KAR Auction Services, Inc.
Form 10-Q
May 09, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 001-34568

KAR Auction Services, Inc.
(Exact name of Registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	20-8744739 (I.R.S. Employer Identification No.)

13085 Hamilton Crossing Boulevard
Carmel, Indiana 46032
(Address of principal executive offices, including zip code)
Registrant's telephone number, including area code: (800) 923-3725

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý   No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý   No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o	Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

As of April 30, 2018, 134,963,883 shares of the registrant's common stock, par value $0.01 per share, were outstanding.

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PART I
FINANCIAL INFORMATION
Item 1. Financial Statements
KAR Auction Services, Inc.
Consolidated Statements of Income
(In millions, except per share data)
(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Operating revenues		
ADESA Auction Services	$528.1	$498.0
IAA Salvage Services	337.3	297.4
AFC	85.1	71.2
Total operating revenues	950.5	866.6
Operating expenses		
Cost of services (exclusive of depreciation and amortization)	535.0	501.2
Selling, general and administrative	187.4	157.4
Depreciation and amortization	70.3	64.5
Total operating expenses	792.7	723.1
Operating profit	157.8	143.5
Interest expense	41.5	40.3
Other income, net	(0.1)	(0.1)
Income before income taxes	116.4	103.3
Income taxes	26.4	34.1
Net income	$90.0	$69.2
Net income per share		
Basic	$0.67	$0.51
Diluted	$0.66	$0.50
Dividends declared per common share	$0.35	$0.32

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Consolidated Statements of Comprehensive Income
(In millions)
(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Net income	$90.0	$69.2
Other comprehensive income (loss)		
Foreign currency translation gain (loss)	(6.9)	3.4
Comprehensive income	$83.1	$72.6

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Consolidated Balance Sheets
(In millions)
(Unaudited)

	March 31, 2018	December 31, 2017
Assets		
Current assets		
Cash and cash equivalents	$330.8	$317.2
Restricted cash	20.6	19.4
Trade receivables, net of allowances of $12.0 and $11.2	963.6	725.5
Finance receivables, net of allowances of $13.3 and $13.0	1,919.9	1,899.6
Other current assets	176.2	175.7
Total current assets	3,411.1	3,137.4
Other assets		
Goodwill	2,212.0	2,191.7
Customer relationships, net of accumulated amortization of $825.9 and $805.0	353.0	375.6
Other intangible assets, net of accumulated amortization of $347.2 and $338.7	344.2	350.6
Other assets	36.3	20.8
Total other assets	2,945.5	2,938.7
Property and equipment, net of accumulated depreciation of $780.2 and $755.1	909.6	908.2
Total assets	$7,266.2	$6,984.3

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Consolidated Balance Sheets
(In millions, except share and per share data)
(Unaudited)

	March 31, 2018	December 31, 2017
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$942.7	$682.7
Accrued employee benefits and compensation expenses	77.1	104.4
Accrued interest	20.7	7.3
Other accrued expenses	167.9	171.5
Income taxes payable	1.3	5.8
Dividends payable	47.2	47.0
Obligations collateralized by finance receivables	1,354.2	1,358.1
Current maturities of long-term debt	16.8	12.4
Total current liabilities	2,627.9	2,389.2
Non-current liabilities		
Long-term debt	2,664.3	2,667.7
Deferred income tax liabilities	194.5	192.7
Other liabilities	259.4	249.8
Total non-current liabilities	3,118.2	3,110.2
Commitments and contingencies (Note 8)		
Stockholders' equity		
Preferred stock, $0.01 par value:		
Authorized shares: 100,000,000		
Issued shares: none	—	—
Common stock, $0.01 par value:		
Authorized shares: 400,000,000		
Issued and outstanding shares:		
March 31, 2018: 134,956,732		
December 31, 2017: 134,315,118	1.3	1.3
Additional paid-in capital	1,255.9	1,251.8
Retained earnings	295.0	257.0
Accumulated other comprehensive loss	(32.1)	(25.2)
Total stockholders' equity	1,520.1	1,484.9
Total liabilities and stockholders' equity	$7,266.2	$6,984.3

