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KAR Auction Services, Inc. (KAR)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the KAR Auction Services Q4 and Fiscal Year 2016 Earnings Conference Call. Today's conference is being recorded.

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

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

Thanks, Jessica. Good morning, and thank you for joining us today for the KAR Auction Services fourth quarter 2016 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended December 31, 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, KAR Auction Services, Inc.

Thank you, Michael, and good morning, ladies and gentlemen. Welcome to our call. I'm excited this morning to be with you to share our overview of our performance for 2016, maybe even more excited to share with you what we see in 2017 and going forward. I want to discuss capital deployment for 2017. And then, very enthusiastic to introduce a new project to you which relates to our online selling platform that we will be referring to as New Wave. And then, longer term, I want to talk about KAR's performance, our strategic focus, and then, capital deployment going forward.

With that said, I want to say at the very outset, I'm very enthused not only about the opportunities that we have in front of us for 2017, but even more so, the visibility that we have for the next three years. I believe that we've made the investment, and we've truly positioned the company to take advantage of the market that we see coming at us over the next three years. And as we complete this call, I'm looking forward to getting on the road with Eric and Michael and spending considerable time with you to share our optimism as we go forward.

So with that said, let me turn to our fourth quarter with KAR's consolidated results. I believe they are very much in line with our expectation. So we do recognize that the results for the segments were a little choppy. And as I've discussed many times with you, I believe, one of the two value of the KAR combination is, what I would refer to, is the complementary and diversified nature of our business where we can have one part of the business perform extremely well when maybe another part of the business is experiencing a little bit more pressure and that's exactly what we've seen in the fourth quarter [ph] we saw this played out (03:40). IAA had an extremely strong performance which did offset the pressure on earnings at ADESA.

I believe that the key takeaways for 2016 results are revenue grew 17%, adjusted EBITDA grew 15% to $748 million and free cash flow grew 9% to $368 million. I'll talk a little bit more about how we deployed that capital or deployed that free cash in a few minutes.

At ADESA, we had a challenging fourth quarter. So let me speak to that. We saw our activity slow in October and early November. Conversion rates dropped at the physical auction despite the shift in the mix to more commercial vehicles. And we saw consigners become very price sensitive during that period of time where conversion rates fell and ADESA's performance, I believe, was consistent with the uncertainty in the retail space that was centered around the election.

Same-store physical auction volume was flat year-over-year in the fourth quarter. Dealer consignment volumes excluding the acquired auctions was down 7% in the quarter. For the year, same-store dealer consignment volumes were down 2%, which was very much in line with our expectations.

Commercial volumes excluding the acquired auctions was up 6% at physical auction. And average revenue per unit was up at the physical auction as well. I believe that the revenue per unit is a reflection of the higher utilization of ancillary and other related services on cars that did not sell in the quarter. And as you know, these ancillary services come with lower margins. However, I do believe this sets us up very well for 2017, when I expect these cars to be sold.

Our leadership in the private label online auction channel was evident with a 16% increase in volume. And again, I believe that we're in a great position, as I look forward into 2017. We've had more commercial vehicles on the ground at year-end. And the mix of vehicles awaiting sale is very good for us. Most of the vehicles that we have on the ground at the end of 2016 are what we refer to as the captive finance vehicles whereas if I compare that to year-end 2015, most of those vehicles on the ground were what we refer to as OEM vehicles or factory buybacks. And in the case of these vehicles at year-end 2016, the fleet lease cars, we generally generate more profit and more revenue opportunity on these captive finance cars. So again, I'm very encouraged by the inventory that we had going into 2017.

Overall, I would say that we definitely had a strong 2016, especially they had a strong first half of the year. And then, for the year, we were able to improve our adjusted EBITDA margin. We grew our adjusted EBITDA 28%. And again, I believe that we're in a great position to deliver even better results, as we look at what's going on in the industry, in the market, in 2017.

Insurance Auto Auctions had an exceptional fourth quarter. Revenue grew 16% on an 18% increase in volume. Adjusted EBITDA was up 22% and we improved our adjusted EBITDA margin. And in contrast to ADESA, Insurance Auto Auctions had a great second half of 2017 (sic) [2016] (07:23) after a relatively slow start in the first half.

AFC's performance was very much in line with independent used car dealer retail activity. For the fourth quarter, retail used car sales by independent dealers was relatively flat year-over-year and our performance at AFC was consistent with this retail trend.

However, our provision for loan losses was increased in the fourth quarter. And I'll let Eric give you the details on that in a few moment. But I believe the bottom line is that we're seeing decreasing used car prices and the retail used car market that is starting to level off. This will put some pressure on the independent used car dealer, and we are now anticipating that our loan losses will be 1.75% to 2.25% range in 2017, and this is a modest increase from what I've previously shared with you.

I believe we have a great visibility into 2017 and we expect a very strong year. We're expecting adjusted EBITDA of $825 million to $850 million in 2017 and free cash flow of $395 million to $420 million.

