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KAR Auction Services, Inc. (KAR)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the KAR Auction Services Q2 2016 Earnings Conference Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Mike Eliason. Please go ahead.

Michael Eliason
Vice President of Investor Relations and Treasurer

Thanks, Leo. Good morning and thank you for joining us today for the KAR Auction Services second quarter 2016 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended June 30, 2016. 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 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, Mike, and good morning, ladies and gentlemen, and welcome to our call. I do look forward to talking about another good quarter performance of KAR. Just to outline my agenda for today, I want to obviously review the highlights of our second quarter performance, update you on our integration activity as well as provide you with an update on our strategy for new geographies, starting with the UK, and then provide you with an overview on the key focus for our strategy in North America and then finish up with reviewing our guidance and provide color on our outlook for the remainder of the year.

The cyclical recovery of ADESA continues to drive our overall performance, and with that said, I'm extremely pleased with the performance at each of our basis segments. KAR's revenue increased 17%, driving 16% growth in adjusted EBITDA. And as I have said before, the real value of the KAR business model is the combination of our businesses. We may experience pressure on one part of our business, for example scrap prices and the impact of foreign currency on bidding by international buyers. But then, on other parts of our business, we are growing at the same time, which is really what we're experiencing at ADESA as we speak.

Let me provide you some highlights on ADESA in the second quarter. Volume is up 18% including Brasher's, up 9% on a same-store basis. As expected, volume growth is driven by commercial consignors. The commercial volumes were up 17% in total, excluding Brasher's. Dealer consignment volumes were down 3%, excluding Brasher's. The decline in dealer consignment volumes is what we've been expecting as we see more off-lease vehicles enter the remarketing channel.

More good news exists on the revenue per unit or the ARPU. Online ARPU increased 14% over last year to $109, excluding ADESA insurance vehicles. Physical ARPU increased 8% to $742. And the big contributors to the increase in physical ARPU were the increase in off-lease vehicles being reconditioned at our facilities, and the growing revenue from our repossession services, especially, within our KAR business unit and then we've seen increases in our transportation revenue led by our CarsArrive transportation company.

While the increase in volume and ARPU drives strong revenue growth, we are all focused on controlling SG&A in order to drive stronger profitability for the business, while ensuring that we are making the right choices to support the short-term and the long-term growth expected at ADESA. ADESA has announced the first sale as new Chicago location and that sale will be held Friday, September 23. And this is a date that I've been looking forward to for many, many years. Finally, we're going to be open for business in Chicago. Great news.

Looking at Insurance Auto Auctions, volume was up 5% in North America and 6% overall. Adjusted EBITDA grew 4% and we are now lapping the tough comps on scrap and currency. Inventory at June 30 was up 11% over the prior year. AFC had a strong quarter. Revenue growth of 13% exceeded the 10% growth in the number of loan transactions. The receivables portfolio increased 18% over prior year to $1.7 billion. Credit losses are up from the prior year, but remain at reasonable levels and the credit quality of the portfolio continues to be strong.

Now, I want to take a moment and update you on some ongoing integration activities. We have now migrated the DataScan technology into our data center and are continuing to integrate the AutoVIN and DataScan businesses now that this is complete. Brasher's integration activity is very much on target. The business is performing very well and after a quarter of working together, I will say again it is great having the Brasher family as part of the ADESA team. As you know, we've also acquired a physical auction business based in the Orlando area. We expect integration activities to be completed in the next six months and this is a key acquisition, which clearly strengthens our position in the Florida market.

I'd like to make a few comments on our strategy as we enter the UK market. In the second quarter of this year, we announced Arval, a major European leasing company began using TradeRev to remarket vehicles in the UK. As well, we have acquired the GRS business in June. And to give you a little clarity on the GRS business, we really think of that as an online only auction business. And I would describe it as being very similar to our OPENLANE business, where we stand in the middle of the transaction, there are no physical sites. The one thing that we are seeing with GRS in the UK is there is more dealer-to-dealer activity than what we see here in North America and Canada and the United States.

But I believe it's a combination of these individual activities that demonstrate our strategy to build a end-to-end remarketing offering with an asset-light focus as we enter new geographies. We now have the ability to serve our customers in the UK with multiple channels and a variety of methods for executing our wholesale car transaction. Our expertise and market position in North America combined with the assets we have acquired in the UK uniquely position us to be a disruptor to the traditional physical auction market in the UK. While we are currently focused on the UK, I believe we have an opportunity to develop similar offerings in other geographies in the future. Most importantly, I would say we have the resources to build this capability in the UK and potentially other markets without distracting the management teams operating our market-leading businesses here in North America.