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Consolidated Statements of Stockholders' Equity
(In millions)
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance at December 31, 2017	134.3	$ 1.3	$ 1,251.8	$ 257.0	$ (25.2)	$ 1,484.9
Cumulative effect adjustment for adoption of ASC Topic 606, net of tax				(3.0)		(3.0)
Net income				90.0		90.0
Other comprehensive loss					(6.9)	(6.9)
Issuance of common stock under stock plans	0.8		5.6			5.6
Surrender of RSUs for taxes	(0.1)		(9.7)			(9.7)
Stock-based compensation expense			6.4			6.4
Dividends earned under stock plans			1.8	(1.8)		—
Cash dividends declared to stockholders ($0.35 per share)				(47.2)		(47.2)
Balance at March 31, 2018	135.0	$ 1.3	$ 1,255.9	$ 295.0	$ (32.1)	$ 1,520.1

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Consolidated Statements of Cash Flows
(In millions)
(Unaudited)

	Three Months Ended March 31, 2018		2017	
Operating activities				
Net income	$ 90.0		$ 69.2	
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	70.3		64.5	
Provision for credit losses	9.6		11.6	
Deferred income taxes	2.4		(3.1	)
Amortization of debt issuance costs	2.7		2.5	
Stock-based compensation	6.4		5.8	
Gain on disposal of fixed assets	(0.1	)	(0.3	)
Other non-cash, net	(4.4	)	2.9	
Changes in operating assets and liabilities, net of acquisitions:				
Trade receivables and other assets	(249.9	)	(94.3	)
Accounts payable and accrued expenses	225.3		83.2	
Net cash provided by operating activities	152.3		142.0	
Investing activities				
Net (increase) decrease in finance receivables held for investment	(29.6	)	21.4	
Acquisition of businesses (net of cash acquired)	(23.3	)	—	
Purchases of property, equipment and computer software	(38.7	)	(37.2	)
Advance to equity method investee	—		(5.0	)
Proceeds from the sale of property and equipment	0.1		0.1	
Net cash used by investing activities	(91.5	)	(20.7	)
Financing activities				
	23.1		31.4	

Net increase in book overdrafts						
Net decrease in borrowings from lines of credit	—			(67.2		)
Net decrease in obligations collateralized by finance receivables	(3.0		)	(41.0		)
Payments for debt issuance costs/amendments	—			(0.1		)
Payments on long-term debt	—			(6.1		)
Payments on capital leases	(7.8		)	(7.4		)
Payments of contingent consideration and deferred acquisition costs	(3.0		)	(3.0		)
Issuance of common stock under stock plans	5.6			4.3		
Tax withholding payments for vested RSUs	(9.7		)	(3.6		)
Dividends paid to stockholders	(47.0		)	(43.7		)
Net cash used by financing activities	(41.8		)	(136.4		)
Effect of exchange rate changes on cash	(4.2		)	1.8		
Net increase (decrease) in cash, cash equivalents and restricted cash	14.8			(13.3		)
Cash, cash equivalents and restricted cash at beginning of period	336.6			219.7		
Cash, cash equivalents and restricted cash at end of period	$	351.4		$	206.4	
Cash paid for interest	$	29.8		$	37.1	
Cash paid for taxes, net of refunds	$	28.6		$	39.3	

See accompanying notes to consolidated financial statements

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KAR Auction Services, Inc.
Notes to Consolidated Financial Statements
March 31, 2018 (Unaudited)
Note 1—Basis of Presentation and Nature of Operations
Defined Terms
Unless otherwise indicated or unless the context otherwise requires, the following terms used herein shall have the following meanings:

