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# KAR Auction Services, Inc. (KAR)

Q1 2016 Earnings Call

# CORPORATE PARTICIPANTS

Michael Eliason
*Vice President of Investor Relations and Treasurer*

James P. Hallett
*Chairman & Chief Executive Officer*

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

# OTHER PARTICIPANTS

Ryan Brinkman
*JPMorgan Securities LLC*

Matthew J. Fassler
*Goldman Sachs & Co.*

Gary Frank Prestopino
*Barrington Research Associates, Inc.*

Anthony F. Cristello
*BB&T Capital Markets*

Craig R. Kennison
*Robert W. Baird & Co., Inc. (Broker)*

Ali Faghri
*CRT Capital Group LLC*

Bret Jordan
*Jefferies LLC*

Benjamin Bienvenu
*Stephens, Inc.*

Robert Labick
*CJS Securities, Inc.*

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

# MANAGEMENT DISCUSSION SECTION

**Operator**: Good day and welcome to the KAR Auction Services Q1 2016 Earnings Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Mike Eliason. Please go ahead, sir.

Michael Eliason
*Vice President of Investor Relations and Treasurer*

Thanks, Tony. Good morning and thank you for joining us today for the KAR Auction Services first quarter 2016 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended March 31, 2016. After concluding our commentary, we will take questions from participants.

Before Jim kicks off our discussion, I'd 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 measure 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, Michael, and good morning, ladies and gentlemen, and welcome to our call. Today, I'd like to provide you with an outlook for the year, review our first quarter performance, and then discuss our capital allocation activities, including our expectations for the remainder of 2016.

We had a very strong first quarter and what we're seeing has caused us to update our guidance after only one quarter. We entered 2016 with a very positive view on our expected performance, and we're pleased that we have already exceeded our expectations. We continue to see very positive fundamentals that will continue through the remainder of the year. Retail new and used car activity continued to be relatively strong. And the industry supply of commercial vehicles, especially the off-lease and the repossession units, will continue to grow throughout 2016. Used car values are declining at a moderate pace.

So what does all this mean for KAR? At ADESA, we expect that we will exceed the volumes through 2016 over last year. Online-only is likely to grow at a greater pace than the physical auction volumes even not at same level as we saw in the first quarter. And the increased supply of off-lease and repo volumes should continue to support the increased volumes at physical auction. We believe the strong revenue per unit or the ARPU will continue as we see our consigners spending money on the vehicles to improve the condition, so the buyer can quickly retail the car. This is also important for maximizing the residual lease returns as well.

We do face some headwinds, especially at Insurance Auto Auctions. We continue to deal with currency and scrap prices. However, these headwinds are consistent with the expectations that we set during our guidance earlier in 2016.

The net of all of this is that we are increasing our guidance of adjusted EBITDA. We expect adjusted EBITDA of $735 million to $760 million. This will include approximately $25 million from the Brasher acquisition. And our free cash flow guidance remains the same as before. The improved operating performance is offset by an increase in cash interest expense, and free cash flow is expected to be approximately $340 million to $365 million for 2016. I will let Eric cover more details of the refinancing which drove our increase in cash interest expense for the year. All in all, our outlook for 2016 remains positive and the year is shaping up to be better than what we originally expected.

Now, let me highlight our strong first quarter performance. On a consolidated basis, we've seen our revenue grow 18% over last year; adjusted EBITDA is up 17%; and our operating adjusted EPS is up 17%. And obviously, this is a great way for us to start 2016. ADESA is driving our strong performance during the first quarter where we're seeing revenue up 22% over the prior year and 17% on a same-store basis. Volumes grew in online-only as well as at the physical auction. Our online-only was up 33%. Our physical auction volume was up 12%. And I'm very pleased to report that this also includes a 10% increase in our dealer consignment volumes year-over-year.

ARPU was up in both channels as well. Online-only ARPU was up $9 to $116 per unit. And physical auction ARPU was up $56 to $737 per unit. We're seeing strong revenue growth from transportation services and repossession-related activity. As well, we're seeing an increase in utilization of ancillary services such as reconditioning and mechanical. ADESA's adjusted EBITDA grew 35% over the prior year, 31% on a same-store basis.

And AFC is also benefiting from the strong wholesale used car activity. Revenue grew on a 10% increase in loan transactions. Average loan values are increasing, and we did see more bad debt in the first quarter than last year. The increase in bad debt expense was right in line with our expectation for the first quarter. And I think it's important to point out that the portfolio has grown 26% over the past year.

As mentioned earlier, Insurance Auto Auctions continued to face challenges in proceeds. Scrap and foreign currency negatively impact the amount bid on salvage vehicles. However, the volume is more than offsetting this pressure. And our ability to withstand these challenges demonstrates the value of our diversified business model. And this is really what Eric and I had been talking to you about for several years is really the strength of our business and the strength of our business model is how complementary these businesses are to one another, and it's really, as I say, a beautiful thing.

So, the pressure that we're seeing at IAA is offset by the strong performance in the other parts of our business. Inventory is up 4% over the prior year at March 31. This is a lower increase than we have reported for many quarters, and I believe there's a couple of things here that I would mention. Number one, I think it reflects on the mild winter conditions. And the other point I would make is we're seeing improved cycle times, especially with one of our largest insurance companies. And as you know, these improved cycle times benefit our consigners. As they say, time is money.