So my outlook for 2017 is based on the following. At whole KAR Auctions, we will see commercial vehicles should increase as lease returns and repossessions are expected to increase over 2016 levels. Dealer consignment volumes may continue to decline modestly in 2017, as we see the SAAR remaining flat to slightly down. And in total, we expect used car volumes to increase. Used car values are expected to decline 3% to 5%, as the increase in supply combined with the heavy incentives that are being placed on new car sales will push down used car prices.

Insurance Auto Auctions is also well-positioned. And again, the drivers of this business were seeing an increase in miles driven, increase in the complexity of these new vehicles, and we're seeing an aging car park that will all contribute to increased total loss rates for the insurance industry. We expect 5% to 7% increases in the industry volumes in 2017, which will drive strong revenue growth.

Our inventory at Insurance Auto Auctions was up 25% over the prior year, again, setting us up for a great start to 2017. Independent used car sales in the U.S. and Canada are expected to level off after seven years of growth. This will result in slower growth at AFC. And SG&A growth has been the topic over the last year. We have been increasing SG&A to support our growth and to meet the growing technology needs of all of our businesses and this fastest strategic initiatives that I believe will be critical to our long-term success and this is what I refer to at the outset of this conversation.

I also expect the pace of growth in SG&A to slow compared to what it was in 2016. We would also expect to complete the integration of the auctions that we acquired in 2016, which will further contribute to improved performance at ADESA.

I believe that our capital deployment in 2016 reflects our ability to utilize cash in many different ways to create shareholder value. We utilized $432 million to acquire businesses. Those were made up of the eight Brasher locations, one location in Flint, Michigan and another location in Central Florida. As well, we also acquired an online auction business in the UK.

We paid $157 million in dividends to our shareholders and we repurchased $80 million of stock in the fourth quarter. Although we had utilized a substantial amount of our capital for acquisitions, we felt our stock was undervalued in the fourth quarter and we purchased 1.9 million shares in the open market. And the deployment of capital for growth and providing a return to our shareholders remains the top priority at KAR.

Now, I'd like to update you on the strategic project called New Wave, which is our next-generation online solution. Our online selling platforms represent one of the most valuable and differentiating assets with nearly 750,000 vehicles sold upstream in 2016.

To remain at the very forefront of this segment of the business, we are investing $20 million to $25 million over the next three years to redesign and enhance our market-leading position. New Wave leverages the latest advances in online and digital technology to deliver a more simplified user experience and enable seamless use across desktop, mobile and tablet devices.

It will also integrate the advanced analytics, pricing and reporting capabilities generated by KAR's data science solutions team. And we expect to begin deploying the New Wave solution later this year and the investment is included in our 2017 capital expenditures estimate.

As I look beyond today and even beyond 2017, let me provide some insights on KAR's performance, our strategic focus and our capital deployment over the next three years. First and foremost, our auction businesses are well-positioned for the next three years. [ph] Of these (13:21) volumes will continue to grow through 2019, and we expect [ph] the repossession (13:25) volumes to grow as well.

We would expect the mix of commercial vehicles versus dealer consignment vehicles of physical auctions to move closer to a 60/40 split. We were 52% commercial and 48% dealer consignment in 2016. This should drive increases in revenue per vehicle sold and partially offsetting the increased commercial volumes will be a decline in dealer consignment volumes.

Our outlook is based on the SAAR remaining at current levels and we're also expecting the recent growth in SG&A to stabilize over the next three years. We've been adding additional talent and technology to all of our businesses to support our growth and provide the foundation for executing on our strategic initiatives that I spoke to.

Now that we built many of the new capabilities within KAR, the pace of SG&A growth should decline and be below our revenue growth over the next three years. And as we look forward, we expect salvage volumes to grow 5% to 7% per year over the next three years. Our strategic focus can be described in two categories. First, expand our capabilities for serving our existing customers. We will continue to invest in technologies with programs like New Wave that I've just described. We will enhance our services around the extensive and unique data that we acquire in all of our businesses. And we will identify and develop new and alternative venues to serve our wholesale customers.

We are constantly watching for innovation and new competitors. And I believe that the consolidation of the whole KAR and the salvage wholesale markets into duopolies does invite competition and disruptors. And my goal is to make sure that we are providing the services that our customers are demanding, and if our current business model is to be disrupted, we need to be that disruptor.

The second category is international expansion. We've had the opportunity to enter new markets with our people, processes, and technology. And I believe that it's always better to enhance an existing business in a new geographic market. And I can tell you that we are focused on mature markets with relatively stable economies outside of North America. We expect to acquire businesses that can serve as a platform for introducing our technology and our service offerings, and we are not looking for transformational transactions, but transactions that would be more in line with the size of the deals that you've seen us do here in the U.S.

And we do have a number of potential targets identified. In addition to new geographies, we are also planning to enhance our offering in the UK by combining our online capabilities with the TradeRev platform. Our target market is the commercial consigner and we believe that the UK will grow over the next three years.

Now, let me speak to capital deployment. We will generate $395 million to $420 million of free cash flow in 2017 and we expect this to grow each year over the next three years. We are currently allocating 45% to 50% of our free cash to a recurring dividend. Our remaining capital is available for acquisitions or return to shareholders through share repurchases or special dividends.

