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KAR Auction Services, Inc. (KAR)

Q1 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the KAR Auction Services First Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only-mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time. [Operator Instructions] As a reminder, today's conference is being recorded.

I would now like to turn the call over to Mr. Mike Eliason, Vice President of Investor Relations and Treasurer. Sir, you may begin.

Michael Eliason

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

Thanks, Chelsea. Good morning, and thank you for joining us today for the KAR Auction Services first quarter 2017 earnings conference call. Today, we will discuss the financial performance of KAR Auction Services for the quarter ended March 31, 2017. 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. And welcome to our call.

Let me start with laying out what I plan on covering on today's call in my comments. I want to provide a update on our guidance for 2017, give you an overview of our performance in the first quarter, discuss what we're seeing in the marketplaces that we serve. I'd like to talk about a couple of key strategies that we have going on within KAR and then provide you with some information on our acquisition of DRIVIN that was announced in mid-April, and then I'd like to finish up with an update on our plans to refinance our existing debt.

So, starting with our guidance for 2017, I can tell you that I feel very, very good about our performance of our businesses and more or so our outlook as we continue to move forward. There are no changes to our previous guidance as you saw in our earnings release. The cars are coming to auctions. And as I like to say, nobody is stockpiling these vehicles. These vehicles are primarily commercial vehicles, off-lease vehicles, repos and fleet vehicles and these cars are going to sell.

They traditionally sell at a very high conversion rate the first time through and if they don't sell first time through for one reason or another, we know they're definitely going to get sold second time through, the vehicles are not leaving our auction once they arrive there.

So, with that said, I would also mention that we continue to see the value in the complementary nature of our various businesses that we've spoken about many times. And again, I remain positive not only in the near term, but in the longer term outlook for KAR.

As I look at our first quarter performance, the quarter fell right in line with our consolidated expectations. We had a solid performance at Insurance Auto Auctions where we're seeing strong top- and bottom-line growth in the salvage industry, or in the salvage business.

I was most pleased that we were able to control the SG&A in this segment and we saw the increased volumes and revenues drive strong growth in the adjusted EBITDA.

Inventory levels at IAA were up 17% over the prior year at March 31 and I would mention that the relatively mild winter conditions allowed us to reduce the backlog of vehicles which definitely served as a bonus for our insurance customers. We still have strong inventory levels and this bodes very well in terms of setting up the second quarter.

At AFC, results were generally in line with our expectations. As we mentioned in our yearend call, we said that we would see more moderate growth in the number of the loan transactions throughout 2017. We now have visibility into the second and third quarter performance. We will continue to see elevated loan losses in the second quarter like we experienced in the first quarter. However, with that said, we are seeing substantial improvement late in the second quarter and into the third quarter on our current performance in the loan portfolio. And we continue to expect that loan losses for 2017 will be in the 1.75% to the 2.25% for the year that we outlined on our previous call.

Like the other business segments, ADESA's performance fell in line with our expectations. With that said, the month-to-month performance within the quarter was what I would term as very choppy. We had a strong January and a strong March and in between February was a different story, as it fell well below our expectations. This was consistent with retail sales of used cars in the U.S. where delays in the processing of tax refunds had an impact. Normally, we would not be discussing our performance trends on a month-to-month basis but I did feel it was important to mention this as it did impact our margins in the first quarter.

The better news, or the good news, is that the supply of commercial vehicles continues to be remain very strong throughout 2017.

A couple of trends that we're seeing going on within our business, very positive trends in the salvage business. Miles driven is growing and fuel prices remain relatively low. We're seeing improvement in commodity prices that will contribute to higher auction values at the low end of the salvage market. Lower used car prices increase the likelihood of an accident resulting in a total loss. Technology and safety advancements are also increasing the likelihood of insurance claims resulting in a total loss.

And one of the challenges in the growth of the salvage business is space constraints, and we expect that we will be adding hundreds of acres of land to meet the needs of our customers in the salvage business in 2017. And I would point out that this expansion of acquiring this land was contemplated in our guidance for 2017.

Our finance business, AFC, is experiencing slower growth this year as expected. The word I would use to describe our lending practices at AFC is disciplined; very disciplined. We have not changed our risk tolerance or our underwriting practices. We are expecting slower growth at AFC than in our other businesses, but this is due to the market served by the independent used car dealers, who is the primary customer at AFC.

For ADESA, I mentioned the choppiness of the performance in the first quarter, and let me clarify that choppy does not mean bad. The supply of commercial vehicles will be well above our prior-year levels and all of these cars will get sold as I mentioned earlier. We expect used car prices to decline about 5% in 2017, due to the increased supply.

With that said, none of this changes our outlook for ADESA in 2017. A couple of areas of strategic focus going on within KAR is, we are focused on entering new international markets and becoming a key player in the markets that we serve. We have started this strategic initiative in the UK. We are seeing excellent progress in the UK market as we develop a platform for meaningful growth in future years. We continue to see great interest in our online and our mobile technologies in the UK market and we have confirmed that we can be a disruptive competitor in these new markets with an asset-light business model. And my goal is to see the UK market become a meaningful contributor to our consolidated results in the next couple of years.

And now, we are beginning to focus on other geographies. We have been in the process of developing a pipeline of potential acquisitions in new international markets.