With that said, despite our strong performance, I know that we need to continue focusing on SG&A. And going back to the call in the previous quarter, I mentioned that we were getting laser-focused on SG&A. We've seen SG&A was up almost $20 million over the prior year, about $10 million of this increase relates to acquired SG&A and the timing of expenses for cost of our medical plan and accruals for annual bonuses. The rest of this increase relates to increases in our technology cost, people and other expenses required to support the growth in our businesses. Our management team is focused on controlling SG&A. We also realized that we need to support the growth in our businesses with the resources, so this is really a balancing act. The key is maintaining SG&A at a level that allows us to increase our adjusted EBITDA margin.

In terms of capital allocation, I think everybody is aware that we closed the Brasher's deal on April 1. This is a deal that we paid $275 million for eight auction locations. We are very excited about adding the Brasher family to the ADESA organization. This truly represents or I should say, this truly strengthens our presence in the Northwest United States where we were previously unrepresented. So with that, we have also announced plans to purchase an auction in Orlando, Florida. We have been focused on strengthening our presence in the key Florida markets. And as you probably know, Orlando is a very strong commercial market and we expect to close this transaction in the next few weeks.

We also announced the payment of our quarterly dividend at $0.29 per share, and we will continue to return capital to our shareholders in the form of a quarterly dividend. We will also evaluate all of our capital needs and utilize share repurchases as we see appropriate. I don't believe that we are done allocating capital to expanding our businesses. We are in active discussions with a number of targets, and at the right price, if these deals can make sense to us, we would certainly look to move forward on doing more acquisitions. There is no assurance that we will get any of them to the finish line in the near-term, but I do like the way our discussions are progressing. And with that, let me finish up my comments with an update on ADESA Chicago.

Construction is on target for opening in the third quarter. The customer reaction has been very, very positive. And I would say to you, as I mentioned before, Chicago is the third or fourth largest car market in the United States. We're moving into a major market that's been a big gap for us at what I would call a real opportune time as we are in the middle of the cyclical recovery. I couldn't think of a better time to be opening this location in Chicago. So, we're excited with that.

So, I'll now turn the call over to Eric for some additional comments, and then we'll come back to you for Q&A. Eric?

## Eric M. Loughmiller

*Chief Financial Officer & Executive Vice President*

Thank you, Jim. I would like to start my comments with a summary of our refinancing of long-term debt that was completed in March. On March 9, 2016, we completed the refinancing of our term loan B1 and revolving credit agreement. We issued $1.350 billion in term loan B3 at an interest rate of LIBOR plus 350 basis points, with a LIBOR floor of 75 basis points. Term loan B3 matures in March 2023. We also established a $300 million revolving credit facility with interest at LIBOR plus 250 basis points that matures in March 2021. The proceeds of term loan B3 were used to repay the outstanding balance on term loan B1 and amounts outstanding on our old revolving credit facility.

In addition, funds from this financing were used for the purchase of Brasher's auctions for $275 million that closed on April 1. As a result of the issuance of term loan B3, we repriced the outstanding debt on term loan B2 to LIBOR plus 318.75 basis points from LIBOR plus 275 basis points. Both the old and new interest rates have a LIBOR floor of 75 basis points.

Term loan B2 has a maturity date of March 2021. As a result of this refinancing activity, we have updated our guidance on cash interest expense for 2016 to approximately $95 million from $85 million. In addition, we wrote off $4 million in unamortized debt issuance costs in the first quarter. We have capitalized original issue discount and debt issuance costs incurred in the refinancing, and this will increase our non-cash interest expense going forward, which I have reflected in our updated guidance.

Now, I would like to clarify a couple of items impacting our financial results for the first quarter. I will start with ADESA. As you saw in our earnings slides released last night, we have provided detail on the incremental operating profit margin for ADESA. The difference between adjusted EBITDA for acquisitions in the last 12 months of $3.1 million, and operating profit of $1.7 million, as disclosed in the earnings slides, is depreciation and amortization of $1.4 million. Excluding acquisitions, incremental margins for ADESA in the first quarter were 42.4% on an adjusted EBITDA basis. This is computed as the increase in adjusted EBITDA excluding acquisitions, divided by the increase in revenue excluding acquisitions for the quarter.

In the online-only channel, we have enhanced our disclosures after seeing the growing impact of the ADESA Assurance Program. The ADESA Assurance Program allows any vehicle purchased in the online-only open venue to be returned within 30 days, no questions asked. We have a very small number of vehicles returned under this program, but we found the impact on ARPU to be more significant. Like purchased vehicles, upon resale of these cars online, we recognize the gross auction price as revenue instead of the net fees. Excluding cars sold after being returned under the ADESA Assurance Program, ARPU for the online-only vehicles increased to $110 per unit in the first quarter from $105 per unit in the prior year.

