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KAR Auction Services, Inc. (KAR)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the KAR Auction Services Q3 2016 Earnings Conference Call. Today's conference is being recorded.

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

Michael Eliason
Vice President, Investor Relations & Treasurer, KAR Auction Services, Inc.

Thanks, Denise. Good morning and thank you for joining us today for the KAR Auction Services third quarter 2016 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended September 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 statement involve risks and uncertainties that may affect KAR's business, prospects and results of operation, and such risks are fully detailed in our SEC filing. 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 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, KAR Auction Services, Inc.

Thank you, Michael, and good morning, ladies and gentlemen, and welcome to our call. This morning, I want to: confirm our guidance for 2016; review highlights of our third quarter performance; discuss capital allocation; and last, give you an update on our outlook going forward. Our 2016 guidance continues to be $735 million to $760 million of adjusted EBITDA. I will let Eric cover more details around our guidance in a few moments.

Now, I'd like to provide you with some comments on our third quarter results. ADESA led the way, with a strong third quarter and these strong results were driven by the increase in volume and the increase in average revenue per unit. Our same-store volumes increased 6% in the quarter. Online only volumes increased 23% and physical auction volumes increased 15% and this was primarily due to the acquisitions.

With the shift in mix to more commercial vehicles, we saw ARPU increases both at the physical auctions and in our online-only venues. And you may ask what's contributing to the lower dealer consignment numbers. I would say, there is a number of things that I would point to. First, we're seeing increased lease penetration, and this is likely reducing the number of trades that dealers are taking.

Retail used car sales were flat in the last quarter compared to the second quarter. And I would also draw your attention to the comp that we had from the previous year. We had a difficult comp, where last year, the volumes were up 10% in the third quarter. And, as we talked about previously, we are likely seeing a high number of commercial vehicles displacing some of the dealer consignment vehicles in the lanes.

So before moving on from whole car, I'd be remiss if I didn't talk about the international markets. And that, I would say, we are very pleased with our acquisition of GRS. As you know, GRS is somewhat the equivalent of the OPENLANE platform here in North America.

And we're excited about the rollout of TradeRev in the UK as well. In fact, TradeRev has exceeded our expectations. And I think when you take the combination of GRS and TradeRev together, I think it puts us in a position to become a serious disruptor in Europe.

With that said, I would also say, it's going to take some time, but I believe there is a significant opportunity there as we go forward. In fact, I'm excited that I've been invited to speak at the European Remarketing Forum in Barcelona here in the next couple weeks. And this will provide an opportunity to further share the offerings that we're going to be providing in the European market.

Turning to Insurance Auto Auctions, there is no question that they faced some challenges in the third quarter, but I still believe that they had a very good performance. As you know, we had the major storms with the hurricanes that are clearly contributing to the increase in total loss vehicles. Our inventory was up 22% over the prior year at quarter end. And we had some additional costs that we incurred in the third quarter related to the Louisiana floods.

The good news is that we will have the revenue and the profits, once the total loss vehicles are sold. As I look at AFC, AFC is experiencing growth in line with the industry in the third quarter. We've been telling you for the last few years that the level of credit losses have been unusually low at AFC. And we did recognize increased credit losses in the third quarter.

It looks like the market is returning to what we would call more historical norms. And Eric's going to cover more on loan-loss trends here in a few moments. But I wanted to let you know that we are watching our loan portfolio very carefully. And I don't see any disturbing trends.

Now, I want to speak a little bit about SG&A. We've been able to maintain organic growth in SG&A within the business units at levels below our revenue growth. And we're also executing on some corporate initiatives to support both organic and strategic growth throughout all of our businesses. And there are really three major areas where we're spending money, and those are talent management, technology and innovation, and strategy.

I think it's important that I give you a little bit more color around this area, and with some real tangible examples. In terms of talent management, we are in the midst of implementing a enterprise system called Workday, which will replace a number of our legacy systems. We expect the implementation of Workday to streamline all of our HR processes, which will improve our effectiveness in hiring, retaining and rewarding our people. And we will begin sunsetting our legacy systems in 2017, which will eliminate the redundant costs.

In terms of technology and innovation, we are updating a number of internal operating systems that will improve our efficiency in our distributed organizations. And examples of these projects are the implementation of Microsoft Office 365, implementing a enterprise-wide Salesforce application and migrating certain IT systems to the cloud. And in the area of strategy, we are building a team of data scientists and looking at opportunities to utilize our unique data to create value for our customers and potentially new revenue sources. Our customers have been asking us to help them make better decisions through the use of predictive analytics.