- "we," "us," "our" and "the Company" refer, collectively, to KAR Auction Services, Inc. and all of its subsidiaries;
- "ADESA" or "ADESA Auctions" refer, collectively, to ADESA, Inc., a wholly-owned subsidiary of KAR Auction Services, and ADESA, Inc.'s subsidiaries, including Openlane, Inc. (together with Openlane, Inc.'s subsidiaries, "Openlane"), Nth Gen Software Inc. ("TradeRev") and ADESA Remarketing Limited (formerly known as GRS Remarketing Limited ("GRS" or "ADESA Remarketing Limited"));
- "AFC" refers, collectively, to Automotive Finance Corporation, a wholly-owned subsidiary of ADESA, and Automotive Finance Corporation's subsidiaries and other related entities, including PWI Holdings, Inc.;
- "Credit Agreement" refers to the Amended and Restated Credit Agreement, dated March 11, 2014, as amended on March 9, 2016 and May 31, 2017, among KAR Auction Services, as the borrower, the several banks and other financial institutions or entities from time to time parties thereto and the administrative agent;
- "Credit Facility" refers to the seven-year senior secured term loan B-2 facility ("Term Loan B-2"), the seven-year senior secured term loan B-3 facility ("Term Loan B-3"), the senior secured term loan B-4 facility due March 11, 2021 ("Term Loan B-4"), the senior secured term loan B-5 facility due March 9, 2023 ("Term Loan B-5"), the $350 million, senior secured revolving credit facility due March 9, 2021 (the "revolving credit facility"), and the $300 million, five-year senior secured revolving credit facility (the "2016 revolving credit facility"), the terms of which are set forth in the Credit Agreement. Term Loan B-2, Term Loan B-3 and the 2016 revolving credit facility were repaid in May 2017 with proceeds from Term Loan B-4, Term Loan B-5 and the senior notes (defined below);
- "IAA" refers, collectively, to Insurance Auto Auctions, Inc., a wholly-owned subsidiary of KAR Auction Services, and Insurance Auto Auctions, Inc.'s subsidiaries and other related entities, including HBC Vehicle Services Limited ("HBC");
- "KAR Auction Services" refers to KAR Auction Services, Inc. and not to its subsidiaries; and
- "Senior notes" refers to the 5.125% senior notes due 2025 ($950 million aggregate principal outstanding at March 31, 2018).

Business and Nature of Operations
As of March 31, 2018, we have a North American network of 75 ADESA whole car auction sites and 175 IAA salvage vehicle auction sites; in addition, we offer online auctions for both whole car and salvage vehicles. ADESA also includes TradeRev, an online automotive remarketing system where dealers can launch and participate in real-time vehicle auctions at any time and ADESA Remarketing Limited, an online whole car vehicle remarketing business in the United Kingdom. IAA also includes HBC Vehicle Services Limited, which operates from 11 locations in the United Kingdom. Our auctions facilitate the sale of used and salvage vehicles through physical, online or hybrid auctions, which permit Internet buyers to participate in physical auctions. ADESA and IAA are leading, national providers of wholesale and salvage vehicle auctions and related vehicle remarketing services for the automotive industry in North America. ADESA's online service offerings include customized private label solutions powered with software developed by its wholly-owned subsidiary, Openlane, that allow our institutional consignors (automobile manufacturers, captive finance companies and other institutions) to offer vehicles via the Internet prior to arrival at the physical auction. Remarketing services include a variety of activities designed to transfer used and salvage vehicles between sellers and buyers throughout the vehicle life cycle. ADESA and IAA facilitate the exchange of these vehicles through an auction marketplace, which aligns sellers and buyers. As an agent for customers, the Company generally does not take title to or ownership of vehicles sold at the auctions. Generally, fees are earned from the seller and buyer on each successful auction transaction in addition to fees earned for ancillary services.

ADESA has the second largest used vehicle auction network in North America, based upon the number of used vehicles sold through auctions annually, and also provides services such as inbound and outbound transportation logistics, reconditioning, vehicle inspection and certification, titling, administrative and collateral recovery services. ADESA is able to serve the diverse and multi-faceted needs of its customers through the wide range of services offered.

IAA is one of the leading providers of salvage vehicle auctions and related services. The salvage auctions facilitate the remarketing of damaged vehicles that are designated as total losses by insurance companies, recovered stolen vehicles for which an insurance settlement with the vehicle owner has already been made, purchased vehicles and older model vehicles donated to charity or sold by dealers in salvage auctions. The salvage auction business specializes in providing services such as inbound transportation logistics, inspections, evaluations, salvage recovery services, titling and settlement administrative services.