In addition to the cash generated from our operations, we also have access to the capital markets. Our target senior leverage is 3 times adjusted EBITDA, and we would expect to use our balance sheet as our leverage falls below 3 times.

And finally, the possibility of a significant reduction in corporate taxes in the United States could be a real positive for KAR. We currently pay U.S. taxes at the Federal statutory rate and a 1% reduction in the Federal corporate income tax rate would result in a $0.02 per share increase in net income. We would also see a similar reduction in our cash taxes and this could be an additional source of free cash flow over the next three years.

So with that, I will end my comments, and I will turn it over to Eric for his commentary, and then, we'll come back for Q&A. Eric?

Eric M. Loughmiller

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

Thank you, Jim. I would like to start by reviewing our guidance for 2017 in more detail. Jim has updated you on our adjusted EBITDA and free cash flow guidance. We expect our capital expenditures to be approximately $145 million, and this includes the capital for New Wave that Jim discussed. Cash taxes are estimated to be $165 million for 2017. There are two conservative assumptions we have used in computing this cash tax number.

First, we are assuming the U.S. Federal income tax rate does not change in 2017 from the current tax rate. As many of you know, we have a relatively high corporate tax rate due to the cash nature of our businesses. Any reduction in the U.S. corporate tax rate would be a direct savings in cash taxes. I currently estimate that a 1% reduction in the U.S. corporate tax rate would reduce cash taxes by approximately $4 million.

The second assumption that is conservative is our anticipated tax deduction for option exercises in 2017. We have approximately 400,000 outstanding options that will expire if not exercised in 2017. The exercise of these and any other vested stock options outstanding results in a tax deduction for the difference between the fair value on date of exercise and the exercise price. Our cash taxes will be impacted by the timing of these exercises and the related fair value of KAR stock on the date of exercise.

Cash interest on corporate debt is estimated to be $120 million in 2017. We have assumed two interest rate increases in 2017 that will impact adjusted LIBOR. As you can see in our reconciliation of net income to EBITDA, adjusted EBITDA and free cash flow included in our earnings release, we expect total interest expense of approximately $170 million, of which $50 million is interest on the AFC securitization and amortization of debt issuance costs included in our interest expense number.

We expect 2017 net income per share of $1.70 to $1.80 and operating adjusted net income per share of $2.15 to $2.25. The difference between net income per share and operating adjusted net income per share is amortization expense related to acquisitions net of the income taxes. We have assumed an effective tax rate of 37% for the year.

Now, turning to our 2016 results, I would like to review an area that, I believe, has been misunderstood by some investors. In computing operating adjusted net income, we are adding back amortization expense related to acquisition accounting for intangible assets established in the opening balance sheet of the acquired entity. We do not adjusted for depreciation and amortization expense related to tangible assets or identified technology assets in service.

In 2016, depreciation and amortization expense totaled $240.6 billion, of which $97.1 million was amortization expense related to acquisition accounting for intangible assets. These numbers can be seen in the reconciliations of net income to adjusted EBITDA and net income to operating adjusted net income included in our earnings release.

In discussions with investors, it appears that [ph] many have overstated (21:39) the add-back for amortization and computing operating adjusted net income. We also have higher depreciation and amortization expense than we expected in the second half of the year, as more assets were placed in service and the related lives were shorter than our original projections. This lowered operating adjusted net income.

For 2017, we expect total depreciation and amortization of $278 million, of which acquired amortization expense added back to compute operating adjusted net income is $101 million. We have not anticipated any acquisitions in 2017 in determining these estimates. We will adjust our estimates, if acquisitions are completed during the year.

Another item of note impacting our 2016 financial statements is the gross up of revenue for purchased vehicles in the ADESA segment. We purchased less than 0.5% of vehicles sold primarily to settle arbitration issues where the seller and buyer cannot reach agreement on the value when there is a dispute over the disclosures of the condition of the car.

Previously, we had recorded these transactions by netting the cost of the vehicle with the ultimate selling price. Because ADESA has the risk of loss on the vehicles purchased, we have included the sale price of the vehicle in revenue and the purchase price of the vehicle in cost of services. This change in accounting for purchased vehicles was identified and made voluntarily by management. There is no impact on gross profit, operating profit or net income. Most importantly, we have excluded the gross selling price from an average revenue per unit at physical auction. Accordingly, our RPU metric is consistent with all prior calculations.

We have disclosed the impact of this reclassification on revenue and cost of services by quarter for 2016 and 2015 in our 10-K that we expect to file this week. ADESA's fourth quarter performance was highlighted by strong top-line growth, but weaker flow-through to adjusted EBITDA than we experienced in the previous three quarters.

We had some unique one-time items that were expensed in Q4. We had a customer of CarsArrive filed for bankruptcy with approximately $4 million owed to us. This represents substantially all of the increase in bad debt expense in Q4 at ADESA.