We recognize that there is a need to balance spending to support the growth with the return to our shareholders. As a result, we are increasing our quarterly dividend from $0.29 per share to $0.32 per share. We target 45% to 50% of our free cash flow to be used for recurring dividends to our shareholders. Our dividend continues to provide a yield that is a premium to the average S&P 500 dividend paying stocks. And we authorized a $500 million repurchase program for KAR's stock and this authorization will be in place for the next three years.

Capital allocation priorities have not changed. As we mentioned, it's return capital to the shareholders through the recurring dividend, continue to grow through acquisitions in existing markets and look to expend into new markets. And when our capital is not needed for acquisitions or for other strategic growth opportunities, we will return capital to our shareholders through the repurchase of our stock.

I'm very excited to share with you that a week ago today, we opened ADESA Chicago and I believe that ADESA Chicago is the auction of the future. We've been truly able to bring the best-in-class of what we do in terms of operations and processes, combined with the state-of-the-art technology, to really create a great venue for both our buyers and sellers. I think that this will be a great experience. And early indications are our dealers are very much enjoying what they're seeing in the Chicago market.

And I'd also mention to you, although ADESA is new to Chicago, KAR is not. This will be our seventh site in the Greater Chicago market. And with ADESA Chicago now being in Chicago, this will bring the full breadth of KAR's service offerings to that market.

In terms of looking at our acquisition pipeline, the pipeline remains active. We have a number of targets at various stages of development. As we look at 2016, I would term it as a landmark year for ADESA and for KAR.

We filled in our map nicely. We've completed transactions at what I would consider attractive multiples. And the integration of the whole car auction facilities is well underway. And we will continue working on these targets and continue our efforts with patience and with discipline around valuation.

To sum it all up, I feel very good about our businesses as I look forward. We would expect ADESA to benefit from the increased lease returns through 2019. Wholesale values are likely to decline. Dealer consignment volumes may continue to be down. And we would expect the dealer consignment volumes to be offset by an increase in the commercial volumes.

And just before I move on from ADESA, I do want to just take a moment and talk about an area that a number of our investors have mentioned to us. And that is, recently, one of the large dealer groups have announced that they are going to begin operating their own auctions.

And I would just say to you, this is not new to us. Other dealer groups have done this, and some continue to do it. But really I think the more important thing is what are we focused on here at KAR, and what are we focused on at ADESA. And that's really providing the best possible service levels that we can provide. And there's really four things that I would draw your attention to. Number one is we feel we have an unmatched physical footprint. We have an extensive technology portfolio that continues to grow. We have an extremely strong buyer base, global buyer base, that continues to grow.

As you know, we're now selling vehicles in well over 100 countries around the world. And then, when you take our combination of online, mobile and physical auction venues, I think that makes up for a recipe that customers will want to sell their vehicles at our auction locations.

So, moving away from whole car and back to Insurance Auto Auctions, I would say Insurance Auto Auctions are well-positioned as we think about severity. The severity of insurance claims continues to increase. The demand for aftermarket recycled parts continues to grow. And we are likely to see some improvement in auction proceeds as scrap prices begin to increase.

And last but not least, AFC continues to be well-positioned to serve the independent used car dealers. And assuming that there are no major changes in credit conditions, we believe that the losses at AFC will continue to stay in the range of 1.5% to 2% of average loan balances. I think all this adds up to a positive outlook for KAR. It will allow us to generate sufficient cash to support our growth initiatives and continue to return capital to our shareholders.

So, I'll end my comments there. I'll turn it over to Eric. And after Eric's done speaking, we'll come back with Q&A. Thank you. Eric?

Eric M. Loughmiller

Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

Thank you, Jim. Let me start by walking through our guidance in a little more detail. There were no changes to our net income per share or operating adjusted net income per share. We increased our expectation for capital expenditures for 2016 to $155 million. The increase relates to: additional costs incurred at our ADESA Chicago facility; increased IT capital expenditures to support the integration of recently-acquired auction sites; and capital expended to support salvage activity related to the Louisiana flooding, which was declared a catastrophic event by our insurance customers.

We also decreased our expectations for cash taxes by $10 million. This reflects the implementation of certain tax planning strategies that accelerate the deductibility of certain items. There is no change to our expectations for free cash flow of $340 million to $365 million for 2016.

In terms of highlights of our financial performance, we saw consolidated revenue increase 16%. That would be 11%, excluding acquisitions. While adjusted EBITDA improved 13%, 9% excluding acquisitions.

Operating adjusted net income per share increased 6% to $0.50 for the third quarter. Increased interest expense, net of income taxes, represented a $0.05 reduction in operating adjusted net income per share as compared to the prior year. Of this increase, $0.03 relates to the interest cost on existing debt, as a result of our refinancing of the term loan facilities in March. And $0.02 relates to additional borrowings for businesses acquired and increased securitization borrowings.