Now, let me speak to the impact of HBC, our UK salvage business on the Insurance Auto Auctions margins in the first quarter. Substantially all of the salvage vehicles sold by HBC are purchased vehicles. The impact of including HBC within our salvage segment is a reduction in the gross profit of 1.4%. At AFC, we experienced increased bad debt expense in the first quarter as compared to the prior year. $5.5 million of net bad debt expense, up from $3.5

million last year was in line with our expectations for the quarter and reflects a level of losses we would expect going forward. This level of bad debt is still at a run rate below 1.5% of average portfolio balance for the year.

We have projected capital expenditures for 2016 of $145 million. In the first quarter, we expended $36 million including $1.3 million for ADESA Chicago. As you may recall, we estimated approximately $19 million in capital expenditures will be incurred in 2016 for ADESA Chicago. We expect the pace of spend to increase as the weather improves and we are anticipating an opening in the third quarter of this year.

In terms of guidance other than adjusted EBITDA and free cash flow that Jim spoke to, I would like to highlight that our GAAP net income per share guidance has been reduced to $1.56 to $1.71. Operating adjusted net income per share guidance has been reduced to $2.03 to $2.18. These adjustments to our guidance reflect the impact of our refinancing, including non-cash interest expense, which is offset by the increase in our expectations for adjusted EBITDA for the year. We have seen recent improvement in the Canadian dollar versus the U.S. dollar, but this is still within the range of our expectations in our initial guidance. We have made no adjustments in our expectations related to changes in the Canadian dollar at this time.

I will now return the call to Tony, our operator, so we can handle your questions. Thank you.

# QUESTION AND ANSWER SECTION

**Operator**: Great. Thank you. [Operator Instructions] First, we'll move to Ryan Brinkman with JPMorgan. Please go ahead. Your line is open.

Ryan Brinkman
*JPMorgan Securities LLC*

Q

Hi. Good morning. Congrats on the quarter.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you, Ryan.

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

A

Thanks, Ryan.

Ryan Brinkman
*JPMorgan Securities LLC*

Q

So obviously ADESA was great from both a volume and ARPU perspective. There was expectation volume to track higher, maybe not quite as high as it did, but obviously it's been strong for a while. From my conversations, the ARPU was a big surprise though. Can you walk us through in a little bit greater detail about the headwinds and the tailwinds to ADESA ARPU? Maybe you can help us sort of gauge the magnitude of the impact to ARPU from, say, lower used car prices. And then we know that ARPU increases from ancillary services just as more fuel cars fall further down into the funnel. But is there also this, like, paradoxically this tailwind where the lower used car prices go, people want to do more ancillary services to preserve residuals? How to think about that?

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah, Ryan. I think you've got – first of all, what you got is you've got sellers wanting to maximize the resale price, getting the most money they can for the vehicle. And so, they're doing more and more work to achieve better results, financial results from the car. The second thing is they want to convert at a higher rate. They want to get more of these vehicles sold the first time through the auction. And the best way to assure that they can get these vehicles sold the first time through the auction is to do more work to them. And the third thing that many of these manufacturers are focused on is they're focused on residual values and keeping those residual values as high as they can, going forward with additional leasing.

So all in all, we are seeing increased utilization. And it's really a question of, how do I make my car stand taller? How do I separate my car from the pack and attract more buyers to my lane versus the lane beside me? So, it's a combination of all those things, I think, that has really driven the revenue here, and I think that the opportunity continues as we see more and more of these leased cars coming and more of these leased cars, and repossessed vehicles making their way to the physical auctions, we feel that there is opportunity to continue to grow those ancillary services. Eric?

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

A

And I'd add to that, the mix of vehicles is important. With more commercial vehicles, when you look at that denominator, it's more cars that are using these services than where there's a heavier dealer consignment. And this quarter, we're at 46.5% dealer consignment versus 53.5% commercial, which is a strong shift from that 50/50. And so, we're selling more transportation and it's profitable transportation because outbound transportation has profit, and we're seeing more activity on the repo side, bringing those cars in through our PAR and RDN businesses and things like that. So, all of that adds up to what Jim was summarizing there.

Ryan Brinkman
*JPMorgan Securities LLC*

Q

Okay, great. That's helpful. And then, to just kind of follow up on the ADESA volume side then. With the big increase, have you started to think about when growth is inevitably going to kind of normalize lower? If we look at the year-over-year increases in lease originations, it looks like the peak increase was in 2013. Is that what you see? And then, I know you don't guide to 2017 obviously, but off lease – and it's going to grow clearly through 2019, but is it also fair to say that it peaks this year? And then, just on a related note, so the potential for modest increase is kind of beyond 2019, not like we're seeing now, but it looks like lease penetration has gone from, like, 30% at the start of 2016 to 34%, 35% now. What do you think is driving that and do you care to guess how high it could potentially go?

James P. Hallett
*Chairman & Chief Executive Officer*

A

Well, I'll start with your leasing question. On the leasing part, I think, it comes back to the fact that people can afford half a car, more than they can the full car, and leasing is really being able to drive a new car and your payment – and it's really matching your payment. So there's just more of an attraction to leasing in the fact that you get to turn the car over every three to four years, I think, is still part of the American culture. In terms of...

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

A

In terms of the peak, the largest increase might have been from 2012 to 2013, but we're looking at least 0.5 million additional lease originations each year going 2014, 2015. And now 2016 is looking like it's on the same path, wouldn't you say, Jim?

