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KAR Auction Services, Inc. (KAR)

Q2 2017 Earnings Call

CORPORATE PARTICIPANTS

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

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

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

OTHER PARTICIPANTS

Aileen Smith
Analyst, Bank of America Merrill Lynch

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

Bret Jordan
Analyst, Jefferies LLC

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Lee Jagoda
Analyst, CJS Securities, Inc.

Matthew Paige
Analyst, G.research LLC

James J. Albertine
Analyst, Consumer Edge Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the KAR Auction Services, Inc. Second 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 follow at that time. [Operator Instructions] As a reminder, this conference call is being recorded.

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

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

Thanks, Takiya. Good morning, and thank you for joining us today for the KAR Auction Services second quarter 2017 earnings conference call. Today, we'll discuss the financial performance of KAR Auction Services for the quarter ended June 30, 2017. After concluding our commentary, we will take questions from participants.

Before Jim kicks off our discussion, I'd like to remind you that this conference call contains forward-looking statements within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995. Investors are cautioned that such forward-looking statements involve risks and uncertainties that may affect KAR's business, prospects and results of operations, and such risks are fully detailed in our SEC filings. In providing forward-looking statements, the company expressly disclaims any obligation to update these statements. Lastly, let me mention that throughout this conference call, we will be referencing both GAAP and non-GAAP financial measures. Reconciliations of the non-GAAP financial measures to the applicable GAAP financial measure can be found in the press release that we issued yesterday, which is also available in the Investor Relations section of our website.

Now, I'd like to turn this call over to KAR Auction Services' CEO, Jim Hallett. Jim?

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

Great. Thank you, Michael, and good morning, ladies and gentlemen, and welcome to our call. Let me outline what I planned on covering today at the outset here. I want to provide you with an overview of our consolidated performance, confirm our guidance, give you a review of our performance for the business units, and then outlook going forward through the balance of the year. And then, I'd like to end my commentary with talking about the impact of our second quarter debt refinancing and the opportunities to deploy capital.

So, let me start with an overview of the second quarter results. If I was to take it in one word, I would say, it was fantastic. Revenue increased 9%, adjusted EBITDA increased 13%, and operating adjusted EPS increased 18%. Consolidated SG&A expenses were up 5% for the quarter and only 2%, excluding SG&A added for acquired businesses. This quarter accomplished what we've been promising to our investors. We leveraged high single-digit revenue growth and double-digit increases in adjusted EBITDA and operating adjusted net income per share, and this truly demonstrates the strength of our diversified business model and the cash that it generates.

We are not changing our guidance for adjusted EBITDA or operating adjusted net income per share for 2017. We expect adjusted EBITDA of $825 million to $850 million. We expect operating adjusted net income per share of

$2.15 to $2.25. And while we're not changing our annual guidance, our strong performance in the second quarter combined with our outlook for the remainder of the year does have us expecting that adjusted EBITDA and operating adjusted net income per share will be above the midpoint of our annual guidance for 2017. We expect free cash flow of $415 million to $440 million, an increase of $20 million from our previous guidance due to lower cash taxes, and Eric will discuss this in more detail in a few moments.

As we take a look at our business performance highlights, I will start with ADESA. ADESA revenue was up 9% and adjusted EBITDA increased 13%. We sold 11% more vehicles than a year ago, and this was primarily driven by increases in the online-only volumes. Acquisitions accounted for 4% of our volume and we saw a modest 1% increase in the same-store volumes at physical auctions. Same-store dealer consignment volumes were down 5%. However, same-store commercial volumes were up 14%. This mix shift to more commercial vehicles is consistent with what I've been telling you for the last several calls.

Most importantly, we controlled SG&A expenses, which were flat year-over-year excluding acquired SG&A. Our conversion rate at the physical auctions was 61%. The increase in conversion rate is due to the mix shift from 51% commercial last year to 54% commercial this year. I believe that our consigners continue to be price-sensitive as we see used car prices decline. The good news is, this is a key factor in how much money a commercial consigner will put into a car in order to maximize the value of the used vehicle. In summary, ADESA had a great quarter. The results were in line with what I've been telling you about the various levers that can drive profitability at ADESA. ADESA is not dependent on any single variable. Same-store physical auction volumes were relatively flat, yet we can drive results by enhancing revenue per vehicle sold and controlling SG&A.

As I look at AFC, we continue to operate our finance company very conservatively. The number of loan transactions was relatively flat. The provision for credit losses was 2.6% of average loan balances for the quarter. We've told you that we expect lower loan losses in the second half of the year. While the second quarter loan losses were up as expected, I have good news to discuss within the quarter. The loss provision was high in April and May as we ran off the defaulted loans that we had discussed on previous calls. Our June provision for credit losses was below our expected loss rates of 1.75% to 2.25% of our average receivables as the credit quality of our portfolio has continued to improve. This is a very good indicator for what we expect to see in the second half of 2017.