Our results for the third quarter were in line with our expectations, as we summarize them today. The ADESA segment led the way in the third quarter. Revenue grew 26%, 16% excluding acquisitions. And adjusted EBITDA increased 30%, and that would be 21% excluding acquisitions.

Incremental margins for ADESA, excluding acquisitions, were approximately 35% for the quarter. The strong ADESA results were driven by increased volume and improved ARPU. Gross margins were down slightly, due to the increase in lower-margin ancillary and other related services. While the percentage declines, we still realized more dollars per car sold.

Insurance Auto Auctions is now past the difficult comps due to declining scrap prices and the weaker Canadian dollar. Revenue increased 6% and adjusted EBITDA increased 7%. We did see an increase in costs related to the

Louisiana floods in the third quarter. These costs are incurred almost immediately after the storm, and the processing and sale of vehicles lags the cost by a month or two. We will see something similar in the fourth quarter related to Hurricane Matthew.

Let me spend a few minutes on AFC now. We saw the increased provision for credit losses impact our results in Q3. First, as a reminder, the provision for credit losses is recorded as a reduction in net revenue for a finance company. This is different than our other businesses, where bad debt is recorded in SG&A.

I am pointing this out because while net revenue increased 3% for the quarter, our gross revenue, before provision for credit losses, was up 10% in the quarter. The provision for credit losses of $8 million for the quarter compares to only $2.7 million one year ago.

In many cases, customers have been able to access credit from other sources beyond the level AFC was willing to provide. The availability of credit has, in some cases, caused certain dealers to get overextended, even where we have not provided additional credit. The amount of credit available to dealers today from other sources is likely contributing to our losses.

The good news is, we utilize a risk-based pricing model. And the level of losses incurred in Q3 and year-to-date are clearly within the range of loss anticipated in our pricing. However, the amount of losses is greater than what we have experienced in any quarter since 2009. Looking ahead, we see losses continuing at levels similar to what we experienced in the third quarter.

Jim provided an overview of key initiatives around talent management, technology and innovation, and strategy that are contributing to higher SG&A costs. How do these costs in the holding company segment show up in our financial statements? I'd point you to a couple of items. The expense items impacted our compensation expense, and professional fees in the holding company segment.

Our businesses, though, do continue to generate significant cash. Through three quarters, our free cash flow for 2016 was up 10% over the prior year. We continue to have a leverage target of 3 times or less and are slightly above that target right now. In 2016, we have deployed our capital through our dividend to shareholders and acquisitions of businesses. Generating cash is a strength of our business model. It is really nice to have a business that throws off cash that can be used for growth and return to shareholders.

So, with that, I'll conclude my remarks and we'll turn it back to Denise for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And we'll take our first question from Elizabeth Suzuki of Bank of America Merrill Lynch. Please go ahead. Ryan Brinkman from JPMorgan, please go ahead, sir.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi, good morning. This is Samik on behalf of Ryan Brinkman. The first thing that I wanted to touch on is ADESA, and looking at the physical auction volumes there, they were up 1% this quarter, excluding acquisitions. And that's sort of a deceleration from the 3% growth we saw in 2Q and the 12% growth we saw in 1Q. So, just one, curious what's driving that deceleration, is it anything related to the recall volumes on the Takata recall? And what would be your, sort of, outlook for physical auction volumes going forward?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yes, this is Jim. I would say to you that there's a number of things that would be contributing there, there is no question. First of all, I would go back to a comment that I made earlier in the year. When dealer consignment was selling at 50% or above, we said that that mix would probably shift or trend more towards 60% commercial and 40% dealer, so it's kind of what we've been expecting.

But with that said, there is no question there has been a softening in the market in the third quarter. There are more vehicles being sold online. We are seeing some price decline. I think the recalls may be having some effect. I don't think it's a material effect, but there could be some effect their.

But at the end of the day, I would say the good news is there may be a buildup of this commercial inventory and all that commercial inventory is on a one-way ticket, as I would call it. And those vehicles are going to sell at some point in time.

And I think as you think about that, even with Eric's comments, you look at ADESA, ADESA was up 21% in EBITDA in the quarter. So, again, even with these conditions and with these conditions affecting dealer consignment, we're still being very, very profitable.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And, Jim, let me add, last year's third quarter was an extremely strong quarter at physical auction, up over 10% year-over-year. So we don't like to blame the comps, but it was a very strong quarter last year that we're comparing to.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Right, right, right, got it. Eric, then just following up on the pricing at the physical auctions, you went from $699 to $758. And I was wondering is Brasher's impact on that pricing? Because doing the math around the volumes you had this quarter from Brasher's and their revenue, looks like the average revenue per unit at Brasher's was like $530. So wondering if the core business had actually higher pricing at the physical auctions?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, it's nice of you to point that out and you've done the analysis. And, yes, I would agree that typical of an independent auction, they just don't have the breath of services that we offer.