We also had cost incurred related to the acquisition of the Flint auction and increased compensation and technology costs related to our strategic growth initiatives. This made the incremental margins in the fourth quarter for ADESA very messy and looks as if this messiness is contained in Q4 and I do not expect it to continue in the first quarter of 2017.

Now, let me speak to AFC's loan loss situation in a little more detail. Actual losses incurred in the fourth quarter aggregated $9.4 million. Generally, these losses are due to cars being sold and, therefore, no longer available as collateral for unpaid loans.

As retail used car sales for independent dealers level off and used vehicle prices decline, it is expected that loan losses increase, especially as you compare this to the last five years of very low loan loss activity. In addition to actual losses incurred, we increased the allowance for loan losses by $2.3 million in Q4. Approximately half of this increase in the allowance relates to a large balance outstanding with an individual dealer in Southeastern United States. We identified this loss during our routine lot audit process. The account was current at December 31, 2016, but because we identified the loss of collateral, we have recognized a loss for the amount of the loan not protected by the collateral.

As we look into 2017, we're expecting loan losses in the first half of the year to be at the high end or above our annual loan loss expectations. We expect loan losses as a percent of loans outstanding to be lower in the second half of the year. A number of risk mitigation processes have been instituted at AFC that are helping identify potential loss accounts earlier in the collection cycle. AFC is also focused on growing accounts with lines of credit less than $500,000 as we have seen lower loss rates within this group of customers.

Now, let me speak to capital deployment and our capital structure. In addition to completing a number of acquisitions in 2016, we also repurchased $80 million in KAR's stock on the open market in the fourth quarter. We had a limited time with an open window for purchasing stock in the open market in Q4. This limited the total amount of stock purchased.

Our net leverage was 3.2 times adjusted EBITDA at December 31, 2016. This net leverage is based on actual adjusted EBITDA and not pro forma results of operations for businesses acquired. Our target net leverage is 3 times or less.

We regularly analyze the loan markets and our debt instruments. The soft call on our current term loan facilities expire on March 9. We have not considered any potential reduction in interest costs in our 2017 guidance.

In conclusion, 2016 was a good year for KAR and each of its business segments given the market conditions we faced. We saw a stronger performance at ADESA and AFC in the first half of the year than the second half. In contrast, IAA had a strong finish to the year after a slower first half. This all adds up to an enterprise that consistently generates cash that can be deployed to enhance shareholder value either by investing in strategic growth or returning capital to shareholders. We have very good visibility for several years and feel it is a great time to invest in KAR.

That concludes my remarks, and I will return the call to Jessica to moderate our Q&A session. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We'll go first to Elizabeth Suzuki with Bank of America Merrill Lynch.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Good morning, guys. Just a modeling question. The detailed 2017 outlook you provided is really helpful. I just wanted to ask specifically about the D&A assumption, which looks like you've got increasing 15% year-over-year. Is any one of the three business segments are bearing more of the burden of that increase or is it pretty equal across the board?

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

A

Liz, it's typical to our past pattern. Technology is probably the biggest driver of that and that's why the shorter lives give you increased depreciation and that is probably a little heavier at ADESA than it is at IAA and AFC. And then, across the physical – so, that's typically half or a little more than half of the total CapEx. And the remainder I would spread equally across ADESA – actually, not equally, I would do equally to ADESA and IAA with a much smaller portion to AFC, as they don't have the physical footprint.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Yeah. Okay. Great. And looking at IAA, what's the penetration rate with recently acquired dealerships? Is there still some more work that needs to be done in building a financing relationship with those dealers or should we expect that IAA is going to grow similarly to core organic growth in the future?

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

A

Are you saying IAA or AFC, Liz?

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Sorry, IAA. In terms of the relationship with the communities that you've recently built.

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

A

The non-insurance customer, right? No. That's an ongoing process and it's blocking and tackling as they say. It's one dealer at a time. I think there's a lot of runway for them. I will point out though that there's significant volume coming from the insurance industry, which puts our facilities closer to capacity. And so, you have to slow down a little bit, if we don't have room for more cars at times. So I think you'll see the insurance industry actually outgrowing the non-insurance industry over the next couple of years.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you.

Operator: We'll go next to Matt Fassler with Goldman Sachs.

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

A

Good morning, Matt.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thanks a lot. Good morning to you. My first question relates to New Wave, just kind of a high level question. Why now? I know it's always a good time to invest in technology. And also, competitively and within the ecosystem, how do you expect this to change your positioning if you could say perhaps where you think it will be three years from now as this investment is done versus where you stand today?

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

A

Right. Well, as I said at the outset, Matt, that we consider our online platform to absolutely be in a leadership position. Just to give you a little bit of detail on that, our online platform provides approximately $80 million in revenue. It's our highest profitability of all of our offerings. And I believe that it's our responsibility to enhance that value proposition, provide more flexibility and more services to our customers. We talk about integration that we can do with our data and analytics, which has become a real major focus of KAR as well as a major focus of our customers. This is what they're asking for.