Insurance Auto Auctions is clearly knocking it out of the park. I could say grand slam. The volumes led to – the revenue at Insurance Auto Auctions was up 13% on 11% volume growth. The volumes led to leverage our cost structure has seen an increased gross margins and increased adjusted EBITDA margins. Adjusted EBITDA grew 27% for this segment and our adjusted EBITDA margin was over 30% for the quarter, and SG&A was controlled and grew less than 4% and inventory levels continued to be high, up 9% over the prior year at quarter end. Clearly this sets up for a very good balance of the year.

Let me now turn to our outlook going forward. Used cars supply will remain strong for the next three years with very good visibility. The mix shift to more commercial and less dealer consignment cars will continue as we expect lease returns and repossessions to increase over this period. And wholesale used car prices are expected to continue declining and this will lead to the use of more ancillary services and may contribute to further increases in repossessions as consumers find themselves underwater on their loans.

I expect ADESA's total volume to increase despite the expected decline in dealer consignment volumes. Remember, we are expecting commercial volumes to reach 60% of vehicles sold over the next few years. We are only at 54% in the second quarter as I previously mentioned. We are expecting dealers to be somewhat conservative in buying inventory as prices are expected to decline. This will increase the importance of having cars in what we call a retail-ready condition. This is good news for our revenue per unit at our physical auctions.

The increases in volumes with the shift to more commercial vehicles will also be good for AFC loan values. I expect the average loan value per vehicle at AFC to continue increasing, which will lead to higher revenue per loan transaction. We're also seeing lower loan losses in the second half of the year, and continue to anticipate loan losses in the range of 1.75% to 2.25% of average loan value for 2017.

And finally, the strong results at IAA are expected to continue for the next few years. Insurance companies are declaring more claims as a total loss, the cost for collision repairs continued to increase and miles driven continued to increase as well. So, let me take a step back for a moment from the details and sum this all up. The outlook for KAR for the second half of 2017 and even beyond 2017 is very positive. I really like how things are coming together and the investments that we made, they can be leveraged in the strong revenue growth and profitability, and cash flow generation.

So, with that, I'll turn it to our recent debt refinancing and capital allocation that we completed in the second quarter. We successfully completed the refinancing of our debt and the issuance of $950 million in unsecured notes within an eight-year maturity in May. Again, I'll let Eric to provide an overview of the impact of our financials, but let me summarize how this impacts KAR. First, we're able to fix interest rates on about a one-third of our debt for the next eight years at 5.125%. We also reduced the senior leverage by issuing the notes which give us increased flexibility as we look at our options for deploying capital. And last, we raised about $300 million in cash with the bond issuance that is available to us right now.

Our priorities for deploying cash, has not changed. We are looking at acquisitions that can provide strategic growth. We have no specific transactions to discuss today, but this definitely remains a priority. We also believe purchasing KAR stock in the open market provides a strong return and we expect to purchase KAR stock in the open market subject to daily limits during our open window in the third quarter. In any purchases of KAR stock in the open market, we will use available cash. In our core business, we announced our plans to acquire land in Florida in response to the needs of insurance customers. This land acquisition will likely occur in late 2017 or early 2018. The forecast for salvage volumes combined with the challenges of supporting our insurance customers during catastrophic events is driving the expansion activities in various Insurance Auto Auction markets.

In conclusion, we had a great quarter, and I'm looking forward to a strong second half in 2017 and beyond. We are focused on executing our business model, which will generate significant cash flows. We are going to deploy capital within our core businesses to support the growth opportunities in our current markets. We will continue to identify opportunities for strategic growth and maintain our disciplined approach to acquiring these businesses. And we will return capital to our shareholders in the form of a dividend supplemented by buying KAR stock in the open market during the open window in the third quarter. Our first and most important priority is creating value for our shareholders.

So with that, I will turn it over to Eric for some additional comments, and I will be back for the Q&A. Thank you. Eric?

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

Thank you, Jim. I only have a couple of topics to cover today before we take your questions. First, let me give you a few more details on our changes in guidance. Our expectations for GAAP net income per share for 2017 has been updated to $1.57 to $1.67. Our previous guidance for GAAP net income per share was $1.70 to $1.80. This change reflects the loss on extinguishment of debt net of taxes, up $0.13 per share recorded in the second quarter. This loss relates to the write-off of unamortized debt issuance costs, as a result of refinancing of our senior term loans in May.

We also updated our expectations for cash income tax payments for 2017 to $145 million from our previous guidance of $165 million. As part of our tax planning strategies, we identified a number of tax accounting elections that could be implemented and would allow us to accelerate certain deductions in our tax returns. These elections required us to receive approval from the Internal Revenue Service prior to adoption. We received the necessary approval in the second quarter. These elections only impact the timing of deductions in the tax returns and have no impact on our effective tax rate.

Although there was no change in our expectations for cash interest expense on corporate debt, I believe this deserves further explanation due to our refinancing activities. We increased our total long-term debt by refinancing our term loans and issuing senior notes to June 1, 2025. The net increase in our long-term debt was approximately $300 million. The interest on the additional debt was partially offset by reductions in interest on our term loans. In addition, we have revised our expectations for increases in LIBOR for the remainder of 2017.

