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KAR Auction Services, Inc. (KAR)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day everyone and welcome to the KAR Auction Services, Inc. Q3 2015 Earnings Conference Call. Today's conference is being recorded. And at this time, I'd like to turn the conference over to Jonathan Peisner, Treasurer and VP of Investor Relations. Please go ahead, sir.

Jonathan L. Peisner
Treasurer, Vice President-Investor Relations

Thanks, Danny. Good morning and thank you for joining us today for the KAR Auction Services' third quarter 2015 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended September 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 Web site.

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. I'm pleased that you let me to add my welcome to our call. Obviously, another quarter has passed and I am very pleased with the results that we're seeing. In fact, all of our businesses are performing at double-digit volume levels. And what I do want to cover today is really a couple of things. I want to speak to our performance. I want to give you a brief update on what's going on with trade web, speak to capital allocation, as well as to our guidance and then focus on what I see as we look ahead going forward.

So with that, from a consolidated standpoint, our volumes increased as I mentioned in all segments which led to an overall of 9% increase in adjusted EBITDA. There is no question, you're going to hear a lot and you've already read about our Canadian currency is having a negative impact overall.

Canadian currency had a negative $6 million EBITDA in the quarter and year-to-date, it's been a negative $13.2 million. At ADESA, we've seen an increase in our volumes in both the online and the physical auctions. We also experienced growth in commercial as well as in dealer consignment.

And our dealer consignment segment was up 10% and this was driven by what we've seen is a very strong new car sales. And as you know new car sales create a lot of trade-ins, and those trade-ins hopefully eventually make their way to the auction which has been very, very strong in our business.

And then we also have seen very good performance in the commercial business, primarily driven by the off-lease vehicles and as well as the return of the factory vehicles. Our factory business is up and this is -- includes a number of rental cars. And as you know, a number of rental companies have gone to guaranteed buyback cars which are what we refer to as the program cars are coming back.

The captive finance segment, primarily driven by off-lease vehicles is up 13% overall. And I think the good part about the increase in the off-lease vehicles is more of these vehicles were sold at the physical auction than what were sold online. And this is true in terms of both absolute numbers, as well as percentages and certainly, this is what we've been telling you over the last several quarters, this is what we've been experiencing over the last several quarters and what we expect to continue to see going forward. The one thing I would point out as you think about captive finance, remember that this includes repossessions as well, but primarily that's this segment is driven by the off-lease vehicles.

A lot of our investors had been focused on incremental margins. And I'm pleased to report that excluding acquisitions, incremental adjusted EBITDA margins at ADESA are 35%, and Eric is going to provide more color in his commentary here in a few moments.

As we look at Insurance Auto Auctions, we've seen very strong growth at 16% volume growth. This is 15% growth excluding HBC. And I believe this is a result of our continued investment in technology, our continued expansion of the footprint, and then our focus on our hybrid methodology of selling these vehicles both live and live online. I think these factors have clearly added value and have led to the volume growths that we've seen at Insurance Auto Auctions. That's not to say that we haven't had a couple of headwinds. I think everybody is familiar with what's going on with commodity prices. And especially scrap metal prices and maybe there is one example I can share with you that really, I think tell us a story quite well and I want to talk about crushed car bodies.

In January of 2014, a crushed car body was selling for about $312. In December of 2014, a year later, that crush car body was selling for about a $198, and then if you fast forward that to September 30, 2015 a crushed car body was selling for $124. That's a 60% drop in less than a two-year timeframe, and it has created a 3% decline in revenue per vehicle at Insurance Auto Options. There is no question that the management team and Insurance Auto Options are constantly reviewing their fees, and looking at their service offerings and certainly trying to offset the impact of scrap metal prices, but certainly haven't been able to increase the fees to a level, where it completely offset the scrap metal prices.

Another thing is that, we spoke about Canadian currency. But foreign currency is also having an impact on the results at Insurance Auto Options. As you know, the U.S. dollar is very strong compared to foreign currency, and this reduces the value of the local currency for our foreign buyers. These buyers are still very active, they're still bidding, they're bidding just as much, but unfortunately with their currency being devalued, they're not able to pay as much for the vehicles as they've been able to pay in the past, as they compete with the U.S. dollar.

So with that, I'll turn to AFC, again, another very good story, up 13% in volume, and I think, the market truly appreciates the business model at AFC, and the service levels that we are providing to our customers there. No question, we've seen increased competition. There has been pressure on fees, but I can tell you, that this still remains a very profitable business, and I think that the AFC management team has been able to respond to the competition and grow our market share in this space. In fact, [indiscernible] (7:45) that the average loan or the average per -- the average loan -

Unverified Participant

Revenue per loan transaction.

James P. Hallett

Chairman & Chief Executive Officer

Thank you. I'm getting mixed up here. Thank you. The average revenue per loan transaction is down approximately $5 dollars overall, just to put that in perspective for you. So, I think we're in a good spot there. We also think about interest rates at AFC. We are very well positioned, as you know, our average loan is about 60 days in duration and I believe that the structure of our securitization limits, our interest rate exposure and although interest rates may increase later this year or possibly in 2016, I think we're in a good position.

If I can turn to TradeRev for a moment, I would start by saying TradeRev remains a very, very high priority for me. And we're allocating more resources to support the U.S. rollout. In fact, we are now tapping into some of the talent we have within the OPENLANE organization to assist us with the rollout of TradeRev here in the U.S. You know, it wasn't that long ago that OPENLANE was rolling out a technology product here in the U.S. and I think they have a lot of experience with rolling out a startup technology company. I think, there is a lot of similarities between the roll-out of OPENLANE and TradeRev, and I think where it would be very wise to use that talent we have within the organization.