And I think there's an opportunity to not only take care of our existing customers and provide a better experience for them, but I also think there's an opportunity to grow new customers on that platform as we go forward. So again, really excited about the opportunity that we're going to be able to actually take this to market here in 2017.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Okay. My second question relates to the salvage business. Obviously, the volumes were kind of blowout. If you could talk to the ASP and what the moving pieces were there, particularly as scrap steel prices have shown [ph] abetting (32:05) declines and have recovered to some degree, where might the RPU or the ASP in that business start to head?

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

A

Yeah, I think, Matt, the salvage business side, I would refer to it as being very, very steady. I think as you look at scrap prices, now, the comps year-over-year are much more in line and we haven't looked at scrap prices in terms of our forecasting and our budgeting. We haven't looked at scrap prices increasing significantly. We've looked at them staying relatively flat with where they are today, if they were to increase, obviously, that would be a bonus for our proceeds. Eric?

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

A

Yeah. And I'd add, Matt, we were down 2% on revenue per unit across the IAA platform on a net revenue basis and that's strictly due to proceeds. And that's pretty consistent with the market. And again, we considered fairly level, but it was down compared to a year ago by a little bit.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Understood. And then, finally, just getting us comfortable with the recovery in loss rates in AFC, as you go through the year, I guess you had some idiosyncratic factors driving to that 2.6% level, to the extent that you're 2.25% or so and presumably the ASP declines in the market don't – used car values don't recover, what will enable you to get that number back down again in the second half of the year?

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

A

We've done a number of things on loss mitigation, but the most important is these losses are concentrated heavily into the largest accounts, meaning the largest credit lines, Matt. And we are very focused on really expanding that lower base at $500,000 or less dealer, because we're finding that in again less risk, even though it sounds like a riskier proposition, the risk is spread over a larger population of dealers, as you've got a very small number with over $1 million that are really disproportionally affecting the losses here in the near term.

And again, the dealers with the larger credits are making the biggest bets. They're also, as we've said before, getting credit from multiple sources in some cases where the smaller dealer is less likely to have the credit available from throughout the marketplace and get over extended at the same level.

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

A

You know, Matt, I would just take you back and remind you that ASP still remains a great business...

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Yeah.

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

A

...not only it's a great service to our customers and very complementary to both IAA and to ADESA, it has extremely high margins, as you know. And again, I think what we're seeing here is we're just seeing a few of those independent lower-end dealers to tail off here as a result of prices that dropped in October and November in the fourth quarter and as volumes dropped and [indiscernible] (35:21), I think there's a little bit of a shake-out that's going to take place. I think Eric said in this comments that we expect most of that, I'd call, a shake-out to take place in the first half of the year, but as we go forward into the second half of the year, we're feeling pretty good about how we're positioned.

And as we scrutinize those dealers, we have absolutely scrubbed every dealer and we've scrutinized these dealers and we've scrutinized their lines. I will say one thing, we've become maybe more focused on their total credit availability, not just from AFC, but what they might have with the other entities as well, and that's something that we're focused on as we extend credit going forward.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

I feel compelled [ph] they're kind of going off for well (36:00). Just asking one quick follow-up to something that you said, understanding that your due diligence processes is getting tighter, wouldn't the larger dealers be somewhat healthier, if you will, just generally speaking, with their scale? Are they ever a leading indicator of what comes down the pike or is that not the right way to think about them?

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

A

Matt, you're absolutely right. They're a great indicator of the positive, but they're equally risky on the negative. So it's fewer of them. I would tell you a majority of them are very healthy. They've got consolidation of SG&A and things like that with their larger scale. But they're also when they make the bet, it's just riskier. And that's why I highlighted in my commentary, it was actually one dealer is the problem in the fourth quarter. It tends to be one or two, Matt, where across the rest of the platform, that risk is spread over 10,000 dealers.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Thank you.

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

A

You're welcome, Matt.

Operator: We'll take our next question from Ryan Brinkman with JPMorgan.

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

A

Good morning, Ryan.

Ryan Brinkman
Analyst, JPMorgan Securities LLC

Q

Hi. Thanks for taking my question. Good morning. I understand the debt charge-offs at AFC, of course, that's been part of the story all along. But what gives rise to the bad debt expense at ADESA? Is it just a risk from the CarsArrive's business? And is that pretty manageable, unusual, non-recurring, et cetera?

And then, well, I think there was an important piece that charge of the pressure on incremental margin in 4Q, was there anything else maybe in your operating expenses that was of a non-recurring or something non-recurring in nature, sometimes before you called out compensation expense or some other factor?

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

Yeah. Yeah. So Ryan, I'll let Eric take the bad debt, and I'll just talk about the performance in general at ADESA in the fourth quarter. I think number one is there was no question that we saw a softening in October and November, centered around the election and a lot of uncertainty. In fact, December was an excellent month, and December performed extremely strong, but couldn't make up for what took place in October and November.

And then, what we did see is we did see a shift in the revenue mix at ADESA during the fourth quarter. A lot more of these commercial vehicles, a lot more of these vehicles that are using the ancillary and related services, and as you know, these ancillary and related services come at reduced margins to what the sales, what the buy and sell these are at the auctions. And along with that, we also had the SG&A pressure where the investments that I talked about that really positions us for the next couple of years here.