And last, we have no changes to our expectations for capital expenditures in 2017 of $145 million. However, we announced earlier this week, our plans to add additional property in our salvage segment. We reached an agreement to acquire property in Florida to meet the needs of our insurance customers in the event of a catastrophic event. We expect to close on the acquisition of this property in early 2018. The acquisition of the property and related improvements is expected to cost approximately $25 million. However, if all conditions are met prior to year end, we have agreed to close on the transaction in December, and we have not included this acquisition in our capital expenditures expectations for 2017.

Over the course of the past 12 months, we have increased SG&A to support our growing operations and execute on our growth strategies. We have previously commented on these increases and expected the pace of growth to slow in 2017. Consolidated SG&A increased approximately 5% in the second quarter over the prior year. Excluding SG&A added for acquired businesses, the increase was less than 2%. By controlling SG&A, we were able to increase our consolidated adjusted EBITDA margin in the second quarter to 26% from 25% the prior year. We had very strong incremental adjusted EBITDA margins in the second quarter. On a consolidated basis, our incremental adjusted EBITDA margin was 38%.

On a same-store basis, our incremental adjusted EBITDA margin was 44.8%. ADESA had incremental adjusted EBITDA margins of 38.8% for the second quarter. Again on a same-store basis even better, the incremental margin was 55.4%. This was driven by the mix of revenue. We saw a strong growth in higher margin ancillary services delivered at our physical auction locations. Insurance Auto Auctions also generated exceptional incremental margins of 56.3% in the second quarter. We have been at or above capacity at a number of our auction sites for the last couple of quarters and this has driven strong margins. We also benefit from a lower level of purchased vehicles. Purchased vehicles represented only 4% of volume in the second quarter.

In the AFC business, we had decreases in revenue and adjusted EBITDA in the second quarter as compared to the prior year. This reflects the $6 million increase in the provision for credit losses in the second quarter as compared to the prior year. Excluding the provision for loan losses in computing revenue per loan transaction, we actually had an increase to $175 per loan transaction in the second quarter of 2017 compared to $167 the prior year. This increase reflects increased interest income as a result of increases in the average loan per vehicle floor. As Jim mentioned, we saw improvement in loss rates in June, and we expect to see improved results from AFC in the second half of the year.

We've provided additional detail on our financial performance in the earnings supplement released last night. We plan to file our 10-Q later today. So, let me now just turn it back over to Takiya, so we can take your questions. Thank you, everybody.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of John Murphy of Bank of America Merrill Lynch. Your line is now open.

Aileen Smith
Analyst, Bank of America Merrill Lynch

Q

Good morning, guys. This is Aileen Smith on for John. Can you talk a little bit about the trend with revenue per vehicle at ADESA in the quarter? Was the year-over-year decline attributable to running up against some tougher comps or was there a specific mix impact or other dynamic that drove the decline? And as used vehicle pricing continues to come down, do you think it's reasonable to assume that your revenue per vehicle could continue to trend positively or at least flat? And maybe, if you could remind us of how your fee structure works that may better explain that dynamic?

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

A

Okay, Aileen, let me start. While total revenue per vehicle was down a little bit, we break it into two components, Aileen, and that was driven by the online-only volumes being a higher percentage of our total volumes. At physical auction, we were actually up $6 per unit sold at the physical auction, and that was a big driver of the incremental margins. The decline on the online was really just driven by the mix of how much was grounding dealer and sold closed versus open.

And as we look at the trend during the quarter, it's pretty consistent; with all these off-lease cars, they clearly want to sell as many online as they can. And as Jim has said to me many times, we're not going to dictate where they sell the car, we'll just have the venue in which they sell them and be there to help them process the transaction. As I look forward, the off-lease cars will remain a significant component of our supply, and we will still see strong online sales. But in order to maximize values in a declining used car environment, we see them using additional ancillary services and things like that.

Now, Jim has experience as a car dealer, maybe he can share with you why they do that to generate a higher retail-ready value.

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

A

Yeah. Well, couple of things. Number one, I would say, I go back to Eric's comment, we don't want to dictate ever where the car sells. It's about providing the right channel and allowing the market to really determine where that car sells. But if the car is able to make it to physical auction, there is a lot of competition for buyers in the lanes, and these sellers are going to absolutely get their car, and what I described in my commentary, as retail-ready condition, being able to take that car right from the auction and place it in the frontline of their lot at the dealership.

And to do that, they know they have to spend the money, and that's exactly what we're seeing. We're seeing these major sellers spend more and more money reconditioning and preparing the car so that dealer absolutely doesn't have to do any of that work as he takes it back to his or her lot. So again, it's about maximizing proceeds. The other thing that they're protecting against is they're protecting against the lease residual prices that go into the guide books. So that's also an important component consideration for them as well.

So with that, hopefully, we have answered your question.

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

A

And Aileen, one more thing you asked about, fee structure. Look at the indices, Tom Kontos, our economist, publishes an index and we are showing that the average price paid for a car [indiscernible] (21:54) auction is increasing. And there is other indices out there that have hit record highs recently that I won't even comment on. But as you look at that, when you look at the [ph] NIVA Index, the RVI Index (22:05), and other indices that actually look at the later model cars, you're seeing a like-for-like decline, but at our auction, the actual price of a car being run through the lanes is increasing and that's been very good for the auction fees for our business. We use fixed tiered pricing and we're agnostic as to what car runs. So the fact that the average price paid at auction is increasing, is very good for our business, both at ADESA, at AFC and even at IAA because that pulls up the value of salvage cars. So, it's really good in all segments of our business. So thanks for the question, Aileen.

