that you've seen and maybe why you chose to break that out? What we should make of that additional color?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Well, Matt, this is Eric. As you know we're down to $99 for this quarter compared to $99 a year ago. And going forward we just think it's valuable for you to see the impact of the captive finance companies and how they're dealing with the grounding dealers as we are seeing increases in the number of transactions that they are choosing to use, our ADESA.com powered by OPENLANE platform to help process that transaction.

So hopefully this will give you, you and other investors better visibility so you can see that is the major driver of why ARPU on the online only declines is, what's the level of grounding dealer sales. So again we think if you have that information, you'll be better informed to kind of anticipate seeing when that activity is occurring.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Right. No, I think, the good news on that line item – and correct me if I am wrong – is that ARPU is down in the first quarter and down last year, and it seemed to stabilize here year-on-year in the second quarter. Is that indicative of the trend you'd expect to see?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes. And again that would have to do with the mix of grounding dealer sales. We didn't go back and provide that disclosure as of the beginning of the year. I'm sure by the end of the year I'll be giving you the full year numbers in the fourth quarter and that will hopefully give you visibility.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Thank you so much, guys.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

You are welcome.

Operator: Next question comes from John Healy with Northcoast Research.

Chris Farnham
Northcoast Research Partners LLC

Q

Good morning, guys. Thanks for taking my call. This is actually Chris Farnham on for John this morning.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Chris.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Good morning.

Chris Farnham
Northcoast Research Partners LLC

Q

Morning. I was wondering if you could talk a bit about the growth in the IAA business being above expectations and some of the drivers of that. Is that all, kind of, market activity due to miles driven or you think there are other factors at play here?

James P. Hallett
Chairman & Chief Executive Officer

A

I think, there's a number of factors that play in, Chris, but I think overall I think we've just done a good job of continuing to win share in the marketplace. As you know, we take you back a long way and tell you that we believe that our model offering every vehicle in both the physical auction as well as offering a 100% of those vehicles online do drive increased proceeds.

And over the course of time, we feel that we've continued to win RFPs and continued to win the larger portion of business with the customers that we do, do business with. And then finally I would just say, as noted before, that a lot of our business is with the majority of the fastest-growing insurance writers in the country.

Chris Farnham
Northcoast Research Partners LLC

Q

Thanks. That's really helpful.

James P. Hallett
Chairman & Chief Executive Officer

A

You are welcome.

Operator: Next question comes from Elizabeth Suzuki with Bank of America.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Good morning, guys. So, FX had almost a 2 percentage point negative impact on year-over-year revenue growth this quarter, which was worse than last quarter. And as we go through the back half of year do you expect that currency headwind to ease at all or do you expect some stabilization?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Liz, at this point, we're not expecting any easing or improvement, as I would say, or weakening of the U.S. dollar. It could happen, but at this point, we're preparing ourselves for the Canadian dollar to stay down below $0.80 per US dollar. So we'll see how it plays out.

The good news is we operate our businesses within Canada. This is not a company where we're dependent upon repatriation to satisfy a lot of the operating costs here. We're generating revenue in Canada, but we're also having the cost in Canada. So again, on the margin percentage not hurting us, other than on the translation.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Great. Thanks. That's really helpful. Just a quick one on IAA, and I think you answered this already, but I just want to confirm. The 0.5% decrease in gross margin attributed to HBC, is that margin impact expected to be ongoing because HBC is a lower margin business than the rest of IAA or are there some near-term integration costs that should normalize in the coming quarters?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

No. That is driven by the revenue model, a substantial number of the cars that they sell are purchased vehicles. That's the model in the UK. And we only had HBC for a month. I think, it'll be an even more significant impact in future quarters where we have a full quarter of volume and activity from HBC. The one thing I will let you know is I will be giving you adequate disclosures so you can understand the two businesses separate from each other because otherwise I don't want someone forming the wrong impressions about what's happening in North America.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch
Q

Okay, great. Thanks. That's really helpful.

Operator: Next question comes from Ryan Brinkman with JPMorgan.

David Karnovsky
JPMorgan Securities LLC
Q

Hi, good morning, guys. David Karnovsky on for Ryan.