So, we do expect to add more resources and continue that more resources as we go forward. And then, just the other thing I would mention on TradeRev, I would like you to think about this as not being a quick hit. I think we need to think about TradeRev over a little bit longer period of time and I think of it as maybe over the next three to five years, that business model really transforms and that's my thinking on that.

As we look at the acquisition pipeline, I shared some comments with you last quarter. I said the pipeline is active. We have targets within all of our business units, but I also mentioned that it wasn't likely, that we would complete any deals, prior to year-end. And as a result, we announced the $200 million accelerated share repurchase program that was initiated around August 6, and we're expected to settle the purchase of those shares in the first quarter of 2016. I can tell you that the senior leadership team at KAR has been very much focused on really reviewing our strategy and clearly identifying what we believe fits and also what we believe doesn't fit within the KAR strategy as we go forward. And I would say that probably my major focus right now is on expanding the buyer base and increasing our market share at ADESA.

I believe that we need to be in a position to truly benefit from the cyclical recovery of the used car supply that's taking place within the whole car business. As far as the other targets that we've got on the radar screen for acquisition, I can share with you that I expect that we will deploy capital for growth early in 2016. We are certainly executing on the strategy that we're determined within internally here and also I would share that we expect to increase our leverage to our target of three times in 2016.

In terms of guidance, our guidance have not changed. We still expect adjusted EBITDA in the range of $635 million to $665 million that will produce approximately $310 million to $335 million of free cash flow. And again Eric will give you a little more color on guidance, but as I look forward, I'm really excited about the picture that I see. I think we have some real positive momentum and our businesses are performing extremely well and working well together.

We've an excellent pipeline of off-lease vehicles. We know the number of leases that have been written over the last three years and we know what those maturities looked like and when they're coming to market, and how they're coming to market. So we have very, very good visibility on these leases as we go forward in the next three years.

As you all know, we're talking about very strong new car sales. I think the most recent information that I read is, looking at [ph] SAAR (12:16) next year of approximately 17.4 million vehicles, which will be a record all-time high and again to my earlier point new car sales produce used car trade-ins and those used car trade-ins hopefully eventually make their way to auctions and we're certainly seeing that in our dealer consignment segment.

Another most recent article in fact just out this morning that you may have read is, Experian put an article this morning and said that outstanding car loans are at an all-time high, nearly $1 trillion, and this represents a 53% increase over the last five years. So I think that bodes very well for our business, certainly bodes very well for the repossession segment. And as you know, I've often said there's a jet correlation between the number of contracts that are written and the number of repossessions that come back to market.

So, with that we spoke about interest rates, possibly they would increase, but we don't believe that would be disruptive. And I think as you think of all these conditions that I just walked through, I think these are very, very positive conditions for both ADESA and AFC. And then as I think about Insurance Auto Auctions, I think about lower fuel prices and then we talk about miles driven; miles driven are at a record all-time high. And then we think about the increase technology and the complexity of these new cars that they're manufacturing.

I think this all bodes very, very well for the salvage volumes that we see going forward. And I also believe that the volumes that we expect at Insurance Auto Auctions will more than offset the negatives that we're experiencing on commodity and foreign currency.

So with that, I think our initiatives here are to expand through acquisition at values that are accretive, and more importantly in a timeframe that really allows us to take advantage of this cyclical recovery that's going on here in the U.S. and that's about to start in the Canadian marketplace.

So, I would also assure you that if for any reason, any of these acquisition targets don't make sense, if we don't get them over the go line for one reason or another, we have other options to deploy capital to our shareholders. Our absolute focus is on returning value to our shareholders.

And so, with that, I'm going to conclude my formal remarks. I'm going to turn it over to Eric for his commentary, and will be back for some Q&A. So Eric?

Eric M. Loughmiller

Chief Financial Officer & Executive Vice President

Thank you, Jim. I would like to start by giving some context around some new information we provided to supplement our earnings release. We've provided earnings slides that provide a tabular presentation of information included in our earnings supplement. This information you'll also find in our quarterly report on Form 10-Q that I expect to be filed later today.

As Jim mentioned in his remarks and you can see in the earnings slides, translation of the financial performance of our Canadian operations had a significant impact on our results when compared to the prior year. This is just a translation impact and did not impact the performance in Canada.

In addition to the impact on adjusted EBITDA that Jim mentioned, foreign currency negatively impacted revenue by $15.2 million and adjusted earnings per share by $0.02 in the third quarter. For the first nine months of 2015, foreign currency negatively impacted revenue, by $34.9 million, and adjusted earnings per share by $0.05. We've also provided a schedule that analyses incremental operating profit margins for ADESA. It is clear that, recent acquisitions have made it difficult to determine the incremental margins for ADESA, as we analyze the contribution for increased revenue, provided by the organic growth in the ADESA business.

First, the incremental adjusted EBITDA margin for the ADESA business is 35% as Jim mentioned. Acquisitions contributed $2.2 million of adjusted EBITDA in the quarter. The difference between operating profit, as disclosed in the earnings slides, and adjusted EBITDA, is the depreciation and amortization expense for the acquired business.

This gives you sufficient information to compute an incremental EBITDA margin for ADESA. If we take it a step further and use a common currency in this calculation, the incremental adjusted EBITDA margin at ADESA is 36%.