Another strategic initiative that we're focused on is bringing improved data and analytical capabilities to our customers. This begins by leveraging the significant data generated by the large number of transactions processed in all of KAR's businesses. We have developed a data science team that is focused on taking large amounts of discrete data and turning it into actionable intelligence. We have introduced our data science capabilities to a number of customers and we're now working on specific projects designed to help our customers navigate the changing used car marketplace.

Integrating our data and analytics capabilities with our mobile, online and physical offerings will be an important differentiator for all of our businesses. We need to help our customers make better decisions on when and what channel and at what price to sell their vehicles. And that is why we acquired DRIVIN. DRIVIN will be an important component of our data and analytics offerings.

First, the DRIVIN organization brings key talent to our team that will allow us to accelerate the pace of developing solutions for our customers. They will work out of their current Chicago location and will give us access to the data science talent that is forming in the Chicago high-tech community.

We are integrating the DRIVIN team with our existing data science team and our technology-based service platforms within ADESA. The DRIVIN team will clearly contribute to our existing customers at ADESA and especially our commercial consigners and our online businesses. We expect we will see the results of their work in our organic growth within ADESA.

Recently I've been spending considerable time with many of our major customers and if there is one hot button that customers are talking to me about is how can we help them make better decisions on selling their vehicles, especially with the onslaught of these off-lease cars that are coming to the market. So, with that said, I'm very, very excited that I was able to announce to our customers that we've doubled down on our data science team, that we have acquired DRIVIN and we've brought this talent and this technology into our organization.

So with that, let me finish with a brief comment on our plans to refinance our debt. Current market conditions are making it possible for us to refinance our current debt at lower interest rates. At the same time, we may have an opportunity to issue bonds that fix the interest rate on a portion of our debt, and Eric will cover this in more detail here in a few movements.

As I look on the last 75 days since our last call, a lot has happened, and I'm pleased with the performance and I like how our businesses are positioned. We've been able to respond to the market conditions and deliver on our targets. We continued to benefit from the complementary nature of all of KAR's businesses.

We have strategic initiatives in place that will provide a platform for continued growth and we will continue to generate a lot of cash. And we will find ways to use that cash to create shareholder value. This is a great time to be in this industry and it's a great time to be part of KAR.

I'll now turn it over to Eric for his comments. We'll come back to you for some Q&A and maybe some closing comments from myself. With that, I'll give it to Eric. Thank you. Eric.

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

Thank you, Jim. I would like to cover a couple of items in more detail. Let me start with a quick overview of our consolidated results. Revenues grew 14% in the first quarter, which led to an 11% increase in adjusted EBITDA and a 13% increase in operating adjusted net income per share.

We benefited from a lower effective income tax rate in the first quarter, as the benefit from stock-based compensation is recognized as a reduction in income tax expense beginning in 2017 in accordance with the new accounting pronouncements on accounting for stock-based compensation.

Previously, this income tax benefit was recorded as an increase in additional paid-in capital. I would like to point out that the impact on our first quarter effective tax rate is higher than what we expect the impact to be for the full year. A majority of our stock-based compensation programs have vesting dates in the first quarter.

Now, let me speak to a couple of items affecting the results of our business segments. ADESA had 20% growth in revenue and 20% growth in adjusted EBITDA.

Gross profit as a percent of revenue was down slightly, but this is consistent with our expectations when revenue growth is driven by the increase in revenue per unit as it was in the first quarter.

While volume growth was attributable to the online-only sales and acquired auction locations, the improvement in revenue per unit reflects the impact of the shift in mix of commercial vehicles to 56% of vehicles sold in 2017, from 53% of vehicles sold at physical auction in 2016. While our same-store volume growth was only 4% in the first quarter and flat year-over-year at physical auctions, I remind you that we had a tough comparison when looking back to last year's first quarter which was up 17% for total volume and 10% for the same-store year-over-year. Despite the modest increase in volume, we still had 8% same-store revenue growth in the first quarter.

As Jim mentioned earlier, February really weighed on our adjusted EBITDA margins in the first quarter. This was seen in the slight decrease in incremental adjusted EBITDA margins on a same-store basis. The good news is our integration activities are well underway and we saw an increased adjusted EBITDA margin from our acquired businesses in Q1.

Insurance Auto Auctions' performance in the first quarter was excellent. Double-digit volume growth drove double-digit revenue growth, increased gross profit as a percent of revenue and an 18% increase in adjusted EBITDA. While revenue per vehicle sold was flat year-over-year, we are seeing signs of improvement in scrap prices that could be a positive factor in future quarters.

The AFC segment is a little bit more difficult to analyze. The provision for credit losses is recorded as a reduction in net revenue for our finance company. Accordingly, net revenue declined in the first quarter as compared to the prior year. The number of loan transactions in Q1 was flat in comparison to the prior year and the provision for loan losses negatively impacted revenue per loan transaction by $12 as compared to the prior year. Excluding the impact of the provision for loan losses, we saw a nice growth in fee and interest income as a result of higher average loan balances and a modest increase in interest rates charged to our customers.

We are seeing improved performance in the portfolio for new loans that is consistent with our expectations for lower loan losses in the second half of the year. Loan losses as a percent of managed receivables were 2.5% in the first quarter and will remain at elevated levels in the second quarter.