**James P. Hallett**
*Chairman & Chief Executive Officer*

A

Right.

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

A

So, when you say peak, maybe the largest year-over-year increase in lease originations might occur from 2012 to 2013, but there is strong growth that's continuing, as you say, into 2016 where we're seeing 33%, 34% lease origination rates.

**James P. Hallett**
*Chairman & Chief Executive Officer*

A

Yeah. I really don't think – truthful answer is I really don't think we know. We do have what we would term as very good visibility for the next few years. But getting beyond that, I think, we just have to wait and see it play out.

**Ryan Brinkman**
*JPMorgan Securities LLC*

Q

Okay. And then last question is on online-only ARPU. I heard, Jim, in the prepared remarks say – I think you said it was up like $109, something like that. When you think about – when growth in online-only was preventing the incremental volume from flowing through to physical, which is no longer the case, I remember you were asked on these calls if there is anything you could do to help get increased fees from online-only, and your response then was kind of like, we're trying but it's really, really hard. So I'm just curious how you're able to take up that online-only ARPU and what the outlook for that is maybe going forward.

**James P. Hallett**
*Chairman & Chief Executive Officer*

A

I think, Ryan, the biggest opportunity there has been what we've been able to do in the open sale. When that car goes from close to open, then we're able to expose that vehicle to a whole new buyer base beyond the franchise dealers. And I think that's where we're able to increase our fees. As you know, the economics get much, much better in the open sale, and that's where we've been able to increase the average fee or the average revenue per car on those online sales.

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

A

And then with that said, Ryan, I'd like everyone to know, in 2011, when we acquired OPENLANE, we had a plan as to what we could do in the online-only space. I would say we are attaining those goals, if not even exceeding those goals, even with all of these close sales. I mean, this has been a great differentiator for our business and a great performer.

**Ryan Brinkman**
*JPMorgan Securities LLC*

Q

Great. Thank you.

James P. Hallett
*Chairman & Chief Executive Officer*

A

You're welcome.

**Operator**: Great. Thank you. Next we'll move to Matt Fassler with Goldman Sachs. Please go ahead. Your line is open.

Matthew J. Fassler
*Goldman Sachs & Co.*

Q

Thanks a lot and good morning.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Good morning, Matt.

Matthew J. Fassler
*Goldman Sachs & Co.*

Q

It's a terrific quarter obviously.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you.

Matthew J. Fassler
*Goldman Sachs & Co.*

Q

First question, on ASP and ARPU, can you talk about the degree to which underlying pricing is changing in any way to help drive that number. And then also, Eric, related to that, if you could – I appreciate the enhanced disclosure. If you could just repeat precisely which numbers are impacted by the returned vehicles, and so what the reported number is and what the adjusted number is just so we can get the right context?

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

A

Okay. On the average selling price, I think, you're seeing what's being published. You're seeing call it 3% or so declines in the average selling price. But when you think about what that does – Jim mentioned it. What that does to the consignor who is trying to optimize if not maximize residuals, they're going to spend money on the car and we see that, Matt. So that's the answer to that.

On the online-only and the ADESA Assurance Program, thank you, I can repeat that, and you'll see it in the 10-Q that we file tonight. We reported $116 per car sold compared to $109 in the prior year. And when I take out the ADESA Assurance Program and I'll give you an example that's directionally correct. That number should be $110 because on a car that we purchase – we repurchase under our assurance and then resell, there's no real economic value to that transaction. We're just making good on our promise.

That $110 compared to $105 if I excluded the past year, by giving you that $6 number and the number of units we sold, you can calculate the value of the ADESA Assurance Program. And when you consider most of those are off-lease cars, let's hypothetically use a value of $15,000 per car that means that 75 cars sold is all in the quarter.

That's how small the number of cars is, yet it had a $6 influence. That's all things you'll get out. It's in our earnings supplement, Matt. But that's what I was calling out because I felt you might reach the wrong impression on the growth in ARPU there. When these 75 out of, what, 180,000 cars or whatever the number was, let me look it up, I should give you the right number, it was a distortion that I felt we needed to clarify.

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Matthew J. Fassler
*Goldman Sachs & Co.*

Q

Got it. And also, just rephrasing the first part of the question, on your fees per se, has there been any change in your pricing or your fee structure of late that would help explain the ASP acceleration, or is it really more about mix in the ancillary services that are being added to the package?

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James P. Hallett
*Chairman & Chief Executive Officer*

A

Yes. Matt, I think, it's a little bit of both, primarily, I would say, focused on the ancillary services and the things that are going on there. But as I've always said, at ADESA more so, we continuously are monitoring the buying fees. And these are nationwide increases, these sometimes can be regional increases or local increases, and there have been some of those go in place probably in the first quarter. But again, I would take you back to – I would focus on the increase in ancillary services more so.

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Matthew J. Fassler
*Goldman Sachs & Co.*

Q

Great. And then just one follow-up from that. So your reported gross margin in ADESA was up, I believe, 98 basis points. It's the first increase of anything in that magnitude you've had in at least two years, maybe more. And you've had other quarters where your volume growth has come close to this. So was that really an outgrowth of that – of pricing in the average revenue per vehicle, or is there something else on the cost side, which I know you alluded to. Is that what's contributing to the better flow-through at the gross profit line?