I would also like to comment, on average revenue per unit or ARPU for ADESA. Let me first discuss ARPU for the online only vehicles.

We saw growth in the number of vehicles sold in online only open sales that contributed to an increase of $13 in ARPU. This increase is net of a negative $4 per unit from the foreign currency translation. At physical auction, ARPU increased $2 to $699. This is better than you think given that foreign currency negatively-impacted ARPU at physical auction by $22.

Another area that our acquisition activity has made comparisons more difficult is in SG&A. On a consolidated basis, SG&A increased $12 million to $128.5 million. SG&A for the third quarter includes $3 million for businesses acquired by ADESA in 2015, $800,000 for HPC acquired in June and $600,000 in professional fees directly related to acquisitions.

In Addition, ADESA SG&A includes a loss on disposal of land of $1.2 million. This is a non-cash loss related to the sale of an idle property. In the 2007 LBO transaction, the land was recorded at the fair value, as of the date of the LBO. The fair value at that time was significantly greater than the acquisition price of the land many years earlier; the sum of these items that I just described is $5.6 million.

Net of this, SG&A grew 5% in the third quarter. I would also want to update you on efforts at AFC to mitigate the risk of increasing interest rates on net interest spreads for floorplan loans.

In 2008, during the financial crisis, AFC instituted a prime rate floor of 5%, as prime has been below 5% since that time this ensured an adequate spread was earned on the loans. In the past two years, AFC had successfully eliminated the prime rate floor for a large portion of its portfolio. This has minimized the impact of increasing interest rates reducing net spreads as the prime rate increases from current levels of 3.25%.

In August, we initiated a $200 million accelerated share repurchase program. We retired 4.6 million shares of common stock based on the initial delivery of shares. This represents 90% of the expected share repurchases. Upon completion of the share repurchases, additional shares will be delivered in the final settlement.

This program will be completed prior to February 19, 2016. I don't expect the final settlement prior to year-end, but we will be able to give you an update on our year-end earnings call.

While we continue to report adjusted earnings per share, we will be using operating adjusted earnings per share beginning in 2016. The reasons are obvious in the third quarter. As you saw in the earnings release last night, adjusted earnings per share increased 5% to $0.42. In comparison, operating adjusted earnings per share for the third quarter increased 9% to $0.47. And amortization expense, net of tax related to acquisitions is a sole reason for this difference.

Our guidance for 2015 has not changed from the last quarter. We continue to expect adjusted EBITDA of $635 million to $665 million. Capital expenditures of $134 million, cash taxes of $130 million to $135 million and cash interest on corporate debt of $61 million. This will result in free cash flow of $310 million to $335 million or $2.17 to $2.35 per share. Adjusted net income per share of $1.62 to $1.77 is expected for 2015. This assumes a fully diluted share count of $142.5 million shares.

You can find a copy of our earnings release, earnings supplement in Q3 2015 earnings slides and in 8K filed last night or on our Web site at www. karauctionservices.com.

That concludes my remarks and we'll now turn it back to Danny, our operator for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you sir. [Operator Instructions] And our first question comes from Ryan Brinkman from JPMorgan.

Ryan J. Brinkman
JPMorgan Securities LLC Q

Hi. Good morning. Thanks for taking my questions.

James P. Hallett
Chairman & Chief Executive Officer A

Good morning, Ryan.

Ryan J. Brinkman
JPMorgan Securities LLC Q

Hi. Maybe just firstly on the reiteration of the full-year guidance. I think that implies a fairly wide range in 4Q for adjusted EBITDA of $140 million to $170 million. Was the decision to not narrow the range just a reflection of the fact that you are on track with how you thought that the year would play out or are there some swing factors in 4Q that could cause EBITDA to be on the higher or lower end of the Spectrum? And if so, what are the most important of those factors?

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

Thanks, Ryan, for the question. And that's a good question. It's been our practice in our history since going public that we only adjust our guidance annually and only during the year if there is a material change to the guidance. And so it's again, with our practice we are not adjusting the range and it's because our expectations are still within the bottom and the top of the range that we described in January. But not a reflection on market conditions on a quarter-to-quarter basis.

Ryan J. Brinkman
JPMorgan Securities LLC Q

Okay. That's great to hear. Thanks. Then, I know you are in a position for what you just said to talk about 2016 more in the next quarter call. I'm just curious if you could talk about though the sustainability of some of the drivers that impacted 3Q? So for example the very strong volumes at ADESA for a lot of reason I think that will continue with what we know about the off lease market. But maybe comment on price net ADESA, used car prices have really defied expectations to fall much. Is that sustainable going forward? And then on the IAA side, people are driving more lower gas prices that should help volumes, but then maybe you don't have next year, the type of market share gains they had this year, I don't know?

And then on the pricing side there, if you just sort straight line that the metal prices are – you expect them to straight line, I'm not sure. What does that imply for IAA pricing going forward?

James P. Hallett
Chairman & Chief Executive Officer A

Okay, Ryan. I'll try and remember everything you said.

Ryan J. Brinkman
JPMorgan Securities LLC

Q

Volumes and price for both divisions, yes.

James P. Hallett
Chairman & Chief Executive Officer

A

Yes, right. Okay. So, with the volumes in the whole car business obviously I outlined in my commentary, we've very good visibility. And again, I'll just remind you of those things is, number one, the leases, we know the leases that were written, we have very good insight especially through our OPENLANE relationships and then just our physical auction relationships, we have very good insight to what's coming on leases. I've mentioned to you the opportunity for repossessions. We expect that repossession segment will continue to grow. Then I had mentioned that the program cars and the rental cars. We're going to see those cars come back in a much larger volume.