Despite my excitement about the opportunities in new geographies, it is important to point out that our success continues to be driven by our strong U.S. and Canadian businesses. We continue to add technology and services that benefit our customers and provide additional revenue sources for all of our businesses. In North America, our strategy is focused on KAR and its businesses operating as one company. And when I say one company, let me explain what I mean. I believe that we can approach the market with one voice and provide the services and technologies to sell cars in any venue they select. This could be mobile apps, it could be private label online auctions, it could be open online auctions, or it could be physical auctions.

And we will have a comprehensive offering of services that will complement our various auction channels. We have a unique set of assets that I believe differentiates KAR and as I've said many times in the past, and I will repeat today, we will not dictate to our customers how or where they should sell a vehicle. Our job is to offer the best selection of venues and provide the services so that we can provide our customers with the highest level of service that we possibly can.

In the UK, much has been written about Brexit. I would tell you that our operations outside of North America are less than 1% of our overall business. Our UK businesses operate within the UK and do not depend on cross-border transactions in Europe. I do not expect the uncertainty surrounding the euro or the EU having an impact on KAR in the next couple of years. And as we investigate new markets, we will obviously consider the uncertainty in Europe as part of this process.

Turning to our guidance, we have made no changes to our guidance for the year. I will let Eric run you through a summary of our guidance in just a few moments. But my outlook for the business remains very positive. The cyclical recovery at ADESA continues. We are seeing increasing volumes of off-lease cars and they are expected for the remainder of this year and then for the next few years. In fact, leasing continues to increase as a percent of new car sales. And as we've said before, the increases in commercial volumes, especially the off-lease and the repo vehicles, may cause dealer consignment volumes to decline in the future. Used car prices are expected to decline. We are a transaction-based business and as we've said in the past, we are far more focused on the transaction than we are on the value of the vehicle.

New car sales may be flat or even decline somewhat in the future, and again, new car sales are not the only variable that impacts the used car marketplace. We're much more focused on what we call that 40 million to 45 million used car churn that takes place on an annual basis. We don't believe that modest declines in new car sales would be a significant risk to our business at this time. There's been a lot of talk about accident avoidance systems and autonomous cars and we don't expect that they will have a material impact on our business for the foreseeable future.

In the near-term, new technologies have increased repair cost and it may actually be a tailwind for the total loss volumes. I believe that we've gotten through the worst of the scrap and the currency challenges. And we continue to generate substantial amounts of cash, which can be used to support our strategic initiatives and to allow us to return capital to our shareholders through our quarterly dividend.

In summary, our businesses are in a good spot. We are well-positioned to deal with any challenges that may arise over the next couple of years. We have strong visibility into the wholesale used car volumes for the next few years. We expect salvage volumes will continue growing. AFC is well-positioned to benefit from the cyclical recovery in the wholesale auction industry. And finally, we have a number of options to deploy capital for strategic growth and to provide a return to our shareholders.

So with that, I'd like to say thank you for joining us today. I'm going to turn it over to Eric for some additional comments before we get back to taking your questions. Eric?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

Thank you, Jim. I plan to cover just a few topics this morning. Let me start by reviewing our guidance for 2016. As Jim mentioned, there have been no changes to our guidance since our last earnings release in May. We expect net income per share of $1.56 to $1.71 and operating adjusted net income per share of $2.03 to $2.18.

In determining our guidance, we expect an effective tax rate of 37.5%. We expect adjusted EBITDA of $735 million to $760 million for 2016. Cash interest on corporate debt is expected to be $95 million, and capital expenditures are anticipated to total $145 million for 2016. Cash taxes are expected to be $150 million to $160 million in 2016. This will result in free cash flow of $340 million to $365 million for the year. Please review our earnings release and earnings supplement dated August 2, 2016 for a reconciliation of non-GAAP financial metrics to related GAAP financial metrics.

In the first six months of 2016, we acquired Brasher's auctions (sic) [Brasher's Auto Auctions] (14:12), Sanford Auto Dealers Exchange or SADE, and GRS for an aggregate purchase price of approximately $355 million. We previously disclosed the historical performance of Brasher's including the expected contribution of approximately $25 million in adjusted EBITDA in 2016, which is included in our guidance. The SADE and GRS acquisitions are not material to our financial statements and details of these acquisitions were not separately disclosed. However, the performance over the last 12-month period preceding our purchase for the businesses was less than $10 million in aggregate. These acquisitions are not expected to materially impact net income per share, operating adjusted net income per share, or adjusted EBITDA for KAR for the remainder of 2016.