James P. Hallett
Chairman & Chief Executive Officer
A

Good morning, Ryan.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Good morning.

David Karnovsky
JPMorgan Securities LLC
Q

Good morning. So, really great volume quarter at ADESA, especially for physical volumes, can you tell us how that 13% growth in physical volume compares to what your expeditions were at the start of the quarter. And then, to the extent that maybe you tracked higher, were there any inefficiencies in servicing volumes such as like premium freight, over time? That maybe prevented some of that strong volume growth from converting to EBITDA?

James P. Hallett
Chairman & Chief Executive Officer
A

Well, in terms of our expeditions we expect it to grow. And we knew that volume was going to increase, but I think the pleasant surprise was all segments were really improving. When you think about – we often just focus on the fleet lease and repo, obviously this is heavily driven by the fleet lease and repo segments, but you know what, we've seen a large increase in factory cars, we've seen an increase in daily rental cars, and as I mentioned in my commentary, a real nice increase in dealer consignment being up 7% as well. So, overall, I think it was all the above contributed to the 13%.

David Karnovsky
JPMorgan Securities LLC
Q

Okay. And then just going back to the online pricing at ADESA in the quarter, any impact there from an increase in open online sales or should we just sort of think about that as the grounding dealer impact that you were talking about before?

James P. Hallett
Chairman & Chief Executive Officer
A

I think, you should really just think about it as what Eric described to you with the grounding dealer.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

There was an increase in open sales, but it was more than overshadowed by the grounding dealer.

David Karnovsky
JPMorgan Securities LLC

Q

Okay. And then just shifting gears to HBC vehicle services, I know you guys can't give specifics on the transaction, but can you just talk maybe broadly about it, why was this the right time for you guys to enter the UK market, and then maybe what's the opportunity there for the long-term?

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah. Good question. And a couple points I would make is number one, we are a distant number two player in the UK with our competitor there having a very large market share. And we believe there's an opportunity to do further consolidation and to become a stronger number two, and based on the feedback that we've got throughout the course of our decision, we feel that the market would very much support a strong number two player.

And secondly, this was really our first entrance into an international market. And we felt that there's much that we can learn from being in the market. And learning and understanding a different business model that they have in the UK, but maybe even more importantly learning and understanding the culture as we go about making other international acquisitions.

David Karnovsky
JPMorgan Securities LLC

Q

Okay. Thanks a lot, guys.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome. Thank you.

Operator: Next question comes from Shreyas Patil with Credit Suisse.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)

Q

Hi, thanks for taking my questions guys.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Shreyas.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Good morning.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)

Q

Good morning. I was wondering if you can just give us a little bit more of some of the puts and takes around the guidance? I mean, so you mentioned that you are including the impact of the ASR and the $5 million to $10 million benefit from the acquisition, but it kind of looks like the EPS and adjusted EBITDA increases are fairly modest versus your old guidance. I mean, are there some other factors that you're considering as well?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, Shreyas, again, we consider all factors. Foreign currency would be a major factor affecting us. One thing I would admit is it's – probably the Canadian dollar has done worse than we expected through the year, and we factor that in. But generally speaking, we give annual guidance and this update is to reflect activities that's occurred, that was not contemplated at the beginning of the year. And our view is we'd rather be evaluated on our results than the movement of guidance.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Okay. And then also maybe just looking at the gross margin side, ADESA gross margins were about 44% in the quarter. That's about flat year-over-year, despite the fact that you guys had a really big increase in unit volume growth. I was wondering if you can give us a little more color there on what were some of the drivers.

James P. Hallett
Chairman & Chief Executive Officer

A

Yes, I mean, the ADESA gross margin was flat year-over-year on a percentage basis. And with that strong volume growth, it really reflects like we've talked before, you get that volume, you get a little leverage on it, you hope to gain some, but the offset is you're going to have more ancillary services that's going to drive that. And the ARPU being up $6, but as I mentioned in my comments, another $12 was lost I mean in foreign currency.