Aileen Smith
Analyst, Bank of America Merrill Lynch

Q

Great. That's extremely helpful. And then, just a follow-up on the off-lease volume dynamic, there is some concern that many of the off-lease vehicles are going to be returned to the dealer who is then going to ground them, and then resell them. Relative to the 10% growth that the industry is experiencing on the off-lease volumes from $3.2 million last year to about $3.5 million this year, are you seeing a similar uptick in the number or the percent of off-lease vehicles that are making their way to your auctions, and is it possible going forward that you could even see outsized growth relative to the rest of the market as the dealers may feel less inclined to buy those off-lease vehicles from the captive fincos with the market value potentially being lower than the residual value.

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

A

Yeah. I would say at this point in time that I would term it as being stable, what we are seeing, but I also think that to your point that as the dealers take a look at the price declines and they take a look at the residual value, then they have to make the determination whether they want to buy it there [ph] at termination (23:45), and pay that residual price or whether they want to wait for it to go into an online channel or get to a physical auction, and hopefully be able to hedge against and perhaps buying at a lower price and buying the vehicle fully reconditioned that we spoke about. So, I think there's an opportunity that we could possibly see more cars get to physical auction, but again that'll all be a matter of how is the retail market performance going forward here.

Aileen Smith
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you very much. That's it for me.

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

A

Okay, very well.

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

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

Q

Thanks a lot. Good morning.

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

A

Good morning, Matt.

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

Q

I've got two questions. Good morning. The first is a follow-up on ARPU, and you probably tackled this in some way, Eric, and I know you talked about the $6 increase year-on-year at physical. I just want to understand the fact that it seems to be a bit of a smaller increase, I guess in Q1 the ARPU was up more, if you look at the ARPU ex-acquisition to the extent that we can get that, the increase seems to have moderated a bit. So, anything within the mix there that would drive that?

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

A

It's really just the denominator is quite big in the second quarter, as you know, Matt, when you look at the volume numbers. And you're probably looking, it's always our strongest quarter across our auction businesses, second quarter has the most volume. The other thing that I would point to is, if I were to dissect it even further, the actual increase in ARPU at the auction for services delivered at the auction facility was up even more than that. And where we were off were things like transportation didn't quite grow as much as that did and repossession activities didn't grow quite as much as that did. So, we actually got that really great mix that I talked about which drove those incremental margins, so high on a same store basis.

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

Q

And then I guess if you could remind us directionally the EBITDA dollars per transaction based on channel because it's interesting, it seems like you had clearly a mix shift towards online channels, you absorbed that and your incremental margins were quite strong. And if we continue to see the mix shift in this direction, is it feasible, likely, et cetera that the incrementals can continue at a very strong pace?

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

A

Well, listen, I don't want anybody to think that we're going to do 55% same store incremental margins all the time, but I think they can continue to be quite strong. And again, as we look at this and as you pointed out, we don't talk

– I'm unable to really dissect or I haven't dissected EBITDA margin, but what I've done is gross margin and the reason is allocating SG&A is a tough science, but let's assume it's equal through the businesses.

On dollars, we're going to get gross margin dollars in the physical lanes where the average revenue was $748 and you're getting a 45% – again, if you look at that specifically 45% to 50% margin, you're looking at $375 in rough dollars of gross margin. And you compare that to the online space where my average, it's again excluding purchased vehicles, is at $105 and that's maybe a 70% average margin across the whole of all those cars. So, you're looking at $70. So, there is quite a difference in it. So, our performance is driven by the cars that get to physical auction, yet our market share and our differentiation with the customer I'd say is driven by how well we perform in the online venues with our digital offering. So they work hand-in-hand, don't just focus on the dollars, also focus on then what that does for our customer relationships, and how we can interact with them. Jim, anything to add?

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

A

No, I think, Eric, you've got it.

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

A

Thanks.

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

Q

One last one, super quick. In modeling LTU volumes for the credit business, should we be tracking this more closely to physical or should we be thinking about tracking it to overall ADESA volumes?

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

A

Yeah, no, Matt, I would say that we should be tracking it more to physical.

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

Q

Got it. That's very helpful.

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

A

And Matt, the other trend to watch is those dealer consignment cars are often to that AFC customer, that's where the pressure point is holding the LTU volume down.

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

Q

Understood. Thank you, gentlemen.

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

A

You're welcome, Matt.

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

Bret Jordan
Analyst, Jefferies LLC

Q

Hey, good morning guys.

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

A

Good morning, Bret.

Bret Jordan
Analyst, Jefferies LLC

Q

Hey, on the physical, I guess as we look at dealer consignments still down, although sequentially slightly better, is there any way to think about where physical might grow in the next year or so. I mean, clearly the online has taken a lot of that volume, you were saying that the commercial seller is really biased to sell online, but is there anything either in the mix or the trends on the dealer consignment that you would see that would show on the physical volume growing better than the 1% we saw in the quarter?