Now, turning to our guidance for 2017. Our outlook has not changed. We expect adjusted EBITDA of $825 million to $850 million; net income per share of $1.70 to $1.80 and operating adjusted net income per share of $2.15 to $2.25. Although our guidance has not changed, we have considered the impact of our proposed refinancing and re-pricing of existing debt, the acquisition of DRIVIN and the impact of stock-based compensation on our effective income tax rate in determining and updating our expectations for 2017.

Now, let me discuss in more detail our plans to refinance and re-price our existing debt. We currently have approximately $2.4 billion of debt outstanding. This represents the aggregate borrowings under term loan B2, term loan B3 and our revolving credit facility.

Based on discussions with our advisors, we believe we can refinance a portion of our debt by issuing unsecured senior notes at a fixed rate. The remaining senior secured debt may be re-priced at lower interest costs than the current facilities.

The effort to refinance and re-price our debt will be pursued on a best efforts-basis and there is no assurance as to the amount or timing of the proposed transactions.

So, that concludes my prepared remarks. I'll turn it back to Chelsea and we will now take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Elizabeth Suzuki with Bank of America. Your line is now open.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Good morning, guys. Your tax rate was fairly low in 1Q and you mentioned the impact of stock-based comp, but you maintained your full year expectation of 37%. Do you think that your effective tax rate is really going to be 38.5% for the rest of the year to make that 37% for the full year or is that just some conservatism on your part?

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

A

Well, Liz, it's what we think, but it's driven by the fact that this benefit is all in Q1, [ph] I'll have a full year of earnings (18:50). If it has an impact, it will be fairly minor relative to the effective tax rate and what we expected at the beginning of the year. And our higher tax rate is really driven by state taxes more than federal taxes and that's the unpredictable portion is what will it actually turn out to be. I'm hoping for good news, but not counting on it.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Okay, great. Thanks. In next quarter, the Brashers acquisition will have anniversaried. So, again, as we're thinking about organic volume growth, what are your expectations for the rest of the year, obviously we have some somewhat tough comps. So, I mean do you think somewhere in the mid single-digits is reasonable for organic growth or is it likely to kind of stay in the lower range?

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

A

Yeah, Liz, I would think that we would expect it to be in that mid-single-digit range or perhaps a little bit better. As we look at – we have a good feel for the existing business, for the new business we've been able to put in place. And then with the volumes that are coming, as Eric would say, we feel good about mid single digits, and we would hope that it could be a little bit higher in that.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Great. And I'll just squeeze in one more quick one which is, with used vehicle pricing coming down on a like-for-like basis, do you think it's reasonable to assume that your revenue per vehicle at ADESA could continue to trend positively just due to mix shift, or do you expect to see some pressure there by the end of the year?

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

A

No, first and foremost I would say that, with pricing – although you didn't necessarily ask it this way, we're very focused on the transaction. We're very focused on getting the car and selling the car. And we know that more and more of these cars are going to be these off-lease cars, and as they get to physical auctions, they are the heavy users of these ancillary services. And now we're starting to see revenues that start with an eight, and those are the numbers that we haven't seen in the past. So, I think our revenues continue to improve.

Elizabeth Lane Suzuki
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks very much.

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

A

You're welcome, Liz.

Operator: Thank you. And our next question comes from the line of Bret Jordan with Jefferies. Your line is now open.

Bret Jordan
Analyst, Jefferies LLC

Q

Hey, good morning, guys.

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

A

Hi, Bret.

Bret Jordan
Analyst, Jefferies LLC

Q

A couple quick questions. And I guess, I'll start with dealer consignment and obviously it stabilized sequentially in the quarter. Could you give us maybe an outlook and where we might expect to see the trends go from here? I think it had gone from sort of a minus 3% midyear last year to minus 7%. And obviously given the comparisons and some of the dealer trends, could you maybe give us an outlook?

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

A

Yeah, Bret. First of all, I can tell you that it's very much in line with our expectations and what we were thinking it would come in at. Before we went into the recession, if you go back a number of years, we were heavily weighted on commercial where we're 70% commercial and 30% dealer. And as we worked our way through the recession, we're able to bring that balance to 50%-50%.

And we always felt that as we went into the cyclical recovery that there would be no question that the off-lease cars would displace some of these dealer consignment cars. And quite frankly, it didn't happen as fast as we thought it would happen, it held up stronger as you probably heard me say before.

We currently, I think Eric reported we're 56% commercial in the quarter, and 44% dealer. We think that number will look somewhere like 60%-40% when it's all said and done. We think that's kind of the numbers that we're pointing to and that's what our expectation would be.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay, great. And then on the IAA, we've heard a lot about hail and flooding in the recent past, are we seeing any sort of catastrophic event growth in the current quarter around IAA? And just sort of a second question on IAA while I have you, what's the export volume looking like, is there any change either around a strong dollar or relative change to the dollar versus the volumes that are sold at IAA that are going overseas?

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

A

Yeah. So, let me first of all say, catastrophic events, hail, storms, hurricanes, snow, sleet, ice, all that stuff related, those events are always going to be part of our industry, always part of what we do. We don't factor them in one way or the other.

Normally when they happen, they are obviously to our benefit and they're good for our business and it's good that we can provide this service for our customers. So, not predictable, not something that we build into our plans, but when they happen, it's good for our business.