AFC is a leading provider of floorplan financing to independent used vehicle dealers and this financing is provided through 130 locations throughout the United States and Canada as of March 31, 2018. Floorplan financing supports independent used vehicle dealers in North America who purchase vehicles at ADESA, IAA, TradeRev, other used vehicle and salvage auctions and non-auction purchases. In addition to floorplan financing, AFC also provides independent used vehicle dealers with other related services and products, such as vehicle service contracts.

Potential Spin-off

On February 27, 2018, the Company announced that its board of directors had approved a plan to pursue the separation of its salvage auction business through a spin-off, creating a new independent, publicly traded company. The transaction is expected to be tax-free to shareholders and should be completed within 12 months from the announcement date, subject to customary regulatory approvals, the execution of intercompany agreements between the Company and the new salvage auction company ("IAA"), final approval of the board of directors and other customary matters.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by U.S. GAAP for annual financial statements. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. In the opinion of management, the consolidated financial statements reflect all adjustments, generally consisting of normal recurring accruals, necessary for a fair statement of our results of operations, cash flows and financial position for the periods presented. These consolidated financial statements and condensed notes to consolidated financial statements are unaudited and should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the Securities and Exchange Commission on February 21, 2018. The 2017 year-end consolidated balance sheet data included in this Form 10-Q was derived from the audited financial statements referenced above and does not include all disclosures required by U.S. GAAP for annual financial statements.

Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. GAAP requires management to make estimates based in part on assumptions about current, and for some estimates, future economic and market conditions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the period. Although the current estimates contemplate current conditions and expected future changes, as appropriate, it is reasonably possible that future conditions could differ from these estimates, which could materially affect our results of operations and financial position. Among other effects, such changes could result in future impairments of goodwill, intangible assets and long-lived assets, incremental losses on finance receivables, additional allowances on accounts receivable and deferred tax assets, changes in litigation and other loss contingencies and changes in self insurance reserves.

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March 31, 2018 (Unaudited)

Equity Method Investment

Prior to the acquisition of TradeRev in October 2017, the Company accounted for TradeRev as an equity method investment because we had the ability to exercise significant influence over operating and financial policies but did not have a controlling financial interest. The Company’s share in the net losses of TradeRev for the three months ended March 31, 2017, was $1.7 million. This amount was recorded to “Other income, net” in the consolidated statements of income.

Revenue Recognition

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which superseded the revenue recognition requirements in ASC 605, Revenue Recognition. The new guidance provides clarification on the recognition of revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Topic 606 also requires additional disclosures to help financial statement users better understand the nature, amount, timing and uncertainty of revenue that is recognized. In preparation for the adoption of Topic 606, we assessed our contracts with customers, evaluated our revenue streams and compared current accounting practices to those required under the new standard. As a result of these efforts, we identified certain impacts to the presentation and timing of revenue recognition for a contract liability (deferred revenue) related to a material right associated with certain volume-related rebates. We have implemented the appropriate changes to our processes and controls to support recognition and disclosure under Topic 606.

We adopted Topic 606 in the first quarter of 2018 using the modified retrospective transition method and recognized the cumulative effect of initially applying the new standard as a decrease of $3.0 million to the opening balance of retained earnings. Prior periods will not be retrospectively adjusted. The Company has included the disclosures required by Topic 606 below.

There were no material contract assets, contract liabilities or deferred contract costs recorded on the consolidated balance sheet as of March 31, 2018. For each of our primary revenue streams, cash flows are consistent with the timing of revenue recognition.

For the three months ended March 31, 2018, revenue recognized from performance obligations related to prior periods was not material. Revenue expected to be recognized in any future year related to remaining performance obligations, excluding revenue pertaining to contracts that have an original expected duration of one year or less and contracts where revenue is recognized as invoiced, is not material.