As you know, there was a trend four, five years ago for these rental car companies to take more of these cars on a risk basis and sell them on their own. Now that trend is kind of reversing itself with a few exceptions and the rental car companies are back to the program cars. So, we're going to see more and more of those program coming -- cars coming back to the market.

Then I spoke about the dealer consignment. I'll tell you, I can speak for Eric and myself, we continued to be amazed with the performance of our dealer consignment business. This quarter alone, dealer consignment represent a 52% of our business. And for that number to stay up at 52% with the amount of commercial vehicles that we see coming through is beyond our expectation, quite frankly, we expect that number to drop down a little bit.

So, again, very good picture at ADESA. Volumes look good; our online business continues to perform very well in that private label space. The other thing that I see and we can talk about is, I see more of our vehicles getting sold in the open online, which is a real opportunity for us and as you know probably the economics really increased when those vehicles make it through the open online space. So ADESA -- and in terms of prices, I don't believe that there's any price so much from the seller side of the equation, but there is price opportunity on the buyer side of the equation.

And then when you think about Insurance Auto Auctions, I think that we're going to continue to deal with scrap prices here for some time, I think we're going to continue to deal with foreign currency for some time. And I think what you're going to see there is, you're going to see I would say, pretty moderate -- level to moderate growth there. And within the AFC business, I think I said it already, but the AFC business is competing very, very well. And there's been pressure there, there's been competitive pressure. But I think our decision at AFC to continue to operate these 106 or 109 loan production offices that we have in the field, services our dealers very, very well and puts us in a very strong competitive position where we really do have a strong value proposition.

So overall, do I sound a little optimistic? Yes, I'm very optimistic. This is -- as I continue to say, this is as good as our businesses have performed collectively on a consolidated basis since we came together in 2007.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And Ryan let me add just a little more commentary. The scrap prices, the Canadian dollar, all took ahead in the first quarter of 2015. As we go into 2016, we will not have the difficult comparisons that we've had all year this year on those two factors. That doesn't mean there is going to be relief, but on year-over-year basis, you won't see the same impact because I'm not saying we're at the bottom and we were at the bottom the whole year, but clearly a majority of the pressure that's been on our comparisons has been felt all this year. And I don't know that it will get significantly worse.

Ryan J. Brinkman
JPMorgan Securities LLC

Q

Okay, that was super helpful. Thanks a lot, guys.

James P. Hallett
Chairman & Chief Executive Officer

A

Thank you, Ryan.

Operator: And our next question is from Matthew Fassler from Goldman Sachs.

James P. Hallett
Chairman & Chief Executive Officer

A

Hi, Matthew.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Thanks a lot. Hey, how are you? Thank you and good morning. I'd like to dig a little deeper into the profitability of the salvage business. I think you shared the impact of the acquisition, you also shared the impact of purchase contracts. And even with that, I guess the margin came down a little bit and we are seeing a bit of a tougher -- a bit of softer moment for profitability of that business. So can you share with us, would have anything will change from Q2 to Q3? And whether you think X the impact of HBC, you can stabilize the EBITDA margin in salvage?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Sure, Matt. This is Eric, and good morning. One thing you're seeing is a typical seasonal impact, Q2 is the strongest quarter volume wise and the salvage industry, I mean it's just -- you've got all the winter accidents that are being sold through the spring and into the early summer. So there is a seasonal impact. And then, we can't fight -- as Jim mentioned, the headwinds that are created by lower procedure or lower average auction values paid for the vehicles. And while we can put in minor price increases over time and have responded that way, we cannot offset all of that. And then the scrap values have steadily dropped and have hit a very low point, down -- in fact, we're already down to about a $120 per ton for crushed car body. So, it continues to -- Jim gave a number that was $124, this month it's dropped another few dollars, it's not meaningful, but still a bottom is there. So that's what we're fighting.

Again, volume, seasonal volumes will help as we move forward. And, but more importantly it's still going to have the headwinds, that Jim mentioned, the foreign currency on the international buyer and scrap metal on all the buyers.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Got it. And just from a margin rate perspective, because once again HPC is very transparent and the purchased car case is very transparent. Does the price compression on -- just associated with what's happening in the broader auction pricing market, and of course related to scrap, does that take down margin rate as well as ASP, which by the way wasn't all that bad. This quarter you held your revenue per car year-on-year, that growth rate down 3% was consistent, so that seems to have hit a stable point?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes, but that down 3% in a quarter where you have lighter volume, is going to have less leverage off of the infrastructure, which is a direct expense. So it's a gross margin impact, not an SG&A impact. And then these purchased vehicles, they really hurt more than it looks here, because an HPC is 90% purchased vehicles and it's in those numbers. And when your margins spin out on that, it takes that gross margin down to low single-digit in some cases and that has a big impact.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

It does look like your backlog in that business is extremely strong. Can you frame for us how you feel about that relatively to perhaps you felt about entering the third quarter?

James P. Hallett
Chairman & Chief Executive Officer

A

In terms of inventory?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Inventory, yes.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Yes. The inventory that you currently hold in the salvage business?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. No, the inventory I think is very strong and as we go into the next quarter, we're going in with increased inventory. And again I think it's result of this volume growth that we're experiencing.

Matthew Jeremy Fassler
Goldman Sachs & Co.