As we have discussed in previous quarters, our acquisition activity makes it difficult to analyze the incremental margins in the ADESA business. We have provided information in our earnings slides filed on Form 8-K last night, providing information on the incremental margins for ADESA excluding acquisitions within the last 12 months. ADESA's actual incremental adjusted EBITDA margin was 31% and 34% for the second quarter and first six months of 2016 respectively. Excluding acquisitions, ADESA's incremental adjusted EBITDA margin was 39% and 41% for the second quarter and first six months of 2016 respectively.

Now let me speak to SG&A. As you saw in our earnings release last night, our consolidated SG&A in the second quarter increased $23.4 million to $146.9 million. In analyzing the increase in SG&A, $10.8 million of this increase is SG&A related to our acquired businesses. We also have $4 million in increases for cash and stock-based compensation which is tied to the performance of the company. Our health insurance cost increased $1.6 million in the quarter for existing employees. This excludes the cost related to employees added during 2016. That leaves $7 million in increases to support the organic growth of our businesses. This represents a 5.7% increase over the prior-year consolidated SG&A. This $7 million increase is IT costs and salaries and benefits for additional non-IT head count.

As Jim mentioned, we are focused on controlling SG&A, but I thought providing this detail would help you understand some of the components of our SG&A growth during the quarter. There is one component of SG&A that I would like to point out. We incurred $3.3 million of acquisition related expenses in the second quarter, all of which is expensed during the quarter. These costs were incurred by KAR and not the acquired businesses. This results in a net charge of $0.015 per share, net of taxes in computing net income per share and operating adjusted net income per share. These types of expenses are not added back in computing operating adjusted net income per share.

Let me take a moment and provide some commentary around AFC's performance. As you can see in the earnings supplement provided yesterday with our earnings announcement, the provision for loan losses has increased modestly over the prior year. For 2016, net losses have aggregated approximately 1.25% of the average portfolio balance. That's an annualized rate, by the way. The loss rate – this is the loss rate now and our historical loss rate for AFC prior to 2008 range from 2% to 3% of the average portfolio balance. We have not made any changes to our lending practices or credit standards. This level of losses is actually consistent with our expectations for 2016. And with that, I'm referring to the 1.25%.

My last update is related to ADESA Chicago. We estimated the cost to be $35 million for this project. We now expect the cost of this project to be about $38 million. The increased costs are related to the technology being deployed at ADESA Chicago. This increase in cost related to Chicago does not change our expectations for total capital expenditures of approximately $145 million for the year.

I'm not going to cover the information we provided in our earnings supplement last night so that we can get right to your questions, so that concludes my remarks, and I will now return the call to Leo, our operator and he can open the lines for questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll take our first question from Elizabeth Suzuki of Bank of America.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Good morning. A number of the auto dealers have mentioned that there was a material portion of their used vehicle inventory that's on stop sale for the Takata airbag recall. Has that had an impact on your business that you can quantify?

James P. Hallett
Chairman & Chief Executive Officer

A

[indiscernible] (19:43) how we can quantify it. I can tell you we do have some vehicles sitting in our inventory. That is on recall. And I will speak to the dealer vehicles in a minute, but the vehicles in our inventory, were really at the direction of the seller. Some of these sellers want to hold the vehicle until the recall is completed. Other sellers will sell the vehicle with an announcement that it does have an open recall. And then obviously there is some cases where there are laws that prohibit you from selling cars at all which are the rental vehicles.

In terms of the dealers and you talk about the stop sales, I do believe their inventory is backing up on the dealers lot and I believe that there were a number of vehicles that the dealers were not able to ship to the auction and as a result there is a backlog. The good news is at some point in time, the backlog will get released, and these vehicles will make their way to the physical auction. So I think it's just a point in time that we have to wait for these vehicles to be cleared.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

Okay, great, that's helpful. And Avis talked this morning about some de-fleeting that they're seeing in the market from the rental companies. Can you talk about the trends that you've been seeing in off-rental coming through the auctions?

James P. Hallett
Chairman & Chief Executive Officer

A

Again, that's a portion of our commercial business. It's the smallest portion of our commercial business, but we continue to receive rental vehicles. And as we start to approach Labor Day, and the Labor Day weekend, that's usually a time that these rental companies start to de-fleet. It is just a seasonal thing. Kids are back in school. Holidays are over. There is less demand and the de-fleeting starts. So, we would expect to see an uptick in the rental vehicles as we go into the third quarter here.

Elizabeth Lane Suzuki
Bank of America Merrill Lynch

Q

All right. Thank you.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome, Elizabeth.

Operator: We will take our next question from Ben Bienvenu of Stephens, Inc. Your line is open.