So, I really think you're looking at a good, strong revenue performance after you adjust for currency, but as we see this, the commercial vehicles will use lower margin ancillary services. And when you have that kind of growth in ARPU, you can accept at least some pressure or some offsets to the leverage that you have on the increased volume in terms of the margin flow-through.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)

Q

Right. Okay. And then just lastly, you had just mentioned about how you expect the PWI business to kind of outpace growth at the core AFC business going forward. So can you remind us again, how the margins play out between those two businesses? Are they fairly similar or is PWI a little bit less?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. PWI, the margins are a little bit less.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Yeah. And we talk gross margin, Shreyas here.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)
Q

Yeah.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

It's a mid-20%s gross margin business as compared to a near 70% margin business – gross margin business on the portfolio of loans.

Shreyas Patil
Credit Suisse Securities (USA) LLC (Broker)
Q

Okay. Got it, all right. Thanks a lot.

James P. Hallett
Chairman & Chief Executive Officer
A

You're welcome.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

You're welcome.

Operator: We will move to our next questioner, Gary Prestopino with Barrington Research.

James P. Hallett
Chairman & Chief Executive Officer
A

Hey, Gary.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Hi, good morning.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Hey, Eric, just a quick question, what was your interest expense guidance prior to what you said today? What was it, about $60 million per year?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

It was $60 million, and it's only gone up by about $1 million.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. Just a quick thought, I mean, why would you take more leverage on? I mean, you've got some cash on your balance sheet. Is that – you had about $200 million, right? Is – I would assume some of that is not – is unencumbered.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Some of it is. And again, there's the timing of the daily cash flows. There is some cash currently residing in Canada that at the current exchange rate and the interaction with my foreign tax credits, it may not be efficient to bring it back. So, we'll use the revolver, and as well as any available cash that we can. So that's why there's not a significant increase in interest expense.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. And then in terms of the – on the AFC side, is this increased competition coming from banks or nonbanks or both?

James P. Hallett
Chairman & Chief Executive Officer
A

The answer, Gary, is both. We're seeing increased competition from our major competitor as well. We're seeing some new entrants in the marketplace by some of the smaller banks and credit unions.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. All right. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

You're welcome.

Operator: Next question comes from Ali Faghri with CRT Capital.

Ali-Ahmad Faghri
CRT Capital Group LLC
Q

Good morning. Thanks for taking my question. Congrats on a nice quarter. Can you talk a little bit about the brick-and-mortar acquisition opportunities on the wholesale side in the second half, if I remember correctly, in the past you've talked about 5 to 10 quality independents that would make good acquisition candidates.

James P. Hallett
Chairman & Chief Executive Officer
A

Yes. We did the completion of the Pittsburgh. We've announced the building of the Greenfield in Chicago. We're still very much a believer in brick-and-mortar auctions. We believe that not only does it give you a physical site, that allows you to also grow your ancillary services and your revenues, but it also gives you another customer base that grows the customer base, and contributes to the online customer buying base as well.

So with that said, we feel that you'll see a continued focus on acquiring some of these independent auctions. We did identify there's probably 5 to 10 of them as you mentioned in the country. I didn't say we're going to get all 5 or 10 of them done anytime soon. But we are always in communication with the independents. We have good relationships with the independents, and I think you'll see us complete Chicago, and I think you can expect that we would be opportunistic as more of these opportunities become available. You would see us act on specific ones if they, number one, contribute to the geography and the customer mix and the strategy that we're looking to build on overall.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

And, Jim, let me add, and be disciplined on how we value the businesses as well. That's part of what drags these things out, is we're very disciplined on how we value the physical auction businesses.

James P. Hallett
Chairman & Chief Executive Officer
A

Very much so.

Ali-Ahmad Faghri
CRT Capital Group LLC
Q

Okay. Great, that's very helpful. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Welcome.

James P. Hallett
Chairman & Chief Executive Officer
A

You're welcome.

Operator: We next move to Ben Bienvenu with Stephens Incorporated.

Ben S. Bienvenu
Stephens, Inc.
Q

Yeah. Thanks. Good morning, guys.

James P. Hallett
Chairman & Chief Executive Officer
A

Good morning.