Q

Great, and then very briefly. I'm sorry.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And Matt, that would be a positive because, usually the summer months, are where you worked that inventory down, because of lower volumes, and the truth is, that the cars entered are exceeding the cars being sold, because of that strong activity Jim mentioned. Miles driven more accidents, technology causing more total losses.

James P. Hallett
Chairman & Chief Executive Officer
A

And again Matt, you probably get tired of me saying it, but at the end of the day, I don't think there is anything more important than our business model at IAA, where we offer every car, physical, as well as online, and it think we've demonstrated quarter-in, quarter-out, year-over-year that the hybrid methodology does provide increased returns for our insurance providers and I think it's showing up in these volumes and I think that's why as you look at the volumes at IAA, they're outperforming the market.

Matthew Jeremy Fassler
Goldman Sachs & Co.
Q

Great. Thank you so much guys, I appreciate it.

James P. Hallett
Chairman & Chief Executive Officer
A

Thank you.

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

Thank you.

Operator: And following from Bank of America Merrill Lynch, we have Elizabeth Suzuki. Please go ahead.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch
Q

Good morning. Could you talk about the conversion rate for ADESA this quarter, because it looks like it was up nicely compared to 3Q, 2014. Could you talk about, what was driving that improvement or if it was just an easy comp?

James P. Hallett
Chairman & Chief Executive Officer
A

Yes, I think that, primarily it's driven by the increase in volume of commercial vehicles. As you know, or as you may know, when you think about commercial vehicles, commercial vehicles tend to have a much higher conversion rate than the dealer consignment segment. And I think the overall conversion rate would have been up, because of increase of those off-lease cars, repossessions, dealer/own cars, factory cars, program cars, the things we talk about outside of dealer consignment.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch
Q

Okay. So we can probably think about that conversion rate is being relatively strong going forward, given the mix of commercial?

James P. Hallett
Chairman & Chief Executive Officer
A

Yes, I believe that these commercial cars keep coming. I would look for that conversion rate to your point to remain strong.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

But Liz, I would highlight, there is a seasonality to our fourth quarter prices, definitely stronger as you get into the first of the year and second quarter -- first and second quarter next year that would be the seasonal impact. Fourth quarter, I'm kind of expecting a strong conversion rate, but it can go either way, right, Jim? As you've been in the business a long time.

James P. Hallett
Chairman & Chief Executive Officer

A

Yes, there is a lot of factors that come into play in the fourth quarter. We'll start dealing with some weather here and we'll start dealing with some other elements that could cause business to possibly slow in the fourth quarter, it's a little bit more unpredictable.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Okay. Great. And just one more which is, at IAA and AFC, your EBITDA margins have been coming under some pressure despite very strong volumes. Could you just talk about specific cost headwinds that are likely to continue? Or what if anything you can do to lower cost of services in a weaker pricing environment?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Well, let's start with Insurance Auto Auctions Liz. First, we've talked in previous calls about the service levels being required by the insurance companies. And that does have the impact of more direct cost for towing, having to move the cars around faster, try to get them through the auction and incur a little bit more labor. I don't know that that's disruptive to us, but that's a pressure when you combine that with lower average auction prices, which comes through the buy fee. I mean, the seller is not really impacted. They're paying a fixed fee, but the buy fee has being directly impacted contributing. And then last, the mix, it's really interesting even though we had 6% purchased vehicles a year-ago and 7% this year, when you dig into that, that 6% last year had a much higher sale price with more margin in it, than this year, while, the price went down, which has put pressure on revenue believe or not, the margins all but disappeared because of scrap prices, because a large number of the purchase vehicles are the very low-end vehicles. So, Jim, do you have anything to add on insurance Auto Auctions?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. Maybe I could just add that, the management team at IAA is very focused on continuing to expand its opportunities working with expanding the buyer base and expanding some of the services that we were providing to the insurance companies. One of the areas that we're really focused on right now is the total loss solution, that we are working with the insurance companies that can really accelerate the turn times that it takes for a vehicle to come in and make its way back to the marketplace.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And now, going to AFC is the next unit you asked about Liz. AFC, its two things. It's -- and it's hard to say, which is greater, then let just call them both impacts. First is competitive pressure causing us to look at our pricing structure on certain deals, and it maybe we don't even lower the fee, but that fee maybe covering a 45-day period of a loan rather than 30 days. And if they go 45 days, we don't get a curtailment which is a very profitable part of the transaction a very, high revenue per loan transaction.

And second, the mix is changing slightly, but PWI expanding, rolling out into new markets, you get the revenue and actually the profitability in that business, historically and will continue to lags a little bit, as you season the service warranty claims. So, and it's a lower margin business, we gave some details on that in the supplement, but you're going to find that business is going to be a mid-teens to maybe 20% margin business and -- as a percent of total revenue that goes up a little bit, it puts a little pressure on the incremental margins there.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Thanks. That's very helpful.

James P. Hallett
Chairman & Chief Executive Officer

A

Good. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Thanks.

Operator: And next, we'll take Ali Faghri from Sterne Agee CTR (sic) [CRT] [38:14]

Ali-Ahmad Faghri
Sterne Agee CRT

Q

Yes, this is Ali Faghri from Sterne Agee CRT. Thanks for taking my question. Just a quick question on capital allocation. In your prepared remarks, you sounded a lot more confident and direct about capital allocation in terms of deploying capital and increasing your leverage target in early 2016, what's driving that confidence?