So if you were to exclude that, yes, the pricing increase at ADESA on a same-store basis was even greater than the numbers that we showed because, again, we give you the numbers on a combined basis. So yes, it was much stronger ARPU above $758, if I exclude the Brasher's volume and the Brasher's revenue out of that.

Now be a little bit careful. There is other related services in there, some of which might have been delivered to the Brasher's that get accounted for within our ADESA business unit. But a lot of it would've been attributed to the ADESA business.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Is there any way of quantifying that impact?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

I just haven't really gone to that level of detail. Yes, I think, if you back out the numbers you did, you would, in essence, quantify that impact. It sounds like your numbers were directionally correct.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay. And just last question here, loan transaction volumes at AFC seemed too slow down a bit. You were up 10% in the first half and you were up 5%, so , again, are you purposely slowing down that growth, given where you are at in the state of the cycle or the credit environment or was there something else driving that?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, as I mentioned in my comments, and, again, another very good question. Yes, I think we're being very careful with underwriting, as we always have been. And when you're seeing flat quarter-to-quarter sales volumes at the retail used car sales, as Jim mentioned, flat Q3 to Q2, giving more credit for more inventory may not be the most prudent thing. We try to match that up. So there is an element of that. And then there is an element of – again, up 5% on a quarter where a year ago, we also had very strong growth at – I'm looking up the numbers for you. LTU growth last year was up 13%, matching that high volume at ADESA.

So what I'm seeing is the ADESA volumes and the LTU's at AFC are kind of moving together. And that's what we like to see.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Okay, well, great. Thanks, Jim. Thanks, Eric.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Operator: And we'll take our next question from Elizabeth Suzuki of Bank of America Merrill Lynch. Please go ahead.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Hey, thanks, guys. I think I had an issue with my headset earlier. So you had mentioned that you're building a team to look at how you can better utilize your unique data and potentially generate some revenue from it. What do you view as the potential size of that opportunity? And can that also be used to gain market share in the auction space as you compete with independents and with Manheim?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yeah, Elizabeth, good question. And I don't know if I can size the opportunity for you, but I can size the importance to you. You know, basically, our customers have their own data. KAR has data right across the entire industry, not only the whole car industry, but the salvage industry as well. And we have millions and millions of data points. And what our customers are really asking us, [ph] they're asking us, say, (24:33) how do we make better decisions? How do we make better decisions on what venue we should sell the vehicle in, perhaps what geography we should sell the venue in? And what is the real expected price outcome that we can expect for a vehicle in the marketplace?

And I think that as we can help our customers make better decisions in this area, it does end up, hopefully, rewarding us with more market share.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Great, thanks. And switching to AFC, what do you think has changed in the last quarter or two with your dealer customers that's causing this more aggressive behavior that you mentioned, where they're taking out lines of credit from multiple sources and getting overextended? And listening to the public auto dealers, it sounds like a somewhat tough environment for new vehicles sales and margins, but the used vehicle retail is pretty strong. So I'm just curious what your dealers are experiencing that's resulting in this behavior?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Yeah, Liz, I mean, the bottom line is, the access to inventory for the independent used car dealer, while it can fuel outstanding performance for them, it also puts their business at risk because they tend to be less capitalized than the national retailers that we compare them to. So in the examples that we've given you, we have dealers who just take on too much credit. They can't sell their way through it.

The [ph] floorplan line becomes new (26:02) and values are softer, perhaps even declining right now. And they get behind and, at some point, they can't catch up. This is normal. And that's what we would really like to focus on.

The losses we're incurring are still between 1.5% and 2% for the quarter. On a year-to-date basis, they remain under 1.5%. This is the type of loan activity we make and we know some of them are going to have difficulties.

And what's happened is we've gone through the last four or five years with below normal loan losses. And so this really looks traumatic, when, in fact, we're back to normal. And this normal is below what it used to be. If you go back to 2005 through 2009, loan losses in a normal cycle were 2.5% to 3%. So I think underwriting has gotten better. I think the credit decisions. I think we have a more stable used-car valuation market, all contributing to better performance, but risk-based lending that we're pricing for, we are taking some risk and the losses went up.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Okay. And just one more quick one on AFC, just given the easy comp in 4Q, do you think AFC EBITDA can grow year-over-year in 4Q and 2017 or are the higher provisions likely to keep the lid on EBITDA growth for a while?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, we don't give quarterly guidance, so I want to avoid that. But we're very comfortable that AFC is still on track to perform well. And we are, though, expecting the loan losses to be similar in Q4 as they were in Q3. And we'll just see what happens in the retail used car space and the amount of flow and see where it comes out at the end of the year.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks very much.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Operator: And we'll take our next question from Matt Fassler of Goldman Sachs. Please go ahead.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thanks a lot, good morning.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Morning.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

I have a couple of follow-ups on the AFC and credit question. First of all, as we benchmark anticipated LTU growth for AFC loan transaction unit growth, should we benchmark that against your anticipated organic unit growth at ADESA or should we start to layer in some capture for the acquisitions, just to think about the right growth rate relative to the auction volumes?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Matt, I think you're on the right track. You follow the organic growth plus a little bit, because with our increased presence in some of these geographies, while we already operated AFC branches in all of those geographies, being in the auction gives you an advantage. And we typically see a benefit from that over time.