And the good news coming out of all this is customers were sensitive to price and resisted price in October and November, started selling in December, but the inventory that we had on the ground going into 2017 is extremely attractive inventory. It's high-dollar cars. It's going to use ancillary services, and I think it positions us very well, as I said in my commentary, as we go into the year.

So all-in-all, I don't look at ADESA in a 90-day period. We had quarters like this before, but as you look at this business over 12 months, I think ADESA had a very good year.

And Eric, maybe you can speak to some of the debts or the debt that you've talked about at CarsArrive and some of the one-time charges.

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

Yeah. Ryan, the CarsArrive, that's a unique item, not repeatable. It's unusual to have that much outstanding from one customer and it's actually a structured reorganization. And so, we have written off 100% of the balance owed to us expecting no recovery. And if the business continues, we would probably look at that as to what how we can continue serving that customer.

And that $4 million accounts for almost the entire increase in SG&A related to bad debt at ADESA. We don't have that in the other business. And we don't see anything across the spectrum of our customers at ADESA. As you know, generally, we are owed more money than we, by our customer – I'm sorry, we collect more of their money than we are owed and have the proceeds of the car in most of the part of the business at ADESA. So it's not exposed to the same level as transportation.

The other areas where there is one-time items, we had some expenses related to professional fees associated with the Flint acquisition that we have disclosed. And then, we had some technology spend that, I think, is unique. Now, it'll transition off. It's actually related to the integration activities and I'm not adding that back, because it's growing the businesses while we're getting ready and executing on the integration especially at Brashers and Flint. And those will taper off in the second half of next year, as we get them on our AMS system. So those are kind of the one-time – I call them one-time, but the biggest was the bad debt.

Ryan Brinkman
Analyst, JPMorgan Securities LLC
Q

Okay. Thanks both for the excellent color. And then, it looks like online only auctions at ADESA rose a strong 16%, while physical was flat. But I understand that almost all of the dealer consignment business, right, which was softer is physical, right? So is it not fair then to infer from the fact that physical overall is flat, that the thesis of off-lease volumes flowing down into lower [ph] runs (41:29) of the funnel with somehow off-track. How did the off-lease at physical and associated ancillary services track relative to your expectations in the quarter?

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

Well, I think that we did see [indiscernible] (41:43) dealer consignment that you mentioned, but there were more cars sold at physical auction. So if you think about it. I think that we would expect – I think it was within our expectations.

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

Yeah, more, there were more institutional cars. Institution cars were up 6% at physical auction, offsetting the 7% decline in dealer consignment, Ryan. That's what Jim's referring to more cars sold at physical auction in the quarter. It was on the institutional side. [ph] And this was in line... (42:19)

Ryan Brinkman
Analyst, JPMorgan Securities LLC
Q

Okay. Perfect. I think this was the most important.

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

Yeah. And then, Jim talked about the early part of the quarter is really what caused it when the consigners didn't like the pricing.

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

Right. I think I mentioned that a couple of times. As you were in around that election time, October, November, customers were just resisting price. And we didn't see that start to loosen up until December. But maybe I can just expand on online a little bit, as we think about it, it is – we've always maintained the position that we don't dictate to our customers whether they should sell a vehicle. We believe the customers should choose where to sell the vehicle. And we believe the market will determine what the best channel for the vehicle is.

And our responsibility is to provide the best venues, provide the best opportunities in these various channels to be able to offer the cars, expand the tools and the things I talked about in data and analytics to help them make better decisions in terms of where they should sell those vehicles and how they should sell those vehicles, and again, continue to grow that buyer base online, and then, let the market take over.

But with that said, with the vehicles that are coming to the top of the funnel, we will sell more vehicles online, but as a percentage, I believe that percentage will drop, and I am convinced that more vehicles will get to the physical auction where we do get to enhance the cars with those ancillary and related services.

So all-in-all, I think, it's historic.

Ryan Brinkman
Analyst, JPMorgan Securities LLC

Q

Next question. Just on geography, investors like these multiples that you pay for things [indiscernible] (43:55) relative to your Wall Street trading multiple. But with Flint behind you, with Pittsburg organically and the Chicago with Brashers, are you pretty much filled out? Is there anywhere left where you could bake a really accretive acquisition? In the past, you've mentioned [indiscernible] (44:11) in South Florida. Any room still to expand like that?

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

A

There's still a handful of what we would call really, really [ph] plum (44:20) auctions, really desirable independents. As mentioned, some of them are second and third generation, and they're at that inflection point of do I stay in or is this the time to exit? And we have had conversations with some of those independents and we believe there may be some additional opportunities, but nothing that we're able to speak to today.

Ryan Brinkman
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you.

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

A

You're welcome.