James P. Hallett
Chairman & Chief Executive Officer

A

I am very optimistic and I am very committed to getting capital deployed here. I think, I shared with you that, we have assessed what fits and what doesn't fit. We've developed a strategy on these targets. We are well down the road and our conversations with a number of these targets and I feel that we will get some of these targets over the finished line in early 2016. And we know that, our investors are very interested in how we're deploying capital and how we return value. And I think, it's been a major focus not only of Eric and myself, but of the entire senior management team is to how we continue to do that. And without being able to give you any specifics, I can just tell you, we all have full time work.

Ali-Ahmad Faghri
Sterne Agee CRT

Q

Great. Thank you. And just one quick follow-up. Is there any way you can outline what the fourth quarter acquisition contributions are going to be?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Ali, that's -- we'll report it as it comes in. We've said where the integration is going to take about a year. So in terms of achieving some targets we set out in the earnings supplement of last quarter, those were for 2016, not expected to be hitting in the fourth quarter of 2015.

Ali-Ahmad Faghri
Sterne Agee CRT
Q

Okay, great. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

You're very welcome.

Operator: And following, we have Gary Prestopino from Barrington Research.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Hi, good morning.

James P. Hallett
Chairman & Chief Executive Officer
A

Hi, Gary.

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

Hi, Gary.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Eric, why was your interest expense up 20% year-over-year? Could you give us some detail on that?

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

Yes. You're looking at corporate interest expense on the P&L, Gary. That includes...

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Right.

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

...the interest on the AFC securitization...

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Right.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

...which has a significant increase year-over-year, the portfolio is up over 20%, I think on a year-over-year basis. I don't have that number right in front of me, but it's a very significant increase. And secondly, while there is no change in the spread on that information, part of the reason that's up as we reported again in the previous quarter, we increased our advance rate. So in other words, part of it is, we're using a securitization more, yes, 31% of the securitization is up year-over-year, so it's a big number. So, that's what's driving it. We have not seen increases on the corporate interest and we've not had changes in our corporate debt. So, it's all being driven by AFC.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

So is that...

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And as you know, that gets adjusted in the adjusted EBITDA calculation in the AFC business, that is taken out of our contract [ph] [41:27] revenue for purposes of adjusted EBITDA in our calculations.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Right. I know that. Okay. And then in terms of Insurance Auto, could you maybe size the percentage of vehicles or your percentage of revenue that is being impacted by strength in the dollar?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. That's a difficult calculation. Eric, do you want to speak to that?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Well, [indiscernible] (41:57) issue because it's one of those things where somebody is going to buy the car and the domestic buyer might be impacted by scrap metal prices and the foreign buyer buy foreign currency because they're going to use the car differently, but neither one of them is bidding more.

James P. Hallett
Chairman & Chief Executive Officer

A

Right.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

So, I would say that we're wanting to be other and splitting hairs and differentiating will be very difficult. On top of that, each buyer is going to have a unique perspective on the value of the car. I mean bottom line, those two factors are both contributing to the value of the car going down because the economic transaction has lost value in U.S. dollars for whoever is buying the car.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Right. And so, I guess some of these guys have agents too here in the United States and they're paying in dollars, but it's hard to get...

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

Well, yes, but again, paying that agents is the same as paying us. They have less local -- they have the same local currency and less U.S. dollars as Jim mentioned.

James P. Hallett
Chairman & Chief Executive Officer
A

At some point in time, Gary, it all reverts back to their local currency.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Yes, right. Okay. And then in terms of, Jim, you talked about expanding the buyer base for ADESA, you're focused on that. At a high level, could you give us an idea of how you do that? I mean, I would assume that everybody who knows, it's an oligopoly, everybody knows you're out there selling cars, so how do you get more buyers through the door?

James P. Hallett
Chairman & Chief Executive Officer
A

I think couple of things, Gary, and we've talked a little bit about this in the past. Number one is, we've publicly stated that we're interested in acquiring additional physical auctions. And we've done an acquisition that we've talked about in Pittsburg where they announced that we're opening a new greenfield site in Chicago in mid-2016, and we've said that we will continue to pursue brick and mortar auctions.

By adding these brick and mortar auctions, there is no question as you go into a new market, you pick up new buyers and not only do you pick up new buyers for the physical auction, but there is a direct correlation with online buyers as to where you have the physical presence.

So, we believe that we -- through these physical auctions we get both the -- pick up the physical buyer and the online buyer, and then, the other areas that we can expand the buyer base -- the two other areas really is number one is, we can enhance our technology, enhance some of the technology in offerings that we've added, won the products that we have added recently, as we've added Autonic, which is a service that we've again added that the dealers are very much appreciating one. It's a -- it gives them real time pricing on vehicles while they're in the lane buying vehicles. Those kinds of technologies will certainly help build the buyer base as they tap into your technologies.

And then, the other area that we've been focused on recently is, we've really been focused on best venue where we've taken an opportunity to take a look at our buyers at IAA, take a look at our buyers at ADESA and where they overlap and is there an opportunity to get more the buyers from each of those segments buying in the other segment and we've absolutely proved that there is an opportunity to bring buyers from one segment to the other.

So, that's another way that we've been able to grow our buyer base. So hopefully that gives you some indication what we were doing.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Yes. That's great. Thank you. And then beyond that just quickly, are you seeing anything beyond normal seasonality in pricing at auction?

James P. Hallett
Chairman & Chief Executive Officer
A

For the most part I would say no. You get adjustments from time-to-time, but for the most part I would say, it's pretty stable. And I think I read an article yesterday again, if you complete everything you read, I read an article yesterday that's saying that, they're expecting used car sales to be up in 2016 as well. And that's also with the prediction that they're going to have a SAAR of 17.4 million new cars. So again, it looks like a very good picture as we look forward.