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

A

Matt, as we look at it, the gross profit is coming really, I think, through the mix of vehicles getting us that leverage in the use of the shops, and it's from the ancillary services. Also, you look at things like PAR and our repossession activity, again, very good utilization. While that might be a lower margin business, it has a lot of scale in it, and we're getting the activity. So, it's more the scale with a little bit coming from the auction fees margin. That would be slightly up, but not account for a significant portion of that 90 basis points.

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Matthew J. Fassler
*Goldman Sachs & Co.*

Q

Got it. Understood and appreciate it. Thank you.

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James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you, Matt.

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**Operator**: Great. Thank you. Next we'll move to Gary Prestopino with Barrington Research. Please go ahead. Your line is open.

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Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Yeah. A couple of questions. First of all, if Chicago starts rolling out this year, how long would a new site like that be a drag on the adjusted EBITDA results?

James P. Hallett
Chairman & Chief Executive Officer
A

Gary, typically, we would tell you for a Greenfield location to be cash flow positive, we normally look at it in a period of 12 months to 18 months. In the case of Las Vegas, which was the last one that we did, we're very pleased that we're cash flow positive there in the first 12 months. And let me say, I'm optimistic that we can have strong results going into that Chicago market. I think we're going in at a very good time. We absolutely got the ideal location. The buyer base is there. The cars are there. The customers are there. I'm expecting a strong performance there coming out of the gate.

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

And, Gary, let me add when we say negative EBITDA initially, it's not going to be a material number. It's not something that we expect to be calling out as an influence on our performance. It's just not a big contributor.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. Just was curious there. And then, just an industry question, in terms of the cars coming through lease or from lease returns, are you seeing less of an appetite for the grounding dealers to take these cars initially? They're flowing through the pipe and then going more towards the independent dealers versus the franchise dealers. Is there a shift that's starting to occur here because the franchise dealers have ample inventory of used cars now?

James P. Hallett
Chairman & Chief Executive Officer
A

I think, Gary, there's – first of all, the grounding dealer, the residuals are maybe a little bit higher than market value. So you're seeing the grounding dealer pass on some of these cars at termination. And then, when they're getting into, as we call the top of the funnel in the closed sale, there is a lot more vehicles to choose from, so the dealers can be more selective.

And then, there's more cars going through the online open sale, which then brings in a whole new buyer base. It brings in all those independents, and you've already said it, but just to reinforce what you said, you've now got all those independents that are able to acquire some of this inventory as well. So, it's a combination of all those things, and primarily, all being driven by the residual value at termination.

Gary Frank Prestopino
Barrington Research Associates, Inc.
Q

Okay. And then, just the last question on the loan loss reserve increase, which is understandable because of the growth in the portfolio, but it is my understanding that, really, you would have a huge loss if there was some kind of an outright fraud at the dealership where the car was domiciled where they bought it from you. Is the increase in the loss reserve really a function over the time from when it was bought to what the market value is now and you've got to write down that loan?

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

Yes, Gary, we actually – writing off the loan, actually this occurs so quickly given the nature of a floorplan lending business. But most of the losses are lost value in the vehicle where we feel we can't recover from other assets.

But the most significant individual losses are what we call sold out of trust. The car is sold. The proceeds are received by the dealer, and they're not remitted for payment on the loan and there's no collateral for us to act upon. As you would suspect, even in declining values, that loss would be relatively minor if we could repossess the car.

But if the car is in the possession of a consumer, consumer protection laws prohibit us from repossessing from the consumer even though we may have held title as collateral. So, again, the losses you see are heavily weighted by the car sold out of trust.

Gary Frank Prestopino
*Barrington Research Associates, Inc.*
Q

Okay. Thank you.

James P. Hallett
*Chairman & Chief Executive Officer*
A

You're welcome.

**Operator**: Great. Thank you. Next we'll move to Tony Cristello with BB&T Capital Markets. Please go ahead. Your line is open.

Anthony F. Cristello
*BB&T Capital Markets*
Q

Thank you. Good morning.

James P. Hallett
*Chairman & Chief Executive Officer*
A

Good morning, Tony.

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

Hi, Tony.

Anthony F. Cristello
*BB&T Capital Markets*
Q

The first question is sort of a bigger picture question. We continue to hear about more technology in the industry, dealers looking for ways to speed up the process of auction and/or move vehicles from dealer to dealer, and in some instances, bypassing auctions.

And I know you've got TradeRev and some other initiatives. I'm wondering if you could expand on how you will take advantage of a shift perhaps in technology and be able to continue to better balance both the physical and online use of where things may evolve.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah. I think, we're very much aware of potential disruption and how we could be disrupted, and I would like to tell you that if there's disruption that's going to occur, we'd like to be disrupting ourselves. And that's exactly what we're planning – what our plans are with TradeRev. We actually feel like we are disrupting ourselves there. So that – TradeRev continues to rollout, and we continue to add resources in the markets that we are in with TradeRev. We are experiencing what I would call success. We're seeing the numbers continue to grow on a monthly basis. We've brought in – we've enhanced some of our technology with other products. We've talked about Autoniq, which gives the dealer real values on his smartphone while he's in the lane.