Operator: Our next question will come from Gary Prestopino with Barrington Research.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Hey. 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

Hi, Gary.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

A lot of the questions have been answered in terms of the flow through of cars, dealer or commercial. But maybe, Jim, based on your experience in the business, when you get into a situation like this where the conversion rates are down, the dealers are not taking the prices that are offered on the cars at the auction, how long from the beginning of that time period to where that situation actually becomes more clear or clears and the dealers will start accepting the prices for the cars at auction? Because these cars eventually have to sell, right? They can't just keep backing up on the dealer's lots. They can't just keep backing up at inventory at your lots as well.

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

A

Yeah. So, Gary, good point. As I like to say, the good news is that these vehicles are all on a one way ticket. They are eventually going to be sold. The commercial consigners are not going to take these cars back out of inventory and transfer them to another location or another channel. Once they've arrived at auction, they're going to get sold on the commercial side.

With the dealers, it's a little bit different, dealer consignment. They'll resist price and they could take their vehicle back and they can try to retail it or wholesale it or package it or do something different with it. But for the most part, I think the market does adjust and it's not like it's going to take them months and months to figure out that the markets changed and I'd better start accepting today's price sort of thing, because this is not going to get better with time.

So in the case of the last quarter, we saw it last for probably 60 days. October, November resisted and December the volumes started to sell and they started to accept price in going into 2017. One of the other things, Gary, that I would speak to and this primarily applies to the dealer side or to the commercial side, and then, there are some things we're doing on the dealer side that I'll talk about as well, on the commercial side, our customers are really asking us to help them make better decisions. And this is the focus on data and analytics. We have put together a data science team here at KAR in 2016. We continue to add to that team. But really, as we call it, to take all of this data that we have, turn it into actionable intelligence and predictive analytics and allow customers to make better decisions.

And I think as we can provide better analytics to our customers, whether it's selling in the upstream venues, in the close sale, the online sale or when it gets to physical, we can help them get more familiar with what that car should be selling for in today's marketplace. So that is something that's in very high demand. And I believe that we're in a position to build those pricing engines and to lead the charge in this area.

The other area that I mentioned to you on the dealer side, we do have some products that, we think, will help the dealers get more familiar with the pricing in the market. And just one product that I would turn to is the product that we call Autoniq. And Autoniq really gives you, I guess I would say, the aggregation of all the various books and the pricing data that is current in today's marketplace. It's on your mobile phone. It's an app. Gives you real pricing in the market, recent pricing in the market and it's a subscription business. We continue to grow that business. Dealers continue to be more dependent on that, as they're in the lanes making decisions. And I think that will help our dealers convert at a higher rate as well.

So there's some things that are going on here that, I believe, will shorten that time span from – I resist the price today, how soon do I get comfortable with, this is the real price I should be selling the vehicle at. Long-windy answer, but I hope you get it.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

No. I get it. And then, lastly, just on that CarsArrive loss that you had, was that all just for physical transportation services or were there cars involved that were lost in that?

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

A

No. That was a 100% transportation services, Gary.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thanks. Thanks, Eric.

Operator: We'll go to Ben Bienvenu from Stephens, Incorporated.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Yeah. Thanks. Good morning.

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

A

Good morning, Ben.

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

A

Good morning, Ben.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

On the interest expense piece of the guidance, I'm curious, does that assume you maintain your leverage target of 3 times and to what extent can you factor in the magnitude of the rate increases that you're thinking about?

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

A

Yes. It actually assumes that we only repay debt as required according to the terms of the agreement, which is a very nominal payment on a quarterly basis, Ben. And we actually reduced our leverage through the growth in our adjusted EBITDA.

So I would tell you using the current level of debt throughout the year is the best way to go on that. That's how we've looked at it. With two LIBOR interest rate increases and in our materials we've disclosed to you, we do have some caps in place. So if interest rates were to grow at a faster rate, at least for the near term, we wouldn't see any impact if we hit up against our cap.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. And then, just to clarify on the cadence of the AFC provisions, you mentioned the first half would be a little bit above average, and then, getting better in the back half. Should we expect that the first half be above the range that you indicated, and then, the back half below or perhaps just toward the higher end of the range, but moderating from this higher 4Q level?

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

A

Well, based on the fact that the fourth quarter was above that range for the one quarter but the year, there is a possibility it could be above that range. I can't predict where it will be, because it basically involves cars sold out of trust and what activity is occurring, Ben. But I think there is exposure to it being above the range in the first half, and then, falling either to the low end of the range or at the low end of the range as you look forward. I mean, who knows where it will end up. The crystal ball is not clear when you look that far out. But that's how we see the pattern as we look at the year.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. And then on the IAA total of inventory growth really substantial, up 25%. You called out part of the increase related to cat volume, I'm curious can you quantify what amount of the 25% increase was related to catastrophic event volume?

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

A

I don't have it in front of me, but it wasn't significant portion of it, Ben.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay.

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

A

But it wouldn't even partly be meaningful. It's across the board. I mean there's a lot of [ph] cars getting totaled (52:09) right now with all the miles driven.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Great. And then, just one last one for me. Your guidance on share count assumes that the share level stays relatively stable. You've got your three-year $500 million authorization in place. Is it reasonable to expect that you'll be ratable in that buyback or more opportunistic? And is the repurchase of the options exercise you mentioned reflected in that guidance? I'm not sure how are you posturing there.