So with that, the second part of the question on the exporting in the currency, I'm going to let Eric take that.

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

A

Yeah. Bret, good question. We're still seeing active export activity. Even though the U.S. dollar is strong, gross auction proceeds or average price paid for a vehicle has come down to the point where it seems to be a very attractive transaction and we haven't seen anything that has caused a change in the interest by the international buyer. And again, we see plenty of cars going overseas, that's always been in that 25% to 30% of the vehicles and it's probably about that same amount right now going to wherever they're buying the vehicles.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. Great. Thank you. Appreciate it.

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

A

Okay. Thank you.

Operator: Thank you. And our next question comes from the line of Matt Fassler with Goldman Sachs. Your line is now open.

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

Good morning, Eric.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

A couple questions, first, on the whole car business and this was asked, I think a couple questions ago, maybe a bit differently. So, we have a couple quarters now under our belt with 4% unit growth ex acquisitions. And I know you talked about the impact of the election in Q4 and then you had the tax rebate issue impacting the entire market plus a very stiff compare in Q1. Jim, when you were talking about mid single digits or a bit better than that, was that essentially discussing the organic unit growth so would that suggest that without those impediments to the market and with some more normative compare, you could see a bit of acceleration underlying the guide for the rest of the year?

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

That would be a yes, Matt.

Matthew J. Fassler
Analyst, Goldman Sachs & Co. Q

Okay. And then secondly, also on whole car, Eric, you talked about I guess one unusual factor that impeded the incremental margins a little bit in the whole car business. Should we be targeting something in the 20% to 25% range as kind of a sustainable incremental margin rate with the kind of line that you guys are discussing?

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

Matt, again, we talked about February really impacting incremental margins. And we saw great movement on the integration of those activities, and as was pointed out earlier, we anniversaried those. We still think we can have stronger incremental margins than the mid-20s on the invested business.

Matthew J. Fassler
Analyst, Goldman Sachs & Co. Q

Got it. And then finally on AFC, so there was a point in time, call it a year ago, when you had talked about increasing competition, and presumably some irrational pricing gunning for that business. I know that the issue for the moment is more loan losses than anything else, we're familiar with what's going on in the market. Should we assume, based on what you said about taking rates a bit higher that some of the competition that had been entering the market and impeding profitability is pulling back, giving you the opportunity for sustained better pricing? Is that [indiscernible] (26:53) responding to that market adversity?

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

Yeah, Matt, I think good point and I would call it responsible behavior. I think people have pulled their horns in a little bit and are acting in a more responsible way in terms of how we look at extending credit. Eric, you might want to add to that.

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

Right. I wouldn't call it pulling back, but I don't think they're using the pricing component as a competitive lever. That's what I would say, Matt. They're still in the marketplace aggressively pursuing market share. There still seems to be ample credit available for customers, and in some cases, more than we would like to lend, and we're making sure that we aren't involved in those customers where they have too much credit. That's really where we're focused.

Matthew J. Fassler
Analyst, Goldman Sachs & Co.

Q

Understood, gentlemen. Thank you so much.

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

A

Thank you, Matt.

Operator: Thank you. And our next question comes from the line of Ben Bienvenu with Stephens Inc. Your line is now open.

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

Focusing on the ADESA business, the gross margin is under pressure, understandably given the mix shift towards institutional commercial volume. What are some of the things that you can do operationally to sustain or prop up that margin and help alleviate some of the pressure as a function of mix?

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

A

Yeah. I think, couple of things. Really there is two things that stand out to me is number one is we absolutely have to get these integrations completed that we acquired in 2016. We acquired a lot of businesses in 2016. I won't go through them all; I think you're familiar with them. But it's [indiscernible] (28:31) those integrations, and then the other thing that we've been focused on – I spoke a little bit about data and analytics and the acquisition that we made there.

We've also brought a lot of talent into the organization and what I would term is key talent, senior levels, highly comp – and this is really bringing the skill set in to support what we're doing in terms of growing the business in just growing the things that our customers are expecting of us. Now, for the most part, those jobs have been filled, the most part we're well into the middle innings of integration and I think you should see those margins start to improve in the back half of the year.

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

A

And we're referring to gross margin as well on that Ben, because part of what we do is going with a management operating system that really focuses on maintaining direct labor in line with the volume running through the auction. So you should see it at both the gross margin line as well as the adjusted EBITDA margin line.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

That's great color. Thanks. Switching gears to IAA, you came into the quarter with inventory buildup 25%; you reported a 11% volume growth and then you ended the quarter with inventory up 17%. Am I right to think that perhaps activity slowed in January, February, while you were selling through the inventory you had at the end of the quarter and then picked back up in March sort of coming into 2Q? And if so, is that just a function of milder weather that we saw during the quarter, maybe help me think through some of the sequencing of that?

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

A

Yeah. I'll start that conversation and then let Eric weigh in as well. At IAA, there is a much longer holding period for these vehicles. The average days itself from the time that the car arrives to the time that it is sold is somewhere in the order of approximately 75 days. And so what you get there is you get an overlap of when the car arrives and when it actually gets sold and it could arrive in one quarter and go into the next quarter. So, you have to think about the processing and the time that it takes to process those vehicles. With that, Eric, you want to add?