I think, it's being aware of what the technologies are that can really add value to the customers both on sell side and on the buy side, and allowing them to make better decisions. I think some of the things that we're doing with data and planning on doing with data in terms of big picture will give the buyers and sellers better information to be able to make more informed decisions.

So Eric, do you want add something?

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

A

Yeah. I mean, like our investment in photo booths allows you to look at an image and you might buy that car online instead of waiting until it gets to – all of this – better inspection reports and enhancing the technology around check-in processes, it's all about taking time out of the process so the car can be sold quickly.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah, and the other thing that I mentioned in my commentary that I'll go back to is we talked about the cycle times at insurance auto auctions, and cycle time is money. And I think people are aware that the average cycle time historically at the salvage business has been in that 75-day to 90-day range. And we have a new product that we're offering at insurance auto auctions called Total Loss Solutions that we're introducing to some of our customers, and it's a product that we can scale across some of our customers that potentially can reduce cycle times, and I'm talking about potentially reducing cycle time significantly by 25 days – by 20 days, 25 days. That becomes a very meaningful number.

Anthony F. Cristello
*BB&T Capital Markets*

Q

And I guess, it seems like so from the technology part on ADESA, you're sort of being part of that evolution of change. With IAA, it sounds like you're being able to help improve what the insurance company see as probably one of their bigger expenses. And so on that cycle time – or if you look at where the biggest opportunities are to communicating with the DMVs and improving that, is it being more efficient at that first notice of loss point? And are you able to see opportunities for yourself to continue to improve and obviously offer better services to your customers?

James P. Hallett
*Chairman & Chief Executive Officer*

A

I think, it's a little bit of all that you've mentioned really. You think about the technology, you think about the enhancements to our existing technology, bringing in new technologies that we've talked about, bringing in the data and the analytics and other things that we may be doing and working on, I think, if you – it's kind of that story a little bit plus, a little bit plus a little bit adds up to a lot. And it's just being very focused on what's going on in their industry and what the trends are and what the shifts are and making sure that we're staying ahead of the curve.

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

A

And, Tony, using automation, the key is you can track it. It's not sitting on somebody's desk for five days waiting. It's in a queue, that someone says this is ready for the next step, and whether that be again at the reconditioning shop or the mechanic shop, right? It's everything, not just paper. It's everything.

Anthony F. Cristello
*BB&T Capital Markets*

Q

Okay. That's great. Appreciate your time.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you.

**Operator**: Great. Thank you. And next we'll move to Craig Kennison with Baird. Please go ahead. Your line is open.

Craig R. Kennison
*Robert W. Baird & Co., Inc. (Broker)*

Q

Great. Thank you for taking my question. It's really on this recall trend. I think, AutoNation recently announced a change to its recall policy and may end up ultimately wholesaling more vehicles if they can get the repair done in a timely fashion. If that goes mainstream, does that have any influence on your volume trends?

James P. Hallett
*Chairman & Chief Executive Officer*

A

Well, perhaps, it could increase our volume overall if they start wholesaling more of those vehicles, but I think that we would probably be required to get those recalls done before the vehicle got resold.

Craig R. Kennison
*Robert W. Baird & Co., Inc. (Broker)*

Q

Okay. Thank you.

James P. Hallett
*Chairman & Chief Executive Officer*

A

You're welcome.

**Operator**: Thank you. Our next question comes from Ali Faghri with CRT Capital. Please go ahead. Your line is open.

Ali Faghri
*CRT Capital Group LLC*

Q

Good morning. Thanks for taking my question and congrats on a great quarter.

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James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you.

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Ali Faghri
*CRT Capital Group LLC*

Q

So, total physical auction volumes were up 12%, and dealer consignment was up 10%. I think that implies commercial was up roughly 12% to 13% in the quarter, which is a nice acceleration from low-single digits last quarter. Can you give us some color on what drove that specifically? Was that off-lease, repo, or maybe timing? And then also maybe some color on the cadence of volume trends at ADESA throughout the quarter.

---

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah. There is no question on the commercial is – there's just more and more volume coming. There's – these leases are continuing to come, and the question I've answered earlier, the grounding dealers passing on these cars and putting more vehicles into the funnel. And then with the financial institutions, those are writing more and more consumer credit, and that's just a straight math calculation.

The more paper written, the more repos you're going to have. If I go back in history, we peaked at about 1.9 million repos back in 2008, 2009, and we took that number down to 1.1 million. Now we're seeing those repossessions climb back up to that 1.5 million, 1.6 million, and I would expect that number will continue to grow as they continue to write more and more paper. So, the heavy influence has been with the commercial cars – there's no question.

And then, I think that on the dealer consignment, I'm extremely proud of what our ADESA organization has done with dealer consignment, and that was really an initiative that many of you are familiar with. It started back in 2009, and when we put that whole network in place, we have 300 people in the field approximately that are very focused on calling on dealers one at a time. We had people calling on the mid-sized groups and the large dealer groups, and we've just really created some good habits for our dealers. And we've started to treat the dealer consignment business more like we treat the commercial business, providing more and more services to them.