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

Yes. And if you read [indiscernible] (46:13) commentary, our economist, he puts out a monthly report that gives you surprising information. It's remained amazingly strong with the supply increasing and that's been a pleasant surprise for everybody in the industry.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Yes. Thank you very much.

James P. Hallett
Chairman & Chief Executive Officer
A

You're very welcome.

Operator: Our next question is from Bob Labick from CJS Securities. Please go ahead sir.

James P. Hallett
Chairman & Chief Executive Officer
A

Hi Bob.

Robert Majek
CJS Securities, Inc.
Q

Good morning. Good morning. This is actually Robert Majek filling in for Bob.

A

You know you sound like Bob.

Robert Majek
CJS Securities, Inc.
Q

Volumes remained pretty strong, are the opportunities to get more leverage out of SG&A, as you integrate some of the acquisitions?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Robert, that's a good question. Yes, and as we announced again last quarter, as we integrate that we do expect to improve the profitability from the current levels. I had mentioned last quarter, these acquisitions that were done to date and they were not added this quarter would add $5 million to $10 million of adjusted EBITDA. And obviously, we're in that range with how we're performing on a quarterly basis, and we expect that to grow to $20 million to $25 million once integrated into our businesses. And so, you see some of that will come out of leverage of the SG&A, and those are all numbers we talked about last quarter.

Robert Majek
CJS Securities, Inc.

Q

Great, thanks. And with the full quarter under your belt from the HBC acquisition, what's your overall impression of the acquisition in the U.K. market?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. Robert, I'm glad you asked. As a matter of fact, I have just been in the U.K. here within the last 30 days and I have an opportunity to personally visit with our office in HBC and meet with the management team as well as meet with the employees.

And I can tell you that these commodity prices are having a stronger impact, more negative impact on our U.K. operations then they're here in North America. As you know, and I think previously mentioned or stated on the call about 90% of our vehicles with HBC are purchased vehicles. So, the impact is being felt heavier, but the good news is I was very pleased while I was there. The management team had prepared for my arrival and they had actually outlined the strategy of how they plan on shifting the business model both for the seller and the buyer in terms of the pricing and they've actually made a shift in that respect and I think they've got us in a good position going forward, and I think we'll be pleased with the outcome as we head into 2016. But there has been no question in terms of our timing on acquiring that business and scrap metal prices being what they were. We got off to a difficult start.

Robert Majek
CJS Securities, Inc.

Q

I appreciate it. Thanks a lot.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: And following from Credit Suisse, we have Shreyas Patil. Please go ahead.

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

Q

Thanks, guys. I just had a couple of questions maybe around the acquisitions at ADESA. Could you maybe just give us a sense of what the impact unit sold was from the acquisitions and is the revenue per unit similar to sort of your core ADESA business?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Shreyas this is Eric. The volume, it accounts for, I am looking it up here, ex-acquisition was about 2% less. So, it contributed about 2% year-over-year on the quarter, obviously, it was zero last year and that's from the Pittsburg auction. The other businesses we acquired don't contribute volume, they're services around the auction process. And does that answer that question, you'll have to calculate what you think that number is, we don't disclose specific volumes.

In terms of profitability, as you won't be surprised, I find in all of our acquisition, the profitability prior to integration tends to be a little bit lower than our core business. Not materially different, but tends to be a little bit lower, as we put in our pride processes as we call them, and another things we do it in auction. As we integrate our technology acquisitions into the technology footprint that we have as a company as a whole and leverage their skills is actually not reducing it, it's leveraging their skills over a broader technology need of the organization then integrating that I do think there is opportunities to increase the profitability once fully integrated. And again, I'll remind you of what I said last quarter, because I am not giving new information that's how you get something that contributes $5 million to $10 million this year to $20 million to $25 million once integrated and we get a full-year results.

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

Q

Okay.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And none of that was coming from beyond normal growth of the top line revenue, it was really how that business should run. Within ADESA we bring new customers that would be on top of those numbers.

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

Q

Okay. So, basically net-net like that kind of -- if you're doing sort of a 15% EBITDA margin this quarter that should eventually go up towards where ADESA is typically performing, let's say 25% in that range?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Right. That would be true. And again you get -- we don't call it all out, but there is integration cost and there is more cost actually we add to it before we take it out as we're trying to integrate the business.

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

Q

Okay. And then just lastly on -- you guys have mentioned that rental units were up in the quarter. I was just wondering if any of that was tied to GM in particular, because they have been pushing relatively higher number of units so far this year just due to timing of the recalls.

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. We're not going to speak to specific customers, but I can tell you, as you look at the segment overall across the board, this segment is up. And that would include probably all the constituents that you could name with may be -- with the exception of the few.

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

Q

Okay. And if I can just squeeze one more in. I just -- about 50% of your volume in IAA was transacted online. I just wondered if you could remind us what the kind of ARPU differential is between online and physical at IAA? I mean we know what it is at ADESA, is it similar or is it a little different?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

There would be no meaningful difference. I mean you might get into online, are they buying a higher value car or lower value car, I can't answer that. It would -- it might tend to be even in some cases they are a lower value car. But in terms of the pricing structure, the only difference is there is an internet fee if you buy online that you can avoid in our business, because we do offer the opportunity to buy live at the physical auction, you would avoid that fee where the rest of the market may not have that differentiation.

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

Q

Okay. Got it. Thanks a lot.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: [Operator Instructions] We'll take our next question from Bret Jordan from Jefferies.