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

A

Yeah. And Ben, I'd point out, last year's first quarter was up 14% over 2015. Again, I don't want to complain about our comps, because they're great news in the past. But we were up against a tough compare, we had very strong flow-through in the auctions and the weather actually helped us get more cars out and that helped us reduce that inventory level a little bit, which is what our insurance carriers were pursuing. So, I would tell you that it was all good news in the first quarter in the way it came together.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

That's great. And then just one last one on the acquisition strategy, you highlighted some international markets that you're looking at, I assume both potentially ADESA and IAA; how do you think about the sort of critical mass that you need to achieve when entering a new market to make the economics work on that business? And what kind of pace do you think about, is the pipeline relatively robust? Or is this – I would assume it's a longer-term time horizon to sort out build out the capacities that you might need?

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

A

Yeah. So a couple things there that I'll mention is, first and foremost I would say that we're focused on mature vehicle markets, where the cars are. And I think a great way to maybe explain it – a good way for me to explain it is to take a look at what we did in the UK. We went into the UK, we focused on businesses that we feel we know something about, businesses that we operate here in North America.

We wanted to buy smaller existing businesses that have a customer base that we could grow in the businesses and we did it in salvage, we did it in an online platform with GRS and we introduced TradeRev. But maybe really, really key was our focus on the management team. Whenever you go into these international markets, certainly I believe that I and the management team support the fact that there's nobody from North America going over there to tell these people how to run the business.

And we have to have management teams that we're very confident in that not only know and understand the business that are interested in staying locked down and being part of our business going forward and we've been successful in doing that. So as we look at these businesses, and we look at new geographies, we're really looking at opportunities in all of our businesses; could be in salvage, whole car, could be with some of our other products and some of our services, a lot of our technologies that are very much in demand around the world, that don't exist, in other parts of the world.

So it's kind of assessing and prioritizing and looking at them one at a time and then I guess the great debate is, which one comes first. And that's something that we just have to take one step at a time in terms of where we get to with the seller and at what point we get there. But I would tell you without getting specific, there are number of opportunities and we feel good about where we are in those discussions and we feel even better about where we are in those relationships and the things that we think about that are important to us. So with that said, I would say, we hope to be able to deliver you some good news on that front going forward.

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

A

And I'll add, we want to get started quickly, but this is a multi-year effort, because what we've learned is when we buy these businesses, we need to allow time for integration and to nurture them and bring to them the capabilities of KAR. So look to get started as quickly as they make sense, but it will be over multiple years that we build out that capability in new markets.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Thanks, guys. Best of luck.

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

A

Thank you.

Operator: Thank you. Thank you, and our next question comes from the line of Ryan Brinkman with JPMorgan. Your line is now open.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning, this is Samik here on behalf of Ryan. Jim, thanks for your comments on New Wave and just wanted to check with you, particularly in terms of timing based on the progress you've made, do you still feel comfortable with the timing. I think you earlier have mentioned that you should be able to launch something later this year. Earlier on this call, you mentioned you are doing specific projects with New Wave. And also in terms of technical capabilities, looks like DRIVIN will be helping in the launch of New Wave. Do you think you need more capabilities, more technical capabilities or acquisitions to sort of provide a integrated platform to the customer?

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

A

Yeah. So if I got all your questions, let me say, first of all, New Wave we obviously announced the capital investment of $20 million, $25 million over the next three years. I would say we're at the very front of that project. Obviously we've begun the work, but we're in the early stages and really nothing more than I can report other than

I believe that the feedback from our employees and the feedback from our customers have been very positive. As I've been out talking with customers and visiting with customers, they're very complimentary of the fact that we continue to make the investment in New Wave.

With that said, your comment on DRIVIN, I would ask you to think of DRIVIN as a complementary service or a complementary company to what takes place within New Wave and within some of our other products and service offerings as well. And is there an opportunity to acquire more businesses like DRIVIN, I think you asked. I would say to you if there was an opportunity that came along and made sense and it was a good fit and we thought it would even build out our service more, obviously we would take a look at it, because in the big scheme of things, these are relatively small investments.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC
Q

Got it. Got it. And secondly just on the IAA group, the average revenue per unit there was roughly consistent with 1Q last year and this is despite a pretty strong increase that we saw in crushed auto body prices. I'm wondering what the headwinds probably there were; you mentioned the export market is still quite strong, so maybe what headwinds are you seeing that's offsetting the better commodity environment there?

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

The commodity environment that we read about is typically being driven by the recyclers. We have a little bit of a lag before we typically see it in the prices paid at the salvage auctions. So that's why I'm optimistic, as I mentioned in my commentary, that we'll see it in future quarters because seeing it hold – we saw some increases last year that didn't hold and it never really was seen in the low-end car.

Right now, we're seeing some positive trends where we think it will start showing up as we get later in the year and come through. So, the recycling that – or the commodity prices you're seeing really are related to what the recyclers are selling their crushed auto body for, after they've bought our car.

Samik X. Chatterjee
Analyst, JPMorgan Securities LLC
Q

Great. Thanks for taking up the questions.

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

Thank you.

Operator: Thank you. And our next question comes from the line of Craig Kennison with Baird. Your line is now open.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.
Q

Good morning. Thank you for taking my questions. So, Hertz recently called out the Uber risk to the car rental model. What is your exposure to the rental fleet and how do you assess the opportunity with ridesharing over time?