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

A

I think it's just a question of how these franchise dealers are able to absorb the vehicles that are going into the closed sale. And they've done a very, very good job of containing to absorb the volumes. As you know, a lot of these off-lease vehicles, I call young cars, they're three years old with 40,000 or 50,000 miles on them, they're very good CPO cars. And right now, there seems to be a demand for those cars, and the dealers are absorbing them. If that should change a little bit, could more cars make their way to physical auctions? Yeah, I think that's quite possible. The other thing that I had mentioned is that if – which would be a good thing would be, if the cars are able to make their way to the open sale or may make their way to the physical sale and prices have declined a little bit, this may give the independent dealer an opportunity to get some of these off-lease cars, which, in general terms, they don't really get the opportunity to get a crack at these cars early in the process.

Bret Jordan
Analyst, Jefferies LLC

Q

Okay. So, you will see physical volumes continuing to grow year-over-year. Does it same like the incremental margin, was it benefited from the ancillary services around physical? So, I guess, as you look out into 2018, would your expectation be that physical growth?

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

A

Yes, Bret, I think that physical can grow and also I would go back to the point that Eric made earlier. I also think that even though it was only $6 on the ARPU, I think the ARPU can grow with these ancillary services as well.

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

A

And Bret, I'll add, even the online sale – not the online only, while they may increase, some of these cars need to be reconditioned before they're going to be sold even online. And so, there is opportunities to move them to auction before they're sold through online offerings other than our private label sites. And the other element is, if you go back a year ago, the leveling off of the volumes at auction occurred in the second half of the year. We are reset to the base where physical auction was fairly flat on a same-store basis last year in Q3 and Q4 as compared to better growth in that earlier in the year in Q1 and Q2.

So I think we're off of a base, and if you look at our investor deck, which we will update next week as we have our first investor meetings on Monday, you'll still see that that we're looking at 2% to 4% growth in industry volumes at physical auction over the next couple of years. So and we'll get our share if not a little better than that.

Bret Jordan
Analyst, Jefferies LLC
Q

Okay, great. And obviously a fantastic IAA quarter. Do you see that growth just being obviously the higher salvage volumes as insurance companies are selling more cars to total or were there any real market share shifts in the quarter or any RFP activity we should be aware of?

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

Yeah, Bret. I think it's primarily what we're seeing is, we're seeing an increase in the number of vehicles that are being declared a total loss as a percent of accidents. You think back just two or three years, I mean, we were talking about total losses being at 13%, and then, we watched that number grow, and now we're getting total losses [ph] as we're starting to (32:32) touch that 20% range. So you think about that. You think about the other drivers of that salvage business, the cost of the body shop repairs. You think about the miles driven increasing. I think all of those factors play into continuing to drive very strong volumes at Insurance Auto Auctions.

Bret Jordan
Analyst, Jefferies LLC
Q

Okay, great. Thank you, guys.

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

You're welcome.

Operator: Thank you. Our next question comes from the line of Gary Prestopino of 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.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Should we expect to see a regeneration of revenue growth at AFC in the back half of the year, Eric, since this loan loss reserve is coming down?

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

A

Well, again, I comment, yes to the extent that we could hold the loan transactions flat we're getting higher interest income. That will drive some growth because of the increase in the average loan value. And also then you'll have not – we won't have that offset of the increased bad debt again if the second half turns out the way we think it might. So with the lower loan loss levels as we commented, we saw in June and we are seeing actually good indications into the second half of the year.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. And then Jim, just, yeah, I know, everybody's been asking this about the commercial vehicles. But in your experience as we get later into a cycle like this, and I know you didn't have the OPENLANE business years ago but do you see – is it usual that the dealers – well franchise dealers will have satisfied their inventory needs. Do you see more of these off-lease vehicles being then purchased by independents, because they're coming out of the closed sales and not actually selling?

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

A

Yeah. I think, Gary that, that is a possibility, especially as we go into the fourth quarter, and perhaps you'll see that the franchise dealers have kind of loaded up on vehicles and it's given the independents, as you said, and I think you said it well, it gives the independents a chance to come in and buy those cars, which normally they don't have that kind of access to. So, I think you could see that happen.

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

A

And Gary, that's a big driver of the increase in average loan value we've already experienced. These cars are already getting to that independent dealer, as we say, further down the food chain as they like to say. The smaller dealers are able to get access to that high value inventory.

Gary Frank Prestopino
Analyst, Barrington Research Associates, Inc.

Q

Okay. Thank you.

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

A

You're welcome.

Operator: Thank you. Our next question comes from the line of Ben Bienvenu of Stephens. Your line is now open.

Benjamin Bienvenu
Analyst, Stephens, Inc.
Q

Yeah. Thanks. Good morning.

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

Good morning.

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

Good morning, Ben.

Benjamin Bienvenu
Analyst, Stephens, Inc.
Q

I just want to revisit the IAA segment. You did have nice volume growth albeit against a little bit easier comparison. But the inventory growth came down. You mentioned that used or purchased vehicles were lower percentage of the mix. But I'm curious as you have a more reasonable level of inventory growth that's still strong and a more reasonable level of actual year-over-year volume growth in the quarter. Are you better able to leverage that volume with higher incrementals when you're not burdened with a tremendous amount of volume. In other words, is this kind of a preferable level of growth to get higher incrementals?