Benjamin Bienvenu
Stephens, Inc.

Q

Yeah, thanks. Good morning guys.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning.

Benjamin Bienvenu
Stephens, Inc.

Q

So, you talked a little bit about your expectation for used vehicle prices, they've been kind of stubbornly high in the front half of the year. I think in the past you talked about maybe an expectation for 3% to 5% decline in 2016, which implies a bit of a decline in prices in the back half. I'd be curious to hear what you are thinking about the market, why you think prices are staying as high as they are?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, first of all, let me say, Ben as we went into the year, we anticipated a 3% to 5% price decline which you have acknowledged. And we are still seeing – we are still very much within that range and it was anticipated. And this was anticipated, just as a result of the volume of vehicles that were going to be coming to the market. So, it's strictly volume-driven. Prices, we are seeing – they were strong in the first half of the year, and they didn't drop 3% to 5% but we are now starting to see them softening a little bit more and we may get to those 3% to 5% levels.

In terms of how that impacts us, as I mentioned in our commentary, we are a transaction company. We are focused on the transaction. And the selling price really doesn't impact us a great deal. Two things, number one is our fees [indiscernible] (23:13) in $500 increments, so a vehicle that actually have to fall in price by $500 for it to have any impact on our economics, and on the flipside of that coin, because of all these off-lease vehicles, we are selling a much higher dollar car, a one-year old car, two-year old car, three-year-old off-lease car, which will bring a higher fee with it. So, the bottom line is, we are not impacted by those fees. Eric?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And Ben, I would like to add, there is more one-year old to three-year old used cars in the marketplace now than there has been in the last three years or four years. As we measure used car pricing, it may be the richer mix is keeping that number unusually high as it works through and now we are going to get to a situation where there is even more supply of those cars and we will start to see it come through the indices as quoted by Tom Kontos in his publications.

Benjamin Bienvenu
Stephens, Inc.

Q

That's really helpful color. And then along those same lines, you mentioned in your supplementary detail, you are seeing grounding dealers that appetite for vehicles at auction wane a little bit that's supporting online only ARPU. Could you just talk a little bit about as we see used vehicle prices decline, I would think that trend should accelerate. And maybe why even with used vehicle prices remaining a little bit higher there, you are seeing that appetite slow a little bit from those guys?

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah. So if I understand your question, there is no question that the grounding dealer is buying fewer and fewer of these vehicles and these vehicles are making their way into the online channels. And I would expect to see that continue. As we see more volume, we have more selection. And the dealer rather than paying what might be the residual value on the vehicle at termination would rather take his chances on buying the vehicle online or in an open sale or closed sale or physical sale.

With that said, let me expand a little bit on that, because we get asked this question a lot. Is as a pure number, there are more vehicles being sold in the online sales. But as a percentage of the overall vehicles that are coming to auction, that percentage is dropping. And we are seeing a drop in conversion rates, which means that more of those vehicles are getting to a open online sale and then eventually making their way to a physical sale, which was evidenced in the second quarter where we saw a 9% increase in the commercial car segment at the physical auction. So Ben have I covered your question?

Benjamin Bienvenu
Stephens, Inc.

Q

Yeah. That's great. Could I slip one more in quickly?

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah.

Benjamin Bienvenu
Stephens, Inc.

Q

So you talked about some of the duplicative cost associated with recent acquisitions, Brasher's in particular. How should we think about these duplicate cost burning off over the next couple quarters and maybe that underlying incremental operating or EBITDA margin at ADESA starting to shine through?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, I would tell you first and foremost everybody is on high alert as it relates to those costs. And we're – we have now started the transition of – I've talked to you a little bit about the DataScan and the AutoVIN transition. That's now at a place that we think we can start taking cost out. In the case of Brasher, we're starting to implement our systems there. We're in the early stages, we've got eight auctions there. That's going to go perhaps a little bit slower. ADESA has performed so well with the transition we don't want to do anything to screw that up, pardon the expression.

And then as you think about the other integrations, we're hoping to get Orlando done in six months. We're trying to compress that timeframe. We're just trying to move, I would say more quickly in a very disciplined and very focused manner, we're putting more resources on it, and as we complete these integrations, then obviously we would look for these costs to go down.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And Ben, I'd like to clarify, Brasher's historical information we disclosed they had about a 24% EBITDA margin which is very close to ADESA. That would indicate there won't be a lot of cost take outs there. There will be some efficiencies, but not as much as some of the other acquisitions including places like Orlando, where that EBITDA margin was much lower than the ADESA margin.

Benjamin Bienvenu
Stephens, Inc.

Q

Okay. Great. Best of luck.