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

Great question. I would say in a word, opportunity. As you think about ridesharing, these are going to be very, very large fleets and these fleets are going to be very much interested in using – I believe in using the auction services. Number one is there's not only an opportunity to sell these vehicles, but I believe that there's going to be an opportunity to maintain and service these vehicles as well, which we have facilities that can provide those services which will be a good thing for KAR.

The other area that I expect that could benefit here is many of these cars in ridesharing would be expected to come back with, say, 300,000 miles on them. I believe that those vehicles will be very, very ripe for the export market and do very, very well in the export market. The other thing is when you start thinking about ridesharing and you start thinking about cars with 300,000 miles on them, start to think about the number of turns that these vehicles could take.

It's like when we're returning vehicles in the rental fleet every six months, right, the miles are going to build up very, very fast. So this isn't a rideshare car coming in and maybe turning once every three years. This is possibly ridesharing building up these miles and turning over with much more velocity, maybe one or two or three times more than what just a single lease car or rental car would, which I believe is going to produce more cars coming into the industry overall.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.
Q

That's great. And then I had a question on TradeRev. I'm just curious where you see the intersection between TradeRev and OPENLANE and whether having both of those assets has created any new opportunities?

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

Yeah. So when you think about OPENLANE and TradeRev, I do believe that it just gives us an additional channel, it gives customers an additional choice in a little bit different environment. As you think about OPENLANE, we're focused on the off-lease cars, we're focused on the private-label business and we're focused on really, really selling those cars in a bid now, buy now environment.

And when you think about TradeRev, TradeRev is the opportunity to be able to sell vehicles for our dealers and our commercial consigners over a mobile application. And again, a very short time period, an hour in duration, happens very, very quickly, and it just becomes another channel. We talk about the waterfall, and may be a term that I haven't used that much in the past but you'll be hearing a lot more about the waterfall as I go forward.

In the waterfall, it used to be that it would go to a closed sale, then it would go to an open sale and from an open sale, then it would move to a physical sale. And as you know, we had two exclusive opportunities in the open and the closed sale. Well, now think about TradeRev becoming another channel in that waterfall. So, now it would go close, it would go open, and now we're having customers move it to TradeRev before they go to shipping it to a physical auction. So I think there is a real opportunity where TradeRev comes in and complements what's going on in OPENLANE.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.
Q

Thanks. And a quick question for Eric on DRIVIN, how should we expect that to flow thorough the financial statements?

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

A

Craig, it will have no impact on our expectations in 2017 and beginning in 2018 we think we will see it through our organic growth because again it's a data-oriented service offering. They have a couple of other revenue platforms that are very insignificant, and that will continue, but primarily you will see it in our organic growth in the existing businesses of ADESA.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.

Q

Will it just show up as additional revenue per unit?

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

A

Yeah, probably more; we're expecting it could have an impact on conversion rates and therefore the total volume in any of our channels; that would be online as well as physical.

Craig R. Kennison
Analyst, Robert W. Baird & Co., Inc.

Q

Got it. Thank you.

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

A

You're welcome.

Operator: Thank you. And our next question comes from the line of Matthew Page with Gabelli & Company. Your line is now open.

Matthew Page
Assistant Vice President, Gabelli & Company, LLC

Q

Good morning. Thanks for taking my call.

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

A

Good morning.

Matthew Page
Assistant Vice President, Gabelli & Company, LLC

Q

Just a couple of questions left for me. The first is, one technology we haven't touched on yet in this call is Autoniq, so I was wondering if you could just provide an update on that and talk about customer acceptance of the product and where you're seeing the opportunity going?

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

A

Yeah. So, you were very, very faint there, but I got your question, give you an update on Autoniq, which is another great story. We acquired this company a couple years ago, it's a subscription-based business that provides, really aggregates the data on the valuation of vehicles from all the different data sources over your iPhone. We continue to grow that business very, very nicely. Our subscriptions continue to grow. We continue to penetrate the franchise, as well as the independent market. And I would tell you, performing not only to our expectations, but maybe performing a little beyond our expectations. So very, very pleased with Autoniq. And as we think about Autoniq, now we think about how we can integrate Autoniq with some of our other offerings.

So, as you think about OPENLANE, you think about TradeRev, you think about some of the things we're doing with DRIVIN and we think about data and analytics, it's how do we bring all those forces together to provide a better outcome for our customers. So, again, glad you asked the question because it's a great story.

Matthew Page
Assistant Vice President, Gabelli & Company, LLC

Q

Great, thanks. And hopefully this is a little bit better, but you also mentioned international opportunities. Are there any geographic areas in the North American market that you feel that IAA or ADESA are not well represented and you'd want to expand your presence?

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

A

I think we're well represented in the markets that we certainly want to be in and I get asked this question from investors. I would tell you that there is probably a handful of markets that we would still take a look at if they were to come available. We would certainly continue to take a look at them; nothing imminent or on the radar as we speak right now.

Internationally, it's wide open. I mean the opportunities there, it's just a question of how soon can we get to them, and we're probably being very cautious in terms of how fast we go, although I do believe speed wins. But we've had a couple of press releases here in the last little while about two major pilots we rolled out with two of the largest leasing and fleet companies in the world, Arval and Motability.