One other thing I'll remind everybody of, we did not buy the loan portfolios from Brasher's. They retain that. We're replacing it; takes time to replace it. That business didn't automatically come to us, but we think over time it will.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

So that should, at some point, layer into a slightly higher growth rate for AFC versus the intrinsic auction, same-store auction lines, if you will?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Yes, that's what I would've expected. And I probably focus more on the industry growth rate than just ADESA, Matt, as you know, because we are loaning to dealers that are buying at the independents as well and at Manheim, in fact.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Now, a related question; we're talking about the early days, I guess, of price compression in the used car world. And presumably, over time, that weighs on recovery rates. And I wonder, as you think about the forward for dealer losses and such and for your accruals, as that starts, is that an incremental or additional risk that could drive credit losses higher? Have you contemplated that as you've thought about the normalization of loss rates?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

You know, I think what we're experiencing now is what we'll be experiencing. I don't see any shocks that would create changes to what we're experiencing right now in terms of pricing.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Great.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

You know, most of the losses are created when the cars are sold out of trust. It's not really driven by declining values as much as you might think, Matt.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Good. And then finally, you talked about some of the margin hits that you've taken in the salvage business with the storms and sort of the real-time cost of doing business. At what point should we expect that to reverse and the gross profit rate accelerates? Is that an early 2017 dynamic, all things considered, all things being equal?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

I think at is Matt. You know, as you look at the activities that have taken place that we discussed related to the storms, you know, we incur costs when we inventory the vehicles and move the vehicles. And we don't really capture that until the vehicle is sold, so we've got that cost that we've got to take care of as we sell the vehicles.

But the other thing that I would point to is the scrap values. And on the scrap values, I would say that they are increasing. The one thing that I would draw your attention to is probably there is going to be a little bit of a lag there, because I think a number of dealers have bought up inventory at these very depressed scrap prices. And they probably have a little bit more inventory than what they would normally carry at this point in time. So, I think they have to sell through that inventory and that'll take some period of time until we get to the current market prices.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Great. Thank you so much.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Operator: And we'll take our next question from Ben Bienvenu of Stephens, Inc.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Yeah, thanks. Good morning.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Good morning.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

So, we've talked a little bit about [ph] the top sales, and it sounds like it's not a hugely material (31:55) piece of business. But we have heard some dealers deciding to wholesale versus retail these units. Is that something that could be a mild tailwind for you guys? And then, when you look at those vehicles showing up at wholesale auctions, what's the willingness of customers to buy those recalled vehicles? What's the reception at the blanket auction?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Well, I think it's more a question of the willingness of the sellers to want to be able to sell these cars or to hold them for recall. And, obviously, our job is to represent the sellers and to certainly work within the guidelines of the auction and to make the proper declarations in terms of what we're selling and how we're selling these cars.

I think it's kind of a mixed bag. We have a number of customers that will sell these cars with the recall situation in place. And we have some buyers that are willing to buy these cars. But I think overall, I don't think it's really having a material impact. I wouldn't say there is any huge tailwind here.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. And then switching gears to AFC, Eric, you talked about how we've been in an environment of lower provisions in losses. You also talked about the growth that AFC's tracking, the volume growth on an organic basis that we see at ADESA. I'm curious if provisions are going to be bumping up over time, what do you think the implications are for your AFC revenue growth? Should we expect a falling out on that piece of the business, or is that something that's baked into your expectation?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

We've been expecting increased loan losses for quite a while. We've been commenting probably for over a year that, at some point, it turns. And what causes a little confusion then is what I explained in my remarks; loan losses are a contra revenue. They reduce revenue. So, I look at it on a gross basis, being up 10% and on a net basis, being up 3%.