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

Well, Ben, let me just comment, the second quarter is a strong quarter because you are typically selling more vehicles than you're taking in. Although I will tell you, we feel very good about the activity that we've seen in terms of total losses of inputs even into the second quarter. And relative to the comps, I mean, again, I don't want to delve on this too much, but last year's second quarter was up 11% over the prior year. We're against tough comps. I think if I look at the business, last year's second quarter was the best quarter in the history of the company in every one of its segments. I went back and looked at this. And so, it was against a tough, a very strong performance. The comps do get a little easier in the second half, but the second quarter of last year was the best quarter in all three businesses in the history.

So, I think we did very well. The 9% is a very strong number going into the summer, especially when you consider a year ago that inventory number was an unusually high number at the end of the year. It was up 11%, and then got even bigger as you got [indiscernible] (37:20) we were over 20% increases year-over-year at Q3 and at the end of the year. So, again, we're on a good spot. We feel really good about that business and the way the insurance companies are treating claims we feel very good for the next few years.

Benjamin Bienvenu
Analyst, Stephens, Inc.
Q

Great. And then, Jim, you touched on this as it relates to capital allocation. You're continuing to look for opportunistic and strategic M&A opportunities coupled with buyback. So you didn't buy back stock in the quarter. Just curious around kind of what the backdrop was that precluded you from buying back stock or led you to be apprehensive about buying back stock?

And then, as we think about going forward, you mentioned open market share repurchase. I assume if you find a big M&A opportunity, you might press the pause button on that and reallocate capital towards M&A?

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

A

Yeah. So, Ben, I think in the second quarter, we weren't buying back stock because, quite frankly, we're very focused on getting our refinancing done, and getting that taken care of. In terms of going forward, we've talked about acquisitions are always our first priority where we can get superior returns. But if there is not an acquisition that is in the near-term, we've said that we can always pull the lever on buying back stock, and we very much plan on buying back stock as I mentioned in our open window here. And we'll continue to buy stock. Again, we will be restricted to our daily limits, but we'll buy back stock accordingly. And if our priorities change or our acquisition strategy changes or accelerates then we would have the option of hitting the pause button to turn our allocation to what we thought was in the best interest of our shareholders.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Great. Thanks. That's it from me. Thanks a lot.

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

A

Thank you.

Operator: Thank you. Our next question is from Chris Bottiglieri of Wolfe Research. Your line is now open.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

Hi. Thanks for taking the question.

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

A

You're welcome.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

I had a quick on the provisioning outlook for second half. So on one hand, these are a very short duration loans, but other hand, you have proven you have a lot of visibility, especially into the 1H outlook. I guess, how do you reconcile the short duration high visibility? I know, you have the monthly trends you cited, but what gives you confidence that the second half gets meaningfully better?

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

A

Chris, that's a good question. Short visibility, but you look at the payoff trends, we look at the retail, we get a lot of reporting – operational reporting from our dealers, and look at their activity levels. And then, I will give our management team credit down there. Where we have focused is trying to get less emphasis on those large credits and build the base, as I like to say, those smaller dealers coming in. So, I feel we have a great mix right now. We're looking at curtailment trends, which means how many loans are getting extended after the initial term.

We look at payoff trends. And then, we look at delinquencies, and all of those are really very positive right now. And we're already in the middle of August. Our visibility would go – again the average loan duration is about 60 days, which means half of the loans are longer, half of the loans are shorter. That's what you look at so.

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

A

And Chris, I will just add that, I don't believe that we look at AFC for growth at this point in time. If anything, I would say to you, we want to be conservative, we want to be extremely disciplined in managing this portfolio and any growth that's going to come is going to come through that disciplined growth that we talked about.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

Got it. So, do you think this is more like self-help and the mitigation controls you've put in place or is it the market. Do you think the actual like underlying independent dealer is getting a little bit healthier at the margin?

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

A

Listen, what happened for these higher loan losses were a very small number of dealers with larger credits that probably misjudged what was happening to used car prices at the higher end of the market.

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

A

Yeah. I think they just caught with inventory that had some depreciation in terms of prices falling and maybe they got caught with inventory that was overpriced at the wholesale market. But I think the other thing that's important to point out here is that the independent dealer is still doing quite well. The independent dealer year-over-year is showing an increase in the total number of used car sales. So, it's still a very healthy market and a very healthy group of dealer. And I'll just repeat what Eric said, I think this was just a very small group of dealers that really got over their skies on some of their buying and got caught with that heavy inventory.

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

A

And the losses are created when we lose the collateral, not the devalue of the car. It really is because they then find themselves in trouble. They sell the car, don't pay us, they may sell it as a discount that they want to admit to us and its fraud. I mean, it really comes down to the increases were created by fraud by a small number of bad actors.