And those pilots have gone very, very well, where we've seen our customers report back to us. They're pleased with the technology but they are even more pleased with eliminating the days to sell, and the fact of the matter is, we've been able to achieve more net proceeds than what they've been able to achieve at the physical auctions that they were using.

So again, a lot of geography, a lot of markets, a lot of interest, not only from dealers but from the fleets and from the OEMs. I believe the opportunity is really unlimited, it's just a case of how quickly can we get to them.

Matthew Page
Assistant Vice President, Gabelli & Company, LLC

Q

Great. Well, thanks for taking my call and good luck.

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

A

Thank you very much.

Operator: Thank you. And our next question comes from the line of Bob Labick, CJS Securities. Your line is now open.

Bob J. Labick
Senior Managing Director of Research, CJS Securities, Inc.

Q

Thank you, and thanks for all the information so far on the call.

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

A

You're welcome.

Bob J. Labick
Senior Managing Director of Research, CJS Securities, Inc.

Q

I want to dig a little deeper in DRIVIN. Could you talk to us a little bit more about the business model itself, is this is a product for the OPENLANE customers, the dealer customers or both, and do they take inventory or is it just an agency transaction?

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

A

Yeah. So let me start by saying, first of all, DRIVIN has a transactional component platform that it can transact business on, but that was not what attracted us to the business. We were attracted to the business for the analytics capabilities that they have and the talent that they had within their organization. As we thought about our data science team, and I may have mentioned this before, but forgive me for repeating if I am.

I've been spending a lot of time with customers. And what customers are really focused on right now is these volumes that are coming at them. And they really have limited information. Our customers have information on their cars. KAR has information on cars within the entire industry. So we have millions and millions of data points.

And what our customers have really come to us and the conversations I'm having along with our senior management team is it's kind of the conversation that go, Jim, how can you take our data along with all this industry data and how can you turn this into predictive analytics? How can you turn this into actionable intelligence that will help us make better decisions on number one, what's the best channel to sell the car and what's the best market to sell the vehicle and then what price should I be getting for the car? All those things. And this is really what DRIVIN brings to the table.

Now, we were building a data science team here, doing a very good job of building a data science team and attracting some really good talent. But we knew if we continued to build that it was going to take perhaps two to three years to build out that team and attracting the data scientists and the Ph.D.s that we would require.

And I kind of would go back and compare it to what we did with OPENLANE. When we bought OPENLANE in 2011, we had the opportunity to try and build this service or buy this service. We bought OPENLANE and everybody knows what a great vision that turned to be.

And this is kind of similar here. Do we build it, or do we go out and acquire it. We went out and we acquired it. And we think it really accelerates the pace, because these customers don't have two to three years to wait for the pricing models and the pricing engines that we're going to build for them; they need it today.

And so really what we're going to do, and I believe I mentioned in my commentary, is we're going to bring that DRIVIN team, and we're going merge it with our data science team that we've been building here at ADESA or at KAR, and I can tell you, we're now going to the market, we're ready to go to the market almost immediately. We're in discussions with some of our major customers on building these pricing engines and we're talking about rolling out pilots here, as early as the second quarter of the year. So this ship is sailing and we don't want to miss the opportunity.

Bob J. Labick
Senior Managing Director of Research, CJS Securities, Inc.
Q

Got it. And so in terms of if it's not primarily transaction based, it's subscription based, or how does the revenue model work?

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

Bob, the revenue model – the interesting part, the revenue model will vary based upon the customer. But we will generally realize the value through the transactions, but not the transactions of DRIVIN, the transactions of ADESA.

Bob J. Labick
Senior Managing Director of Research, CJS Securities, Inc.
Q

Okay, great. Thank you.

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

You're welcome.

Operator: Thank you. And our next question comes from the Gary Prestopino with Barrington Research. Your line is now open.

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

Hey, Gary.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Couple of questions. Number one, Eric, what gives you the confidence that, in the back half of the year, the reserves at AFC are going to decline, relative to the first two quarters?

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

A

So Gary, what's interesting is, you have visibility into what the performance of new loans is doing. And we've already seen improvement in the portfolio for loans made in the last 90 days. So again, we have visibility into actual transactions and the things that are causing the write-offs and the bad debt now are cars that were perhaps put on the floor plan and current at the end of last year that aren't selling and you start to get the age of the vehicle and things like that. So we have all of that information. That's what gives us the confidence, it's real data on the actual loans that are outstanding.

It is little harder to look into Q4 but we already have visibility into things that we've loaned on now, what's again, the payoff rate, et cetera, because if it's not paid off now those will start to become issues in Q3.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. So, some of the steps that you outlined, I think in the Q4 call as far as the future lending are starting to take hold and you're just doing a better job of it?

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

A

Right. I think we always did a great job of lending the money. What we've done is focused on what part of the market do we have the least risk and it's actually the lower end of the market. And as we mentioned in the yearend call, it's really these large balances that have caused the issue in the last couple of quarters. And deemphasizing that and not taking as much exposure into that part of the market is paying off for us.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. And then the choppiness that you saw in the independent dealer market in Q1, attributed to some of these tax refunds not coming through in February, does that portend that coming out of Q1, you were still seeing the independent dealer market, was still showing some strength and then that would translate into a better environment for the auction business itself?