Ben S. Bienvenu
Stephens, Inc.
Q

So you continue to have really strong growth in IAA. I'd be curious to know that the extent to which you're seeing insurers put additional pressure on the cost side on you guys as the accident frequency increases and higher volumes potentially impact there profitability.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Yeah, Ben, good question. Really the pressure comes from service-level agreements that are embedded in these insurance contracts. The pressure I would describe as we're expected to pick up the cars faster. It helps to reduce the cost of storage and things that the insurance company might be incurring prior to it getting to the salvage yard. Again, the model works very well for us and I'd say the pressure is really focused on the tow cost.

Ben S. Bienvenu
Stephens, Inc.
Q

Okay. Great. Shifting gears back to ADESA at the physical auction, still making progress there on ARPU, despite the FX headwinds, how much more runway do you feel like we have on revenue per vehicle? Is it purely a product of mix shift playing out or are there some things that you guys can do internally as well to drive that higher?

James P. Hallett
Chairman & Chief Executive Officer
A

Well, there's no question that as you think about the mix and you think about more of these commercial vehicles coming to the physical auction. Those are the heavy users of ancillary services. So rather than try and put a number on where ARPU can go, I can tell you that I think the mix will drive that ARPU, and I would expect that that still has room to go north.

Ben S. Bienvenu
Stephens, Inc.
Q

Okay, great. Thanks. Best of luck.

James P. Hallett
Chairman & Chief Executive Officer
A

You're welcome,

Operator: Next question comes from Bob Labick with CJS Securities.

Bob J. Labick
CJS Securities, Inc.
Q

Good morning.

James P. Hallett
Chairman & Chief Executive Officer
A

Good morning, Bob.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Good morning, Bob.

Bob J. Labick
CJS Securities, Inc.
Q

Just jumping back to IAA, the 3% price decline was, I think, probably a lot less than people may have feared given the 45%, 50% declines in scrap and some of the things you already talked about. Can you talk about if there are any offsets you have there, is it the higher purchased vehicles, I guess, going up from 6 to 7, or any other pricing or offsets that you've been able to institute and where you expect that price headwind for the back half?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Bob, good question. Yes. One of the offsets is the number of purchased vehicles increasing. Gives you an – on those cars you do have an average – higher average ARPU because it's the gross auction price versus the fees. But again, we think we can manage that, not a big change. In the second half of the year, it's again, let's talk North America, because in the UK it will be totally different. In North America, I – we're kind of expecting it to continue at the current levels.

James P. Hallett
Chairman & Chief Executive Officer

A

And may be one thing that I would add to that, as you said, what are some of the things that we may be able to do to affect that is, in one of the initiatives that we're taking is we're working on building our buyer base at Insurance Auto Auctions. We've now taken a look at our buyer base at ADESA, we've taken a look at our buyer base at Insurance Auto Auctions and how those buyer bases overlap. And the types of vehicles now some of the non-insurance vehicles that are coming to IAA that we're able to bring some of those whole car buyers from ADESA, IAA, it's kind of about the best venue as to where we sell these cars.

And then as we're thinking about these, probably the best opportunity for us to take additional fees is usually where you see prices falling in that declining market.

Bob J. Labick
CJS Securities, Inc.

Q

Okay. Great. That's very helpful. And then just jumping over on the whole car side, the – I think, industry volumes were up about maybe 8% or so in the quarter versus your 14%. And I know you have obviously significant strength on the institutional side, but can you talk about some of the drivers there and what's enabling you to outpace the industry right now?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, first of all, I'd say that we look at those numbers with a little bit of caution. We were at 14% and the industry did report 9%. But we really don't put a lot of credence in those numbers until we get a yearend result, and we get a full report. But with that said, our commercial business is very strong. And all segments, as I reported earlier are doing well. And that's right in our kitchen.

And then you take – on top of that, you take the job on dealer consignment being up 7% is really a phenomenal job. Many of you go back in history with me to where in 2009 our dealer consignment business was at 25% of our total business. And we knew with the headwinds that we were going to face on the commercial side that we had to get a lot better with dealer consignment. And this is probably one of the initiatives that I'm most proud of is the fact that we've been able to take that dealer consignment up to 50% of our business and not just take it up, but to hold it there. In fact, dealer consignment was down 1% as an overall percentage of our business. I think it was down to 49% in the quarter. But holding that dealer consignment business along with getting all that commercial business in all segments, has really contributed to what you're seeing in that 14% increase.

Bob J. Labick
CJS Securities, Inc.