And I think the proof is in the pudding. We're getting the results and our dealers are all about results and that they have a good experience. They're returning, and I think that dealer consignment team, again, has just done a remarkable job. And quite frankly, Eric and I have been saying this for probably the last two years or three years is, we are surprised that the dealer consignment numbers have held up as strong as they have when you consider the impact of all of these commercial vehicles coming back. So, it's really been a great win for us.

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

A

And let me clarify, I think you'll find the commercial volumes were up much more than 12% to 13%. If 46.5% of the physical auction volumes were up 10%, the other 53.5% were up by a greater amount. Ali, we can walk you through that at a later time, but you'll get a much higher number than the 12% to 13%.

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Ali Faghri
*CRT Capital Group LLC*

Q

Great. And then just on the cadence of volume trends as well throughout the quarter.

James P. Hallett
*Chairman & Chief Executive Officer*

A

I think, it's been steady. There was again...

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

A

I'd say it followed our seasonal pattern. January was January because of the slow start to the year and got very strong in March because that's when the lease returns really pick up.

Ali Faghri
*CRT Capital Group LLC*

Q

Great. Thank you.

**Operator**: Thank you. Next...

James P. Hallett
*Chairman & Chief Executive Officer*

A

Sorry. Go ahead.

**Operator**: Oh, thank you. Next we'll move to Bret Jordan from Jefferies. Please go ahead. Your line is open.

Bret Jordan
*Jefferies LLC*

Q

Hi. Good morning, guys.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Good morning, Bret.

Bret Jordan
*Jefferies LLC*

Q

A question on the IAA inventory, up 4%. You talked about improved cycle times. Was there any impact from generally warmer and less icy weather in the Northern or Northeastern states, and then again some volume shift with farmers in the quarter, or is it primarily just the cycle times?

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah. Bret, I'd mention that there certainly were some impact from the mild winter that we experienced. In terms of customers, we really don't get into talking about specific customers. But you have your wins and your losses, and they pretty much offset each other.

But maybe the bigger impact was improving these cycle times. And as I mentioned in my commentary, especially with one very large customer that we mentioned previously that they had kind of taken a pause, and they kind of taken the time out to restructure a lot of their internal processes.

And now that they've got those restructured and they're working with us in our Total Loss Solutions now in terms of how they cycle these vehicles to the market, that has reduced inventory at the end of the quarter.

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

A

Let me clarify one thing. They are utilizing the expertise of Total Loss Solutions. We are not processing titles for them.

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Bret Jordan
*Jefferies LLC*

Q

Okay. Okay. And a housekeeping question on SG&A. You said $10 million of the incremental $20 million was acquired. How much of that was Brasher's eight, how do you see Brasher's adding to SG&A on the year?

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

A

Brasher's is not in our numbers.

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Bret Jordan
*Jefferies LLC*

Q

Okay.

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

A

They were acquired April 1st, so they don't even hit for one day, Bret. But Brasher's, again, we'll give more color on that. We just closed the transaction. It will – it's got a business that looks very much like the ADESA business with about 25% – 24% or 25% EBITDA margins coming in. And it's a local operation. It'll fit very nicely in the business model of ADESA.

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James P. Hallett
*Chairman & Chief Executive Officer*

A

And the other thing that I would just add is very similar mix to what you see at ADESA as well between commercial and dealer.

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Bret Jordan
*Jefferies LLC*

Q

Okay. Great. Thank you.

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James P. Hallett
*Chairman & Chief Executive Officer*

A

You're welcome.

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**Operator**: Thank you. Next we'll move to Ben Bienvenu from Stephens. Please go ahead. Your line is open.

**Benjamin Bienvenu**
*Stephens, Inc.*
Q

Thanks. Good morning, guys.

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**James P. Hallett**
*Chairman & Chief Executive Officer*
A

Good morning.

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

Hi, Ben.

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**Benjamin Bienvenu**
*Stephens, Inc.*
Q

Touching on the salvage business, your acquisition that you made in the UK, I'd just be curious to hear the progress there, how discussions with insurance companies are going, to the extent you can opine, and then your thoughts on the broader market there as well.

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**James P. Hallett**
*Chairman & Chief Executive Officer*
A

As it turned out, our timing wasn't great when we did that acquisition. I think, as we said, scrap prices couldn't go any lower than they were at the time that we were getting that acquisition closed. And we've mentioned previously that we did go over and we sat with the management team.

We did kind of restructure the business model a little bit, not in terms of the amount of cars bought, but in terms of some of the pricing that was going on. And as Eric mentioned in his commentary, we're pleased that HBC was a positive contributor in the first quarter, and we think we've got the business model right, and we think we can continue to grow that. And in terms of looking forward, we're a very, very, very distant number two player, but we think there is opportunity to do further consolidation, and we'll just have to stand by and see how that plays out.

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**Benjamin Bienvenu**
*Stephens, Inc.*
Q

Great. And then your comments earlier around active discussions and deals, should we think there's possible opportunities in both North America and abroad, and then also ADESA and IAA? Maybe give us a sense of what those opportunities look like by business segment.