I still think we'll be in a great position, because we're a strong lender in the market with the independent dealers to continue growing the AFC top line. And that'll be supported by the increased sales, because there's a strong backlog of vehicles coming to market over the next several years that'll be very interesting to the independent dealer. So I feel very good about it.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. And then just one last one, if I could; you talked about the Chicago facility being open. I'm curious about your expectation for how that facility ramps to full utilization. Any sort of rough timeline you could paint for us there would be helpful.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Well, you know, you're talking to the eternal optimist here, but I would tell you that, first of all, the facility itself is absolutely outstanding. The dealer reaction and the commercial customer reaction has been very supportive. And we kicked off our first sale last week. And that went very well. We can only look back on history. The last greenfield that we opened was Las Vegas. And in Las Vegas, I believe we were cash flow positive in the first 12 months. Being the optimist, I would hope to improve upon that.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. Thanks.

Operator: And we'll take our next question from Gary Prestopino of Barrington. Please go ahead.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Hi, good morning, everyone.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Good morning, Gary.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Morning, Gary.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Eric, Jim, with AFC, first of all, are you seeing some of these dealers that are having issues, are they the dealers that you deal directly with at your auction sites or are these more or less dealers that are buying outside of your auction?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, our dealers buy at our auctions and outside our auctions. But I would say most of the dealers would have activity at ADESA, yes, without a doubt.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. So what happens when a dealer runs into issues, like you were saying, where they get extended and all that, you got to take back the cars or whatever, do they become a non-customer going forward?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, for a while, yes, because what happens is we have an industry reporting tool that allows us to report to the entire industry that this entity has defaulted on a credit agreement. And they go into something the industry calls the KO book, the knockout book.

And so they would be prohibited from buying cars at any auction who is the member of NAAA. So this is really important that we do this. And if this happens at one of our competitors that has a floorplan, we are made aware of it through the same vehicle. The key is the industry doesn't want our customers who aren't performing to just shop around and find out who will give them credit and who will sell them cars. So they will go through a period. And then, the one thing we do and maybe, Gary, I should go to this. We take these write-offs now. It's not uncommon for us to have recoveries, but it takes a while.

They have other cars on their lot that are not collateral for our loan. They have real estate and things like that. We get personal guarantees from every customer who has a line at AFC.

So when we look at that, we are in a period with very low recoveries right now because we had significant recoveries post-2009. We'll have an opportunity maybe to recover some of these losses down the road, if there's assets there once we get through the process; in some cases, a bankruptcy or them liquidating assets or whatever it may be.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay, thank you.

Operator: And we'll take our next question from Bret Jordan of Jefferies. Please go ahead.

Bret Jordan
Analyst, Jefferies LLC

Q

Hi. Good morning, guys.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Good morning.

Bret Jordan
Analyst, Jefferies LLC

Q

I think you've talked in the last year or so about increasing competition in AFC from nontraditional lenders. And, obviously, they have put some money in the space that may be driving these higher loan loss provisions. Are you seeing any change in their level of activity? Are they pulling back since they're seeing higher credit loss as well?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Bret, good question. Yeah, we'll tell you competition seems to have normalized for us. It's us and NextGear are the primary suppliers. Your larger credits probably have access to some bank lines. I will tell you that we're generally seeing that not being as competitive as it was a year ago or so when we talked about it.

I think it was spring of 2015, when we saw regional and local banks being very active. We're probably, I would say not seeing as much of that now for the very reason you're pointing out. They get into this business and they do not have the resources we have within ADESA. Lot inspections, seeing them at auction every week and all the things we can do in the local market, we tend to do better at this business than the banks do.

Bret Jordan
Analyst, Jefferies LLC

Q

And then a question on AutoNation entering the auction space. You said you'd seen other dealerships in the past take that approach. What's been the history of other dealers feeding into a dealer auction? It would seem like that would be benefiting a competitor. Could you give us any sort of history of peers that have tried this in the past and how they gained traction as far as sourcing whole cars?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You know, I think it's really immaterial in the big scheme of things. It's not like other dealers are feeding into their auctions. It's they're primarily doing this for their own inventory. In some cases, they are auctioning these vehicles among their own locations. You take AutoNation with the number of rooftops that they have, sometimes they're auctioning these cars just within their own network. But in other cases, they are auctioning to outside dealers as well. But they're not taking inventory from other dealers to sell, if that's where you were going.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. Thank you.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Operator: And we'll take our next question from Robert Majek of CJS Securities. Please go ahead.

Christopher Moore
Analyst, CJS Securities, Inc.

Q

Great. Thanks. Yeah, it's Chris Moore for Robert. Yeah, maybe we could start with where you started actually on GRS. Can you talk that a little bit further in terms of it sounds like you're quite excited about what's happening there with milestones, timelines, just kind of any more detail you might be able to provide.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yeah, I think, as I mentioned, GRS is what we would compare to the OPENLANE platform here in North America. And you know, we bought that business. It does have an existing customer base. We've seen that with the customers that we have on the system, we have already grown additional volumes.