Chris Bottiglieri
Analyst, Wolfe Research LLC

Q

Got it. That makes a lot of sense. And then, sorry, just one last [ph] rhetorical (42:54) question, you guys gave so much details, you might have given this, but have you said what dealer and commercial organic volume growth is at physical, not the total, but basically have you given that data? Do you have that compared to Q1?

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

A

Yes. Jim gave it. Dealer consignment was down 5% year-over-year at physical.

Chris Bottiglieri
Analyst, Wolfe Research LLC
Q

Okay. And how about commercial, do you have that number or at physical?

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

We don't – we gave you the total commercial which includes all commercial at 14% though, Chris, you and I talked – you'll be able to figure it out. We don't isolate that number. And then, did you say you wanted that number for the first quarter?

Chris Bottiglieri
Analyst, Wolfe Research LLC
Q

Yeah, just for the comparison, if you have it just top of mind?

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

This is on a same-store basis. So I'm excluding acquisitions, it was down 7% in Q1, down 7% in dealer consignment in Q4, down 4% in Q3 of last year.

Chris Bottiglieri
Analyst, Wolfe Research LLC
Q

Okay. Great. Well, thanks a lot for your time. I appreciate it. Good luck for the next quarter.

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

Okay. Thank you.

Operator: Thank you. Our next question is from Bob Labick of CJS Securities. Your line is now open.

Lee Jagoda
Analyst, CJS Securities, Inc.
Q

Hi. This is actually Lee Jagoda for Bob. Good morning.

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

Good morning.

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

Good morning.

Lee Jagoda
Analyst, CJS Securities, Inc.
Q

So, just one from me. If we take a step back, can you talk a little bit about the technology acquisitions you've made both domestically and internationally, maybe talk about the market sizes and opportunities and where those companies are in terms of their growth and portability profile? And then as a follow-up to that just any new markets that you might be looking at?

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

A

Yeah. So, there is a lot there. Let me try and break it down. First of all, we've done a number of acquisitions internationally that we've spoken about in the past. Our GSR platform which is very much what we would compare it to our OPENLANE platform here in the U.S. and Canada. That platform we've now continued to build the buyer based on that and it continues to perform as expected.

We've rolled out our TradeRev, which is a digital product as you know over the mobile phone, we've rolled that out in digital, the full digital transformation is a big deal for us, and very much a part of our strategy. That's been rolled out not only in the UK, but also it's been much more focus put on it here in the U.S. and continues to do very well in Canada. We see TradeRev as being a real opportunity for us as we go forward. And then, so I would say on the international front, just in terms of sizing it, I would say you shouldn't really think about this kind of in the short term. You should think about it having some meaningful impact over a longer term, I'd say looking out maybe two to three years, you should expect to see stronger results there as we continue to grow these businesses and integrate these businesses, and build the customer base.

We did a acquisition called DRIVIN, which was our data acquisition. This is data and analytics, and this was something that was very much being requested by our customers. This acquisition even though it's only been 60 or 90 days has done extremely well. Our customers were really pleased that we made the investment, and I can tell you that we have already gone to the market with a number of pilots with different customers and the feedback has been very, very strong in terms of the information that we're able to provide them. When you think about it in combination, you take KAR's data, you take our customers, and you take the capabilities that we have within DRIVIN and within our technologies, I believe that we are unmatched in this area in the industry in terms of the offerings that we're able to provide.

So with that, the other thing I mentioned, we've talked about previously was talked about our investment in New Wave, and this is our private label business that we have a very, very strong market share in. We announced I guess the couple of quarters ago that we're going to invest $20 million to $25 million in upgrading our private label platforms in terms of increased features, benefits, enhancements, and we're doing that. We've hit kind of the first steps in a progression of new releases that we want to do. But I'd say it's in the early stages, but number one, I think our employees are excited about the investment that we're making in this product, and that translates to even our customers being more excited that we're putting this kind of money into these programs to support their business. So hopefully that gives you a flavor for much of what's going on in this space.

And then, of course, I guess, you have asked primarily about technology, but then also I think not to be forgotten is the fact that we made 13 acquisitions in terms of brick-and-mortar auctions last year, the Brasher's Group, Orlando, Flint, all those auctions continued to perform as expected. They are what we expected to buy, they're performing as we expected, and I would say that they're all doing I guess I said as expected. So hopefully that gives you a good recap.

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

Thanks. That's great. Thank you very much.

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

You're welcome.

Operator: Thank you. Our next question comes from the line of Matthew Paige of Gabelli & Company. Your line is now open.

Matthew Paige
Analyst, G.research LLC
Q

Good morning. Thanks for taking my call. Just one question for me. Thinking more longer term, I guess, as the rental car companies work to position themselves as potential autonomous fleet managers, I'm curious how you envision car fitting into the model?

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

So, I think what we're talking about here is, we're talking about mobility. And certainly, this is an area that not only the rental companies are getting focused on, but certainly, the ridesharing companies and the OEMs. When we think about mobility, we think about large fleets of vehicles. And when we think about large fleets of vehicles, we think about our customers that have large fleets of vehicles. So I think we're going to be dealing with the very same customers that we're dealing with today. And as we think about mobility coming forward here, and I believe that that ship has already started to sail.