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

A

Yeah, Gary, I think that we would expect that there will be continued increase in kind of what's taken place as we now get these tax refunds coming through. We would expect that independent market to pick up a little bit.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. So it wasn't to have anything to do with the fact of extension of credit to the independent dealers for selling cars, it was just – a lot of it how had do with that tax issue?

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

A

Yeah, I think what happened is independent dealers got caught holding some inventory and then were unable to move their inventory, which kind of choked them a little bit. And their only release was to either take that car back to the wholesale market and be forced with perhaps some potential losses or holding the vehicles. And I think that they've had to some vehicles and now they've got to work their way through vehicles that were maybe bought at a little bit of a higher price in the previous market that they now have to liquidate in the current market.

....

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

A

And Gary, I'd like to remind you what Jim said, with a strong January and strong March, the inventory they bought in January didn't sell at the same pace that they expected. That's what slows it down, they sell the cars, March picks up again.

....

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thanks. Then lastly on DRIVIN, who is the end customer? I mean, I went to their website, I looked at it, it looked like a specialized, almost, search engine for dealer-to-dealer transactions. And from what you're talking about, it seems that you're going to more or less emphasize the data versus the dealer-to-dealer transactions. So who is the end customer? Is it your consigners, it that the dealers? How does this all work? And then the other question would be, where are they getting the data from, or where would you get the data from? Are there direct connects into the dealer's VMS system?

....

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

A

Okay. So there is a lot there, Gary, but let me try and get that for you. First of all, understand that I did say that DRIVIN has a platform where they can transact and what I was referring to there is, we're servicing both the sellers and the buyers in terms of matching vehicles. DRIVIN has the ability to be able to know and understand a dealer's inventory, what inventory he buys, what inventory he sells, and to be able to match the inventory needs with the inventory that is being offered.

So, there is that capability where we serve the buyer and the seller, but then from the data standpoint, the data is really focused on helping these major commercial consigners. I think about the OEMs and the [indiscernible] (55:42) and the fleets and the rental companies and that whole commercial segment is helping them better understand the pricing of their vehicles. And then when you move the vehicle through the system, there is usually a reason why the vehicle doesn't sell in a close environment and it's either price or condition.

So, when that vehicle comes from a closed environment to the open environment, there has to be – there should be a price adjustment there, there should be a price adjustment unless it's just purely condition. But so, it's helping them understand how to price that vehicle in the open market. And then if it doesn't sell in the open market, then I mentioned to you, there's an opportunity to re-price that car and put it on TradeRev, because you would go through all these channels to avoid maybe the transportation costs and the days to sell, the depreciation cost of actually sending it to a physical auction.

So, it's helping these customers make better upstream decisions before they decided to finally send it to a physical auction. And this is where this data is really going to help them and as I said, I've sat in on a number of presentations and the discussions are very much heading in a direction where customers are really saying, think we need this help.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thank you.

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

A

Thank you.

Operator: Thank you. And that does conclude today's question-and-answer session. I'd now like to turn the call back to Chief Executive Officer, Mr. Jim Hallett, for closing remarks.

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

Thank you, Chelsea, and maybe I can just take a moment here and wrap up today with a few additional comments is first and foremost, I want to thank you for being on the call, and I want to thank you for the interest that you continue to take in our company. One of the things that I look back on is – as I look back on my career, over 40 years in the retail car business, over 30 years in the auction business, and I've seen a lot of change, and priding myself as an entrepreneur, I very much welcome change and I embrace change. But I will tell you, I've never seen change at the pace of change that we're seeing in the current market.

The customers' expectations, their pain points, the areas in which they need help and require help and the services that they need is accelerated beyond anything I've ever seen in my career. But the good news about that is, I feel that we, KAR, have never been in a better position to provide that service and to deal with this rate of change as we're positioned to today.

If I can, if you think about it just for a moment, we came together in 2007, and we got off to a great start and then along came the recession, we're working our way through the recession. We acquired OPENLANE in a down market at a critical time and we all know how that worked out, and then we went into the recovery in 2013, and we continued to focus on acquiring businesses that will continue to improve our customers' experience, help their economic outcome and take this company and transform it to another level.

And just quickly, we focused on technology and we focused on brick and mortar. We acquired TradeRev, we acquired DRIVIN, Autoniq, we acquired DataScan, we acquired CarsArrive, RDN and there is probably some that I'm leaving out there. And then we acquired brick and mortar. Last year you've seen us acquire 12 brick and mortar auctions. And then we invested in our existing platforms and we brought new benefits and features and enhancements. And with all of that, we've built a great company and we have positioned ourselves very well.

I would tell you in 2007, we may have been seen as a bit of a laggard. I can tell you today, I couldn't be more proud of this management team and what we've been able to accomplish and I see KAR very, very much as a leader in this industry, in all aspects of this industry. And now we have great visibility into 2019 and we know what's coming at us. And I would tell you, I am more confident and more enthusiastic and more energetic as to how we're prepared for what's next.

So, with that, I'll say thank you and we look forward to bringing you more good news. Have a good day.

Operator: Ladies and gentlemen, thank for participating in today's conference. This does conclude the program and you may all disconnect. Everyone have a great day.