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**James P. Hallett**
*Chairman & Chief Executive Officer*
A

Yeah. And I think you should think about all of our businesses and that we're actively looking at opportunities and targets, and you should think of them both domestically and internationally. And as I mentioned in the past, we're still very much a believer in brick and mortar. We believe brick and mortar still has a role to play here, and we can buy these at what we would believe are very attractive multiples. And as I've said previously, there's 5 to 10 what I would consider really plum-type acquisitions out there. Not that we're going to buy 5 to 10; that's not what I'm saying. Don't misunderstand that. But I'm saying of those 5 to 10, we are in active discussions with a number of those. And I would hope that we could possibly close on some additional independents with no time line in mind.

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Benjamin Bienvenu
*Stephens, Inc.*

Q

Fantastic. Best of luck going forward.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Thank you.

**Operator**: Thank you. Next, we'll move to Bob Labick with CJS Securities. Please go ahead. Your line is open.

Robert Labick
*CJS Securities, Inc.*

Q

Good morning.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Hi, Bob.

Robert Labick
*CJS Securities, Inc.*

Q

Hi. A lot of my questions have been answered, but just according to some trade magazines, TradeRev has moved into the Washington, D.C. area, and I was wondering if you could just talk about your progress and your plans on rolling out in the U.S. Obviously, it started in Canada and stuff. And just tell us how long you would expect this to take or how you're planning the rollout, if there's a lot of capital that has to go behind it at all. Give us some more insight on to that, please.

James P. Hallett
*Chairman & Chief Executive Officer*

A

Yeah. So a couple things. First of all, I'll acknowledge the Washington, D.C. market. We did have a press release announcing that TradeRev is now representing the Pohanka Group there. I think, it's 17 stores, and we're managing – we're selling, I believe, the majority or all of their vehicles, all of their trade vehicles and overaged inventory on TradeRev. So, that was a big announcement for us.

We've also updated our technology on TradeRev. We've come out with what we call TradeRev 3.0. That's been rolled out in both Canada and the U.S. We've added a number of resources here in the U.S. in terms of people. And it's really one market at a time, and it's just getting to these markets in an organized manner. And the markets that we're in, we're experiencing success, like the one you mentioned with Pohanka. Pohanka is not the only deal. But we're experiencing success. We're building the buyer base, and we're building the seller base as well. And again, we're seeing positive trends where the volume continues to reach new levels each month. So, we're very pleased with TradeRev. But I think the thing that I would remind you of is I do believe TradeRev has an opportunity to really be transformational in that dealer-to-dealer space. But I wouldn't want to suggest that this is going to be an overnight deal. I think, this is with a longer term vision.

I think about TradeRev as really being fully deployed and really hitting on all eight as they say probably over the course of what I would think the next three years to five years. I think it has the opportunity to really transform that dealer space. So, with all that said, we're very pleased with what we're seeing.

Robert Labick
CJS Securities, Inc.
Q

Great. Appreciate that. Thank you very much.

James P. Hallett
Chairman & Chief Executive Officer
A

You're very welcome.

**Operator**: Thank you. And we'll take our final question in queue from Bill Armstrong from C.L. King & Associates. Please go ahead. Your line is open.

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

Good morning, gentlemen. In Insurance Auto Auctions looks like the declines in revenue per vehicle are getting less negative. I was wondering if you could just discuss what you're seeing in terms of scrap pricing. Is that starting to become less of an issue? And you were mentioning cycle time is reducing. Is that helping your revenue per vehicle in any way?

James P. Hallett
Chairman & Chief Executive Officer
A

Bill, as I said, I don't think scrap prices can go any lower. So, anything is going to be an improvement. And we are seeing a slight improvement in scrap prices. Also, Eric mentioned we're seeing a slight improvement in currency as well. And then – so, yes, that is helping mildly I would say, very mildly at this point in time. And certainly, the improvement in the cycle time is just moving these cars to the system quicker.

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

Does that cycle time improvement really – does that help your revenue per vehicle, or is it more maybe a help on the gross margin side?

James P. Hallett
Chairman & Chief Executive Officer
A

Bill, to the extent that they get a higher auction price because it didn't further depreciate, there might be a slight tick up in the buy fee, but that would be the only way you'd see it.

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

I see. Okay. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

You're very welcome.

**Operator**: Thank you. And at this time, I'd like to turn the conference back over to Jim Hallett for any closing comments or remarks.

## James P. Hallett
*Chairman & Chief Executive Officer*

Thank you, Tony. And, ladies and gentlemen, thank you very much for being on the call. Again, we continue to appreciate your interest and your investment in our company. Obviously, we're very, very pleased to report on the quarter that we've reported on. But more so, I would say that we're pleased with the visibility that we have going forward.

And not only in 2016, but as we talked about, as you look out the next couple years, we think the business is in really good shape. We think management is very focused on managing this business and providing you with the best results that we can possibly provide you with and making the best acquisitions and deploying capital in the most disciplined manner to get the greatest returns. So we're excited about the business and really we'll look forward to coming back to you next quarter and hopefully reporting more good news. So with that, thank you for being on and have a great day.

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**Operator**: Thank you. This does conclude today's conference. You may disconnect, and please have a great day.