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

A

Yeah. So I'll take a piece of that, and then, maybe I'll let Eric add to it. But I think the stock repurchase is always an option to us. We've always said that we're going to have 45% to 50% of our free cash and dividend. We're going to continue to look at acquisitions and the one thing that we're not going to do is we're not going to sit on cash. We're not going to stockpile cash. And if we get to a position where we don't have immediate plans for acquisitions, we will look to stock buybacks.

I would say that as we look at the first quarter, and we're two-thirds of the way through the first quarter, the first quarter is the quarter where we have the highest use of cash. So it's unlikely that we would think about anything here during the first quarter, but it's always an option as we go forward.

Eric, do you want to add to that?

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

A

No. I think that covers it very clearly.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Thanks so much.

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

A

You're welcome.

Operator: Our next question will come from Bret Jordan with Jefferies.

Bret Jordan
Analyst, Jefferies LLC

Q

Good morning, guys.

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

A

Good morning.

Bret Jordan
Analyst, Jefferies LLC

Q

My question, not to overflog the ADESA incremental margin, but it sounded like I think you used the word messy on the quarter. Was the flat physical volume ex-acquisitions, I guess, the big driver? And if we think about maybe going forward sort of trying to take a look at dealer consignment, it was down, I think, 3% or 4% in the prior quarters, and then, down 7% in this quarter, if we take out that window around the election, were we in that low to mid-single-digit range? And I guess, going forward, if we stay flat at physical, with the lower SG&A, you're forecasting a lot of positive incremental margins at ADESA?

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

A

Bret, you've analyzed it reasonably well. The fourth quarter seasonally is always experiencing a lower incremental margin in the core business, because there's a higher mix of ancillary and related services. And then, there is cars sold as a result of the end of the year. And in prior years, I'll just speak to history, that has always set us up well as it did last year for a strong start to the year, because you got the low margin revenue behind you and you get that high margin auction revenue when they sell the car.

I would tell you, December was very strong, had very good incremental margins. Even on a seasonal basis, they probably would have been better. I mean, again, I don't want to get into a month, but that's a little bit unfair, because you have the burden of some cost in October and November that contribute to that for the cars that did sell. And we saw a little bit of slowing at the end of Q3 and we talked about it then in the ADESA business.

So I think it all led up to, basically, there's pent-up supply of vehicles that is going to be very good for us as we look into 2017 and there are one-time type items like, in SG&A, is that bad debt from CarsArrive that I talked about. Also, in SG&A is some of the professional fees related to acquisition activity that impacts the incremental margins a little bit. And that stuff will not recur and that's where I commented the messiness doesn't continue into the first quarter.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. So you think you returned to physical volume growth in the first half of 2017?

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

A

Yes. That would be fair with our outlook.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. And then, one question on the IAA inventory. I think you've said that catastrophic didn't play a major role in that inventory build. Are cycle times normalized now or is there anything happening from a title transfer or with any major insurers that is backing inventory up?

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

A

Well, I will say, in certain states, there is some pressure on cycle times. It's the volume. It's more the volume and getting through them. But it's not evident as much, because we had such strong volume actually sold, Bret. So this is why the cycle times, I think, are getting longer with a couple major insurers, not like they did in the past where they became burdensome, but there's just a lot of cars to process and you can't just sell more cars each week. The demand has to be there. And so, it will take longer to sell the car even if the titles have been processed when you have this much inventory. But it, again, sets us up for a great start to 2017.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. And to the question that was asked earlier, I didn't quite hear, did you say the catastrophic was not a major contributor to that inventory build?

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

A

It's not a major component of the inventory. There is some, but as you know, a lot of the catastrophic events were earlier in the fall and these cars have been selling through at a rapid – as fast as they can.

Bret Jordan
Analyst, Jefferies LLC

Q

All right. Great. Thank you.

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

A

You're welcome.

Operator: This does conclude today's question-and-answer session. Mr. Eliason, I'd like to turn the conference back to you for any additional or closing remarks.

James P. Hallett

Chairman & Chief Executive Officer, KAR Auction Services, Inc.

Okay. Thank you, Jessica. This is Jim. First and foremost, I want to thank you for being on the call. I think as I've said, we are in a great position. We feel very, very good about our business. We spoke about the investments that we've made. We spoke about really having a defined strategy and a real plan in terms of how we're going to execute going forward.

And I would continue to remind you not only optimistic about 2017, but really optimistic about 2018 and 2019 as well, the visibility that we have. And again, I know that people are focused on ADESA's fourth quarter. It's not like it hasn't happened before, and I would say not to be so much focused on the quarter, but be focused on the long-term vision and execution that we have going forward here. I think it's a great business and I can tell you I've never been more confident and more excited about the business, and I look forward to continuing to show you good results as we go forward here.

So thank you for being on today. We appreciate your interest and we look forward to chatting with you more, and as I say, we'll be getting on the road and having some more one-on-one discussions. Thank you.

Operator: This concludes today's call. Thank you for your participation. You may now disconnect.