James P. Hallett
Chairman & Chief Executive Officer

A

Thank you.

Operator: We will take our next question from Matt Fassler of Goldman Sachs. Your line is open.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Thanks a lot. Excuse me, good morning.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Matt.

Matthew J. Fassler
Goldman Sachs & Co.

Q

I have two questions. The first relates to incremental margins. Eric, if you could just repeat the incremental margin numbers that you gave for ADESA, excluding acquisitions, it would be real helpful. I have the slides and just want to make sure that my understanding of the numbers matches up.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes. This is incremental adjusted EBITDA margin. The slides are incremental operating margin. So, they are different.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Got it. Okay.

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

And the incremental adjusted EBITDA margin was 39% for Q2 and 41% for the first six months of 2016 excluding acquisitions.

Matthew J. Fassler
Goldman Sachs & Co.
Q

Got it. And so if we look at the operating margin, I think, the delta between the second quarter and the first quarter was probably a little bit greater. This was – I guess, it was a 4 point difference year-to-date in Q1 versus a 2 point difference for EBITDA. So any sense as to what accounts for that bigger gap?

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

About the only difference between the two is amortization. Although there are a couple of add backs related to acquisition cost that would not have been added back or not have been adjusted for an operating income, the $3.3 million I referred to.

Matthew J. Fassler
Goldman Sachs & Co.
Q

Got it. And if you think about the underlying trend then which I guess is best reflected in EBITDA to the extent that that was off a little bit, but still at a very strong level. Is that just a function of volume in dollars, and do you think that the kind of incremental margin ex-acquisitions that you generated in Q2 is sustainable with the kind of volumes that you're seeing?

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

Well, again, incremental margins is tough. I did comment in the first quarter that that was exceptional.

Matthew J. Fassler
Goldman Sachs & Co.
Q

Yeah.

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

And on the very strong volume growth. I would consider though again this 39% in this quarter, to be a reasonable number to attain with the type of volume growth we demonstrated which I think we can continue.

Matthew J. Fassler
Goldman Sachs & Co.
Q

Got it. In your prepared remarks I know you spoke about the salvage inventory backlog, which I know is usually a very good leading indicator of the sales that you are likely to see at IAAI. As we look at the cars sold, the compare got a lot tougher. And the revenue number moderated a little bit. Just any comment on what you think is sustainable on that business too?

James P. Hallett
Chairman & Chief Executive Officer

A

You know, Matt, we've always thought about that business as a low single to mid single digit volume growth on an annual basis. And we think that we can maintain those levels.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Got it. And...

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

And you pointed out perfectly that 11% growth in volume would be above that trend, going into the third quarter.

Matthew J. Fassler
Goldman Sachs & Co.

Q

And we've heard a lot from so many different companies on weather impacted businesses, to the extent there was a mild winter. Are we seeing the consequences of that now that might depress the growth in salvage on a very short-term basis?

James P. Hallett
Chairman & Chief Executive Officer

A

You know, Matt, couple years ago I said we're going to stop talking about weather.

Matthew J. Fassler
Goldman Sachs & Co.

Q

I thought you've forgotten.

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah. You know, weather is just part of what we deal with. And we deal on it. We deal with it on an annual basis. We know it's going to happen, we don't know when it's going to happen, we don't know if it's going to be in terms of storms and tornadoes and hurricanes, or if it's going to be in terms of ice and sleet and snow. But we know these things are going to happen. So I've gotten away from talking about whether because at the end of the day, I think, it's a net-net. I think, the one thing I will have mentioned to your point is I think the 11% build up in inventory is really the result of recent weather activities that have taken place here in the last couple months.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Got it, like the Texas floods, et cetera?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes.

Matthew J. Fassler
Goldman Sachs & Co.

Q

Understood. All right. Thank you so much, guys.

James P. Hallett
Chairman & Chief Executive Officer

A

Thank you, Matt.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Thanks, Matt.

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

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Ryan.

Ryan Brinkman
JPMorgan Securities LLC

Q

Thank you for take my question. Good morning. I see on page seven of the supplemental that ADESA online only ARPU rose 24% from $99 a year go to $123 this quarter. On previous calls you talked about how as more vehicles are transacted online, you'd like to improve your online only ARPU, but it's quite difficult to do. So have you kind of figured out the formula here with this I guess ADESA Assurance program. Is that driving the increase or are you more just taking price from the sellers which you had indicated was hard or is it the mix of online only open versus closed which you touched a bit on earlier?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Ryan, this is Eric. Let me start with explaining the $124. That $124 when you adjust for ADESA Assurance which was less than 200 vehicles repurchased, it would be $109, a 14% increase, and we give that number. And you will see it in our 10-Q, it is in the supplement as well. With that, you actually hit on it. The $109 up from $99 reflects the mix of vehicles. As an example we only had 105,000 grounding vehicles versus 99,000, up literally 6,000 units, yet the total of online sales at ADESA increased 14,000 units, so more of them were outside of grounding dealer. And within that you are going to have more open sales activity versus private label close. So it's really – we would describe it as that's reflecting the mix of the sales channel, but $109 is the number I'd look at, not $124, and we do disclose the number.