We think there is an opportunity to bring other customers onto the platform. We are in discussions. And matter of fact, I have just recently returned from the UK. And we are in discussions with a number of customers that are very interested in the platform. And so we think there is a real opportunity to expand that platform.

And then I'll just add on, also, in combination, we have the TradeRev opportunity. And TradeRev has absolutely exceeded our expectations in the UK. And I think the combination of both of those products really allows us to sell more cars, both on the GRS platform and on the TradeRev app.

In fact, I can also tell you we have customers knocking on the door wanting to know who can be next to go on to some of these platforms. So again, it's just a matter of timing and a matter of making sure that we put the team together and put the talent together to make sure that we can do a good job of managing these new customers on-boarding.

Christopher Moore
Analyst, CJS Securities, Inc.

Q

Great, thanks.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Christopher Moore
Analyst, CJS Securities, Inc.

Q

Last question, just back on the inventories for a second, obviously, it looks like a lot of the variability is coming from weather. Are there any other changes or drivers that are affecting inventory levels?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

No. I think we mentioned that there's no question that sales have softened and prices have softened. And this is where I guess you can say the buyers and the sellers have a different point of view.

And the fact of the matter is, is the inventory is within our facilities. And we know that the good news is, at some point in time, these cars are going to sell. So, conversion rates have dropped off a little bit. So, there'll be a period of time where they may be a price adjustment for the market to return. But we do know that things will normalize here. We would expect that things would normalize here as prices adjust. But we don't expect any major price adjustments. The price adjustment that we're seeing is very much in line with the price adjustments that we started the year with, saying that we would expect in 2016 the prices could adjust in that order of 3% to 5%.

And my most recent conversations with our economist, Tom Kontos, Tom points out that prices are down at about 3.6% year-to-date. And so that's very much in line with what we're thinking. So, I think it's normal and there's some seasonality here as well with the holidays coming up. I don't think there is anything that I would panic about.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And, Chris, were you also wanting to talk about IAA inventory?

Christopher Moore
Analyst, CJS Securities, Inc.

Q

Yes.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Okay. So on IAA inventory, we're up 22%. What I would point out to is if we were to exclude the cat, what we call the cat cars, the catastrophic event-related cars, we were still up double digits. And in fact, the cat cars make up less than half of that increase.

So, we're seeing strong performance on the total losses, and Jim mentioned it in his remarks. Severity is going up on auto claims and they are totaling more cars, whether it's a catastrophe or just a wreck on the road. So, it's a really strong backdrop to that performance in that industry. And we're seeing normal activity increasing as the complexity of the vehicles, the cost of repairs are going up, all of that is boding well for our salvage business.

Christopher Moore
Analyst, CJS Securities, Inc.

Q

Thanks, guys.

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

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

Q

Good morning, gentlemen. My question is on foreign exchange, particularly in the salvage business. Could you tell us what kind of impact you're seeing on the bidding from international buyers? And specifically, I'm referring to the Mexican peso. What kind of impact with the weaker peso are you seeing from international buyers in terms of a bidding at the salvage auction?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And, Bill, we see the international buyers being active, but their bidding is lower. Ironically, so is the domestic buyer, their bidding is lower as well, driven, we think, by scrap prices. So we're not seeing the recovery in proceeds of the average auction price yet, but we think there will be some relief if scrap prices come up. While it might be foreign currency, it takes less money to buy the car right now, because of the competitive pressure on everybody to buy the cars at the right price. You're not going to bid more than the last bid.

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

Q

Right, got it. Although you did see a 1% increase in your revenue per vehicle, which looks like that trend is slowly improving. Is that fair to say?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

That is fair. And we're seeing that as, again, in this market, we've been able to see a modest increase in our buy fees.

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

Q

Yeah, got it, thank you.

Operator: We'll take our next question from John Healy of Northcoast Research. Please go ahead.

John Healy
Analyst, Northcoast Research Partners LLC

Q

Thank you. Wanted to ask a little bit about the opportunity to take the GRS business, the bigger things, across the UK. When you guys look at the UK consignment market, how do negotiations go and if you wanted to get a piece of the leasing business with one of the manufacturers for their UK business? I mean is it, can you leverage the relationships you have in the U.S. with OPENLANE or is it very different when you're working with the internationals about their business outside of the U.S.?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yeah John, it's really all of the above. Let me tell you that we have been introduced to relationships as a result of relationships that we have here in North America, which obviously is a very good introduction.

On the other hand, we've been traveling these international markets for the last seven or eight years. And we have been establishing relationships not only with the providers, but with the OEMs. And then in Europe and the UK, these large leasing companies; you have a number of very, very large leasing companies that really control a lot of the cars. I'm talking about lease companies that have fleets of 700,000 and 800,000 vehicles in their portfolio.