Bret Jordan
Jefferies LLC

Q

Hey good morning, guys.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Good morning.

James P. Hallett
Chairman & Chief Executive Officer

A

Hey, Bret. Hi, Bret.

Bret Jordan
Jefferies LLC

Q

I have a question on TradeRev, you are talking about maybe accelerating some investment or reallocating some resources into that program. Is that something that is going to be an increased investment or just, you're bringing folks in from other parts of the organization. I guess is it impactful on EPS next year?

James P. Hallett
Chairman & Chief Executive Officer

A

Your first question -- is that, we're utilizing internal resources and we're also...

Bret Jordan
Jefferies LLC

Q

Yes, I guess, are you bringing in incremental resources or just reallocating internal, is it going to ...?

James P. Hallett
Chairman & Chief Executive Officer

A

And we're definitely recruiting some additional talent into the organization that we think can specifically add value to rolling out TradeRev. In terms of anything meaningful in the next year I think you asked, I would say, I would not expect anything meaningful in 2016.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And Bret, let me add, those resources are being added to the company that owns TradeRev of which we own 50%. It does not hit our P&L as anything other than our interest in a minority-own subsidiary. So it's below the line per se.

Bret Jordan
Jefferies LLC

Q

Okay, great.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And it's not going to be material.

Bret Jordan
Jefferies LLC

Q

Right. And then a question sort of big picture on crushed car bodies. Do you have a longer terms of inflation adjusted in a range that that's been in, so we can get a feeling for how close to the bottom we might be?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

I don't have any in front of me, Bret. But I can tell you the bottom would have -- the last bottom we had I recall was following the 2008 Olympics when China discontinued buying crushed car bodies in the United States pretty much and it probably got below the current levels. My recollection is, it's bottomed out below a 100 at some point. But generally speaking, I don't know what the bottom is, but we're in the range of the bottom now.

Bret Jordan
Jefferies LLC

Q

All right, great. Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

At some point, it doesn't have as big an impact on us anymore, because they're at the minimum bid and that's the key. The bigger impact is, when you move from Jim's numbers of 312 to even 198 and then 198 to 124, those were big shifts, because they were affecting minimum bid, they were still taking away some of our ARPU.

Bret Jordan
Jefferies LLC

Q

Yes. Great, thank you.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: And we'll take our next question from Bill Armstrong from C.L. King and Associates. Please go ahead sir.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning Bill.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Good morning Bill.

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

Q

Good morning, Jim and Eric. Just a couple of question on SG&A. With the Insurance Auto Auctions, your telecom costs were up about $1 million and that's actually been the case for the last three quarters. What's -- why they're up so much and kind of what should we look forgoing forward on that?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Well, I don't want to get technical; Bill, but I can answer the question. The telecom costs are going up, because we're upgrading the networks and the accessibility. When you run a live and live online auction, the important part of telecom is that's your network that ties directly into your network access. And again, I don't want to get too specific, but we've been upgrading the infrastructure throughout all of our businesses, then it just happens to be one of the larger differences that we're using because we explain everything over a certain dollar amount and that's one of them. But it's really the updating of the infrastructure at all of the auctions and it's part of our normal process, and with that, the cost has been going up.

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

Q

Got it. Okay. And then on the holding company, looks like SG&A is about $25 million per quarter, is that a good run rate to use going forward?

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

Well, you're probably excluding D&A when you're at that number because it's actually not...

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

Yes, yes, excluding the D&A.

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

It's about 28, yes. Well, again, I don't want to get too forward-looking on that, but I'm not seeing any significant changes at this point in time. Although technology is the biggest component of that and as we look at our business investing in technology, some of that could get in the holding company and the benefit we drive in the business segment because most of our technology spend is in the holding company where the benefit of that in revenue ends up in the business segments. But, Bill, I don't want to get into specific guidance on that number, but I think it's a good number for now unless we -- and we'll tell you if we're going to make major shifts, I don't see that happening.

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

Okay. And just one last question on HBC, about 90% is purchased vehicles. Is there an opportunity to start to shift the model more towards an agency model in the U.K. as you go forward, I know [indiscernible] (58:34) had some success doing that, but not completely. But what's the outlook there, what's your view on trying to move that mix more towards an agency model?

James P. Hallett
Chairman & Chief Executive Officer
A

Bill, I would tell you at this point in time, we have no plans to try and change that model. I think one thing that we've learned from our international relationships is, people very much appreciate allowing the local culture to kind of manage the local culture and not have people from the U.S. and North America come over and tell them how their business model should work. And at this point in time, we have no plans on changing or disrupting that model.

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

Okay. I understood. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

You're welcome.

Operator: Ladies and gentlemen, at this time we have -- are done with our Q&A session. I'd like to turn the call back over to Jim Hallett, for any closing or additional remarks.

James P. Hallett

Chairman & Chief Executive Officer

Good Danny. With that ladies and gentlemen, I just want to say, thank you again, thank you for your interest in our company. And I can just recap by saying we feel very, very, very good about the company and very good about how the company is performing. I won't go through the list again, but there is a long list of bright spots and opportunities in this company. We're never without some challenges and a few headwinds that we spoke about, but we really like the visibility we have, we like the picture that's in front of us, and now it's up to us to go out and execute and deliver that value.

So with that, we look forward to a great fourth quarter and reporting year-end results. And I thank you for your time for being on the call this morning. Thank you.

Operator: Ladies and gentlemen, that does conclude today's presentation and we appreciate everyone's participation.