We think it really smells opportunity. We think there's going to be a lot of opportunity with these large fleets, not only are there going to be a lot of vehicles, not only are they going to turn over with more velocity, but we think there's also going to be opportunities to provide a lot of other services at both ADESA and Insurance Auto Auctions, in terms of maintaining these vehicles, servicing these vehicles, reselling these vehicles, and in some cases reselling them in the international market, some cases in the domestic market.

We think there's going be an opportunity to be installing technology, removing technology, there's a lot that we think can come into this space. And as a result, we've dedicated resources to mobility. Here, at KAR, we continue to work very closely with who we believe these mobility providers will be, just staying current with their plans and current with what their expectations are, what services that they think they're going to need. And again, end of the day, it's going to be a different revenue source for us, but we think a very good one.

Matthew Paige
Analyst, G.research LLC
Q

Excellent. Well, I appreciate the color, and good luck in next quarter.

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

Thank you.

Operator: Thank you. Our next question comes from the line of James Albertine of Consumer Edge. Your line is now open.

James J. Albertine
Analyst, Consumer Edge Research LLC
Q

Great. Thank you. Good morning and congratulations on a fantastic quarter.

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

Thank you.

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

Thanks, Jamie.

James J. Albertine
Analyst, Consumer Edge Research LLC
Q

If I may, as we look at the off-lease trends and apologies if you've touched on this or alluded to this earlier, but we think about the shifting mix of off-lease currently being a lot heavier cars than demand is calling for a lot lighter on the truck side, that's going to shift more to tucks over time, I mean, it should based on new vehicle sales trends historically. I'm wondering if there's any way we should think about this impact in your ancillary or I should say, dealers ancillary spending to sort of reconditioned vehicles and/or the number of units that you're going to get from sort of the off-lease channel, if you will?

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

Yeah, I don't know if there's any way Jamie to really quantify that. I think the vehicles will have to stand and speak for themselves. I think certain vehicles will obviously get sold in a closed sale. I think the dealers will have a choice, they'll be able to cherry-pick and pick out the best vehicles that best suit their needs. And based on the condition of the vehicle and the equipment in the vehicle, and even right down to the color of the vehicle, it will determine whether those cars get sold in an online venue or whether they make their way to physical auction. So, I think regardless if it's trucks or crossovers or SUVs or cars, I think at the end of the day when you mix it all up, I think the outcome is going to be kind of similar to what we're seeing now.

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

[indiscernible] (52:49).

James J. Albertine
Analyst, Consumer Edge Research LLC
Q

Sorry. Go ahead, yes.

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

We've been through this once before. In 2009, we had a glut of off-lease cars relative to the market at the time coming back, and it was a fantastic year. I think the key is all of the cars will sell, it's just at what price, in what condition. So, 2009 was very much similar to this as we were coming out – the SAAR was obviously very low that year post 2008 financial services crash, but we saw the strongest volumes to-date and now we're back to those levels. So, we're ready to handle it and all the cars will sell.

James J. Albertine
Analyst, Consumer Edge Research LLC

Q

Understood. And if I may ask one more on the technology side, again, you've addressed this multiple times on the call and also in your prepared remarks. Is it fair to say that we're at a point where if you were pivoting from where investment is higher than the benefits of investment, in other words the benefits now are going to start to accelerate as the investments starts to decelerate. Are we at that point or is it still a little too early, still a lot of integration to consider here as we model out the back half of the year?

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

A

Yeah, that's really a good point. We have made these investments and, the revenue tends to follow the investments and there's the integration that needs to take place. We're in the early stages with some of that technology, especially as we talk about DRIVIN and we talk about TradeRev, and our drive towards digital and our drive towards data, which have become very, very important parts of our strategy. I think that it's a little bit early, but I think where this starts to show up is I think this starts to show up eventually in our market share in just our organic growth and same-store. So, we'll look forward to that all coming together at some point in time.

James J. Albertine
Analyst, Consumer Edge Research LLC

Q

Okay. Well, very good. Thank you for taking the questions and best of luck in the next quarter.

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

A

Thank you.

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

A

Takiya, I think we've got time for one more question, if anybody is in the queue and then we should be done.

Operator: Thank you. [Operator Instructions] And I'm showing no further questions in queue, at this time. I would like to turn the conference back over to Jim Hallett, CEO, for closing remarks.

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

Okay. Thank you, Takiya. I want to thank everybody for being on the call today and certainly want to thank you for your continued interest and your investment in our company. You've heard me talk about the second quarter, and hopefully, I've been able to share with you how pleased I am with the quarter, how pleased I am with the performance. But I can tell you that, I'm done talking about the second quarter, as we say in Canada, that's like last year's snow now. So we're moving on to the balance of the year.

I'm really excited about where we're at. I'm excited about how we're positioned. I'm excited about, what I see coming forward here in the balance of the year, the visibility we have, the volumes that we know are coming, the opportunities that exist within the business, and as we spoke often today about our new investments in data, in digital and really driving our strategy, I think we have a real opportunity here to really deliver some good results and hopefully have a very strong finish to the year.

So with that, we'll sign off and we'll look forward to talking to you next quarter around. Thank you very much for being on our call.

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