So it's a matter of getting yourself introduced. And we've done that. We've done a good job of establishing relationships. And then, I think it comes down to your product. Do you have a product that they see as something better than what the current market is offering them? And I can tell you in the case of TradeRev, we did a large pilot with Arval, very large leasing company based out of Paris. And we started with a small slice of their business. And they gave us the feedback that you're giving me more money in a shorter time period and a higher conversion rate than I'm getting at physical auction. And when you've got a product that will do that, it doesn't take a whole lot of talking.

On the other hand, you've got GRS. I would say that the market resisted technology. The UK and European market resisted technology for a long period of time. And they tried to force everything into that physical auction environment. And, quite frankly, the customers are looking for an alternative. And nobody has really taken the opportunity to provide that alternative. And this is where we've been able to step in with GRS and TradeRev. And I think that's the opportunity.

John Healy
Analyst, Northcoast Research Partners LLC

Q

Thank you.

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

And, Jim, you might add we're at the beginning of what looks like a cyclical recovery, similar to the U.S., where there is a significant number of leased cars that are going to be coming back to the market over the next several years.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yeah and, Eric, that would remind me to mention the other thing that is taking place in the UK and Europe is now we're getting into this personal leasing. Previously, most of the leasing in the European countries were company leases. And now we're getting into personal leasing. And if I have my numbers right, there's going to be 600,000 personal leases returned to the marketplace here as we go into 2017.

And this is a whole new opportunity in the remarketing space in Europe and the UK and in other markets, where leasing in North America has been very prevalent. We know what those leasing numbers look like in North America. But personal leasing, private owners, private leasing has not been a big deal like it is in North America. Now we're seeing that start to come into the marketplace. So again, just, it reinforces our thoughts on what the opportunity is there.

John Healy
Analyst, Northcoast Research Partners LLC

Q

Got you. And along those lines, how do you see yourself deploying capital in the UK? Is it reasonable to think that you guys might – opening up some marshalling yards or trying to establish more of a land footprint or can you do this without what I would say the yard capacity?

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Yeah. We'd like to think that our initial thoughts are asset-light. Do as much as we can through technology, really focus on deploying the technologies that we can transport from North America. In some cases, we'll have to build some features and enhancements to accommodate the local market. But also acquire technologies and build technologies, and to do it in an asset-light model. That's not to say that there couldn't be brick-and-mortar at some point in time. That's not to say that there couldn't be a marshalling yard. But the real focus in Europe and the UK and some of these international markets beyond that we're talking about, are really hopefully going to be driven by technology. And I think if you take a look at those markets, especially the European market, the European market has really embraced technology, maybe even more so than what we have here in North America.

John Healy
Analyst, Northcoast Research Partners LLC

Q

Got you. And then, just a final question for Eric, when you look at kind of the distribution of loan losses for the AFC business, I know you said we're going to be at more of a normalized level of, I think you said, 1.5% to 2%, but what was kind of the extreme on the far end of the losses?

Eric M. Loughmiller
Chief Financial Officer & Executive Vice President, KAR Auction Services, Inc.

A

Well, John, if you go back to 2008, fourth quarter, you probably got the mid to upper single-digit in a quarter. But for a year, really it topped out more at around 3% on a historical basis. So and, again, that was for a year. So I really think that's what we're talking about. We're talking about 1.5% to 2% becoming the norm, because I think there is much more discipline in the independent dealer space in how they operate their businesses.

John Healy
Analyst, Northcoast Research Partners LLC

Q

Okay, sounds reasonable. Thank you.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

You're welcome.

Operator: [Operator Instructions] And we'll take our next question from Jordan Hymowitz of Philadelphia Financial. Please go ahead.

Jordan Neil Hymowitz
Managing Principal, Philadelphia Financial Management of San Francisco LLC

Q

Most of my questions have been asked. I will follow up later. Thank you.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

A

Thanks, Jordan.

Operator: It appears there are no further questions at this time. Mr. Jim Hallett, I'd like to turn the conference back over to you for any additional or closing remarks.

James P. Hallett
Chairman & Chief Executive Officer, KAR Auction Services, Inc.

Great. Thank you, Denise. And I just want to say thank you for those who are on the call this morning. Obviously, we appreciate your interest in our company. And I would just tell you, again, I remind you, this is a great business.

We have businesses that we think we're performing very, very well. We know we have good visibility here as we look out through 2019. In terms of the volumes and the dynamics that are taking place in the marketplace, we like what we see.

We think there's good opportunities not only here in North America, but we're excited about some of the international opportunities that we're looking at. And we think it all bodes for a very, very good future and a very good story going forward.

So, thank you for your interest, appreciate you being on today. And we'll look forward to talking to you next quarter. Have a great day.

Operator: That does conclude today's presentation. Thank you for your participation. You may now disconnect.