Ryan Brinkman
JPMorgan Securities LLC

Q

Okay. That's helpful. And then I know, a lot of the focus with regard to ADESA volume is on the institutional side. Can you talk a little bit about the puts and takes on the dealer consignment side, the visibility there. I know, [ph] it lasts – start (34:25) with flat in the second quarter versus up 3%, but what are the other factors influencing dealer consignment volume, dealer decision to hold the vehicle for resale versus auction, et cetera? And how should we think about those volumes trending going forward?

James P. Hallett
Chairman & Chief Executive Officer

A

Yeah. Ryan, I feel very good about our dealer consignment and have continued to feel very good about it. You know, we did talk a little bit about perhaps some cars got held at dealers because of recall and they weren't able to get pushed through the system and I anticipate they would come through the system here in the coming weeks and months, as these recalls get cleared. And as I look forward, I take a look at last year in the third quarter our dealer consignment was up 10%, in the fourth quarter our dealer consignment was up 9%. I would tell you those are pretty tough comps. And it's going to be hard to replicate that. But, I do believe that our dealer consignment will continue to perform well.

Ryan Brinkman
JPMorgan Securities LLC

Q

Okay, thanks. And just last question. It's clear you're very excited about ADESA Chicago. How should we think about the materiality of this new location? How quickly the volume is expected to ramp-up? You have now with Brasher's, I think, 76 locations or so – is it one divided by 76 or is this a bigger footprint store in one of the biggest markets, and so the volume benefit to you is going to be greater?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, Ryan, you're talking to the eternal optimist here. You know, I've been waiting on ADESA Chicago for a long time. And it is – as we tell you, it's the fourth largest car market in the United States and we think we're very well positioned geographically there in comparison to our competition. You know, it's not going to have anything meaningful that we can report for the balance of this year. But, I think as we look at the last greenfield that we did in Las Vegas; Las Vegas was actually positive cash flow in basically the first 12 months.

You know with no predictions, I feel that Chicago has the opportunity because of the size of the market and the number of cars in that market and the number of dealers in that market and the need for another auction to be in that market. I feel very optimistic about what Chicago will be able to do going forward. But, I'm not able to break it down as 1/76, or I'm not able to break it down into the numbers that you'd like to hear.

Ryan Brinkman
JPMorgan Securities LLC

Q

Okay, thanks for the color.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: Thank you. We'll take our next question from Gray Prestopino (sic) [Gary Prestopino] (37:06) of Barrington Research.

James P. Hallett
Chairman & Chief Executive Officer

A

Hey, Greg.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Good morning. Hey, Greg.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Yeah, Greg changed his name. Hey, couple of questions just in terms of SG&A expense as a percent of sales, obviously, you had a one-time issue with the – in the quarter, but going forward as you further integrate some of these companies and all should we expect that to come down relative to where it's been as a percentage of sales?

James P. Hallett
Chairman & Chief Executive Officer

A

You know, Gary, good question, and I think, Eric did a good job of breaking down the SG&A. And we're doing everything we can, everybody in this company is focused on SG&A and getting SG&A down and wherever we can reduce SG&A, wherever it makes sense, we're going to do it.

But as I look at SG&A, I really look at it in three buckets. I look at it in performance, I look at it in terms of acquisitions, and then I look at it just in terms of investments and what I would call our organic business or our ongoing business. And as you know, this business is growing, it's becoming much larger. We mentioned that we have more – we have to invest more in our technology, we have to invest more in people and other resources to continue to support this business. But I think the important thing is if you take a look at what happened within our business units, I think, our business units are doing a good job of controlling SG&A.

And as we think more about that one company that we spoke about in our commentary, that's where I really look for opportunities. As one company, I look for opportunities to be able to take some of these technologies and leverage them across the entire company, as you would like a shared service, and I think, if we can do those types of things, those are the things that will have the most meaningful impact on reducing SG&A going forward.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Okay. Well, I only ask the question in the context of you doing more institutional cars, we're not going to see dramatic increases in your gross margin because you've got more touch points there. So that's why I asked that question.