Q

Great. Thank you very much.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: Next question comes from Bill Armstrong with C.L. King & Associates.

William R. Armstrong
C.L. King & Associates, Inc.

Q

Good morning, Jim and Eric. Just a clarification on the guidance. So the adjusted EBITDA guidance is up $5 million, and we're also looking at I guess a lower share count. So was there some offset? Where is it from the acquired companies maybe higher depreciation expense that's also factored into the EPS guidance?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes. Well, we don't get into that level of detail. It's higher depreciation and amortization created from the purchase accounting of acquired enterprises that affects the net income per share.

William R. Armstrong
C.L. King & Associates, Inc.

Q

What diluted share count then are you using for the full year in coming up with the EPS guidance?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Well, again, I'm not going to give my assumptions. As we disclosed in our release last night, we'll execute this in the next few days and we expect delivery of approximately 4.5 million shares at inception of the program. So you should factor that into your share count for the remainder of the year.

William R. Armstrong
C.L. King & Associates, Inc.

Q

Okay. And then the remainder of the shares would be because it also indicates a six-month total program period, is that how we should, kind of, think about that?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes. I've assumed any settlement of additional shares would occur after year-end.

William R. Armstrong
C.L. King & Associates, Inc.

Q

I see. Okay. And then just shifting gears quickly, the new ADESA Chicago facility maybe just a quick update, have you broken ground on that? And could you remind us what the timeline is for getting that facility up and running?

James P. Hallett
Chairman & Chief Executive Officer
A

Yes. Ground has broken and the timeline isn't soon enough. But with that said, we would expect to be operational before the end of 2016.

William R. Armstrong
C.L. King & Associates, Inc.
Q

End of 2016? Okay. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

So, yes, probably a little bit over a year from now.

William R. Armstrong
C.L. King & Associates, Inc.
Q

Got it. Okay.

James P. Hallett
Chairman & Chief Executive Officer
A

Thank you.

Operator: [Operator Instructions] And we will take our next question from Bret Jordan with Jefferies.

Bret Jordan
Jefferies LLC
Q

Hey. Good morning, guys.

James P. Hallett
Chairman & Chief Executive Officer
A

Good morning, Bret.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Hi, Bret.

Bret Jordan
Jefferies LLC
Q

A quick question on the IAA inventory, is there any change in the inventory quality, I mean any higher value Texas flood vehicles that would be in that mix that would impact ARPU into the second half or is it pretty much running on average?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President
A

Well, of course, some flooding in Texas is well known, and there would be some inventory from that. But it's really across the board. It's not concentrated in any area. And I would expect it to be representative kind of the broader market that inventory level right now.

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah, you know, Bret, the other thing I would just – the other thing, I would just add to that, and we've commented on in the past is, we know these events are going to take place on an annual basis. It's just we don't know when and we don't know where. But it's kind of the normal course of business throughout the year. And I think most recent floods in Houston are indicative of that.

Bret Jordan
Jefferies LLC

Q

Okay. And then one question on the EBITDA expectations from the acquisition at $20m to $25m is that assuming some sales growth or is that just synergy available to you at the current run rate?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

That's on a current run rate where we think the businesses perform once integrated and the cost would level up on a full-year basis.

Bret Jordan
Jefferies LLC

Q

Okay, great. Thank you.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

You're welcome.

Operator: And ladies and gentlemen, with no further questions in queue at this time, I'd like to turn the conference back over to Mr. Hallett for closing remarks.

James P. Hallett
Chairman & Chief Executive Officer

Okay. Great. Thank you, Shannon and thank you ladies and gentlemen for being on. We appreciate you being on. We appreciate your continued interest in our company.

We're very pleased with our results and with how the company is all functioning well together. As I've said in the past, the company is now functioning in my opinion, as well as the company has ever functioned since we've put these companies together in 2007. It's kind of was our expectation and now watching it come to fruition is very, very gratifying for us all here in management. So, we look forward to continuing to do some good work, and reporting some good news here as we continue to move forward.

So with that, thank you for being on today and I appreciate it.

Operator: And ladies and gentlemen, that does conclude today's conference. We do thank you for your participation. You may now disconnect. Have a great rest of your day.