James P. Hallett
Chairman & Chief Executive Officer

A

And then, Gary, we agree with the strong topline revenue growth, it would naturally we would expect the SG&A as a percent of sales – of revenue to begin declining.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

And then just lastly, vehicles sold at physical auction locations were up 15%, but only 3% at the base ADESA business excluding Brasher. Is that just solely a function of that you are seeing more leased vehicles coming through the pipeline or are you seeing more participation in open sales over the net?

James P. Hallett
Chairman & Chief Executive Officer

A

Well, Gary, let me start by saying the math hurts us a little bit, the 3% decline in dealer consignment, which we've highlighted for you is what causes that. It's up 9% on commercial, and part of that is really tough comps.

Last year was a very strong year. Second quarter had good growth. So I think it's year-over-year that's causing some of that to look perhaps a little lower than it did in the first quarter. But we feel very good about the strength of the business and the number of cars coming into auction, and you'll see I think a continued strong performance on the volume front at ADESA not just this year but in a couple years going forward.

Gary Frank Prestopino
Barrington Research Associates, Inc.

Q

Okay. Thank you.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: We'll take our next question from John Healy from Northcoast Research.

John Healy
Northcoast Research Partners LLC

Q

Thanks. I just wanted to dig in a little but more on the dealer consignment commentary. Jim, you sounded optimistic going forward, but I just wanted to think conceptually, is there any sort of, I would say, shrinking or cannibalization going on in the business because of the growth in off-lease and simply maybe that there are as many trades for the dealer consignment market for the dealer to process just because those cars are moving through an institutional consignor. Because I know we've all been talking about the improvements on off-lease, but is it reasonable to think that in the flat-to-down SAAR environment or a flat SAAR environment that the dealer consignment market or addressable market probably shrinks? And your optimism is based on taking share. I'm just trying to think about how all these different factors flow together.

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. So, John, let's go back to when Eric and I had first started talking about the cyclical recovery, and that was nearing the end of 2012. And one of the things that we pointed at that point in time is we said with the amount of off-lease cars that we see coming over the next few years, we would expect dealer consignment to taper off a little bit. And, quite frankly, we've reported to you on a quarterly basis over the last two or three years how well dealer consignment has held up, even with this onslaught of lease cars coming.

And, again, as we look at the volumes of off-lease cars that came in the last quarter being down 3%, I don't really feel that signals anything significant. I feel very good about our dealer consignment and I feel that we're in a good spot with dealer consignment knowing that if you allow me to repeat, some of these cars are being, as Elizabeth said at the very first point, our very first comment, that we talked about the stop sale cars that are sitting on dealers' lots that weren't able to get to auctions. We've got some recalled vehicles sitting in our inventory that we're not able to sell. So, at the end of the day, I think that we're in a good place, and I don't really see a huge change coming here.

John Healy
Northcoast Research Partners LLC

Q

Okay. That's helpful. And then I just wanted to ask about the Insurance Auto Auctions business. One of your main competitors there put out some pretty aggressive CapEx plans for the next 20 months or so in terms of opening 20 new yards and 20 expansions. How are you guys thinking about that business? Do you need to put a lot more capacity into the model? And is there anything changing competitively between the two of you guys?

James P. Hallett
Chairman & Chief Executive Officer

A

You know, John, I would say, this is what we do every day. We don't wait to buy 20 yards to announce 20 yards. We're buying, we're expanding our lots all the time, we're relocating our lots all the time, we're green-fielding our lots all the time, we have a very competent real estate staff in this company that is continuously working on buying and acquiring and expanding and leasing real estate and it's just part of what we do. And I can tell you there isn't a month that goes by that we're not having a real estate discussion about where we need to be or how we can better service our customers by expanding capacity. And so it's just an ongoing part of our day-to-day work.

John Healy
Northcoast Research Partners LLC

Q

Sure. Thank you so much.

James P. Hallett
Chairman & Chief Executive Officer

A

You're welcome.

Operator: Our next question is from Bob Labick of CJS Securities.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Bob.

Bob J. Labick
CJS Securities, Inc.

Q

Good morning. Sticking with IAA, if we back out HBC, looks like gross margins grew for the first time in about six quarters now that the scrap and FX have stopped being a big headwind. Can you just talk a little bit about the opportunity for further gross margin expansion there and how you're looking at the operating leverage at IAA?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

Yes, Bob. Good observation, and yes, the gross margin did expand. And I would attribute it to two factors. Number one, we're seeing the beginning of really on proceeds are the bids at auction, which will naturally as they increase will bring up the buy piece. Second, you'll get some details, etc. in the earnings supplement. The percent of its volume that will purchase vehicles actually is down and starting to decline, which is also a positive contributor to gross margin. So I think it's those two factors: higher proceeds and it's modestly higher right now. But I feel scrap is coming off the bottom and starting to increase. Recent scrap prices are actually getting up in the above $150 now. Combined with, if the purchase vehicles are less, that will be a positive to gross margin.

Bob J. Labick
CJS Securities, Inc.

Q

Okay, great. Thanks. And then also we've seen you've recently announced some expansion of some locations to accommodate run-and-drive at IAA. Could you just talk a little bit about what percentage of cars are run-and-drive now and maybe what they've been or where you expect them to go? And where you source those cars? Are those coming over from ADESA at times or what are the primary sources for those run and drives?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President

A

It's interesting, Bob, you bring that up. IAA's business model has always been a live auction and we have been running and driving cars all the way back to when Jim and I started talking about it in 2007. So this isn't new. I do think it's getting an increased focus because when you run the car and the buyer can see that the engine operates, it generally we believe yields a higher bid on the vehicle. So expanding that I will tell you it's less than half the cars. I will give you that, but it's a substantial number of cars and we have targets for each of our locations to run and drive as many vehicles as possible and they have incentives to do that. And again, it's to drive higher returns for the insurance companies is why we're doing it.

Bob J. Labick
CJS Securities, Inc.

Q

Great. Thanks very much.

Operator: [Operator Instructions] We'll take our next question from Bill Armstrong of C.L. King.

James P. Hallett
Chairman & Chief Executive Officer

A

Good morning, Bill

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

Q

Good morning. Good morning, gentlemen. My question kind of segues from the previous one and that is at IAA so it looks like you're starting to see some higher bids at the auction. Do you think this is being driven mostly by scrap prices leveling off or do you see foreign-exchange? In other words, are you seeing more foreign buyers coming in now and maybe bidding more?

James P. Hallett
Chairman & Chief Executive Officer

A

Yes. I think, Eric mentioned that we are seeing what we would call modest lift on scrap prices, which is a good thing. Certainly no celebrations going on. Nowhere near where it was at the high point, but that's certainly helping, and then the international buyer activity, I would say, is pretty much the same as it's been. I don't think we've really seen any impact or any increase based on anything that's happened with currency relative to the last quarter.

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

Q

So sounds like it might be more scrap driven.

James P. Hallett
Chairman & Chief Executive Officer
A

Yes.

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

Are you seeing any changes, either increases or decrease, in the usage or the use of various services that you provide at the auction? Maybe generating additional incremental fee income?

James P. Hallett
Chairman & Chief Executive Officer
A

Bob, are you talking specific to IAA or are you talking whole car as well?

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

Well, I was speaking to IAA, but while we're at it, we could maybe talk about ADESA as well.

James P. Hallett
Chairman & Chief Executive Officer
A

Yes, there might be a little bit more color on ADESA. I would say not any increase that I would speak of going on at IAA in terms of additional services. But certainly at ADESA, we're seeing with these off-lease cars, they are the heavy users of the ancillary services. And I think we reported our average ARPU is up $742. This is being driven by obviously all of those services, anything ranging from mechanical to reconditioning, to paint and body to cutting keys to [ph] pop and dents (49:01). It runs the full gamut and we're definitely seeing more and more of these customers use those services, and it's really a way for them to differentiate their vehicles in the lane and try and be the prettiest girl at the party to attract the highest price.

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

And I'll add because of earlier questions, as prices moderate, we would expect consignors to think about spending more on the car for that very reason, right Jim?

James P. Hallett
Chairman & Chief Executive Officer
A

Right.

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

Okay. Great. That makes sense. Thank you.

James P. Hallett
Chairman & Chief Executive Officer
A

Okay, great. Thank you.

Operator: And it does appear that we have no further questions at this time. I'd like to return the call to Mr. Jim Hallett.

James P. Hallett
Chairman & Chief Executive Officer

Great. Thank you, Leo. And ladies and gentlemen, I just want to say again thanks for being on. We're very pleased with the quarter. We're very pleased with our business. As I've talked with management and others, I feel that all of our businesses are performing as well as one right now as well as they ever have over the course of the last I guess nine years almost now since we came together. And, again, I think we have good visibility. I think the businesses are well positioned. We're focused on managing these businesses and running these businesses to give our shareholders the best possible returns we can. And I appreciate you being invested in our stock and our company, and we look forward to delivering you a good third quarter. So thank you for being on today. I appreciate it.

Operator: Thank you. This does conclude today's KAR Auction Services Q2 2016 earnings conference call. You may now disconnect your lines. And everyone have a great day.