ADESA Auction Services

Revenues and the related costs are recognized when the services are performed. Auction fees from sellers and buyers are recognized upon the sale of the vehicle through the auction process. Most of the vehicles that are sold through auctions are consigned to ADESA by the seller and held at ADESA's facilities or third party locations. ADESA does not take title to these consigned vehicles and recognizes revenue when a service is performed as requested by the owner of the vehicle. ADESA does not record the gross selling price of the consigned vehicles sold at auction as revenue. Instead, ADESA records only its auction fees as revenue because it does not take title to the consigned vehicles and has no influence on the vehicle auction selling price agreed to by the seller and buyer at the auction. Our buyer fees and dealer seller fees are typically based on a tiered structure with fees increasing with the sale price of the vehicle, while institutional seller fees are typically fixed. Revenues from reconditioning, logistics, vehicle inspection and certification, titling, evaluation and salvage recovery services are generally recognized when the services are performed. ADESA generally enforces its rights to payment for seller transactions through net settlement provisions following the sale of a vehicle.

IAA Salvage Services

Revenues (including vehicle sales and fee income) are generally recognized at the date the vehicles are sold at auction. Most of the vehicles that are sold through auctions are consigned to IAA by the seller and held at IAA's facilities. IAA does not take title to these consigned vehicles and recognizes revenue when a service is performed as requested by the owner of the vehicle. IAA does not record the gross selling price of the consigned vehicles sold at auction as revenue. IAA seller revenues represent the combination of the inbound tow, processing, storage, titling, enhancing and auctioning of the vehicle and are recognized at the date the vehicles are sold at auction. Related costs are deferred and recognized at the time of sale. Generally, IAA buyer revenue is recognized on the date the vehicles are sold at auction. IAA typically enforces its rights to payment for

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Notes to Consolidated Financial Statements (Continued)
March 31, 2018 (Unaudited)

seller transactions through net settlement provisions following the sale of a vehicle. Buyer revenue not recognized at the date the vehicles are sold at auction includes annual buyer registration fees, which are recognized on a straight-line basis, and certain buyer-related fees, which are recognized when payment is received.

AFC

AFC's revenue is comprised of interest and fee income, provision for credit losses and other revenues associated with our finance receivables, as well as other service revenue. The following table summarizes the primary components of AFC's revenue:

	Three Months Ended March 31,	
AFC Revenue (in millions)	2018	2017
Interest and fee income	$81.9	$71.3
Other revenue	2.9	2.9
Provision for credit losses	(7.7)	(11.1)
Other service revenue	8.0	8.1
	$85.1	$71.2

Interest and fee income

Interest on finance receivables is recognized based on the number of days the vehicle remains financed. AFC ceases recognition of interest on finance receivables when the loans become delinquent, which is generally 31 days past due. Dealers are also charged a fee to floorplan a vehicle ("floorplan fee"), to extend the terms of the receivable ("curtailment fee") and a document processing fee. AFC fee income including floorplan and curtailment fees is recognized over the life of the finance receivable.

Other revenue

Other revenue includes lot check fees, filing fees, lien holder payoff services and other related program fees, each of which are charged to and collected from AFC's customers.

Other service revenue

Other service revenue represents the revenue generated by Preferred Warranties, Inc. ("PWI"). PWI receives advance payments for vehicle service contracts and unearned revenue is deferred and recognized over the terms of the contracts utilizing a historical earnings curve. The average term of the contracts originated in 2017 was approximately 1.7 years and PWI had unearned revenue of $33.3 million at March 31, 2018.

New Accounting Standards

In May 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-09, Compensation - Stock Compensation (Topic 718): Scope of Modification Accounting, which clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. The new guidance is expected to reduce diversity in practice and result in fewer changes to the terms of an award being accounted for as modifications. Changes that do not impact the fair value, vesting conditions or classification of an award will not require modification accounting. The new guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU 2017-09 in the first quarter of 2018 and the adoption did not have a material impact on the consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which addresses diversity in practice that exists in the classification and presentation of changes in restricted cash on the statement of cash flows. The new guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU 2016-18 in the first quarter of 2018 and the adoption resulted in an increase of $0.5 million in net cash used by investing activities for the three months ended March 31, 2017. The increase related to reclassifying the changes in our restricted cash balance from investing activities to the cash and cash equivalents balances within the consolidated statements of cash flows.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which provides guidance on the statement of cash flows presentation of certain transactions where diversity in practice exists. The new guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted ASU 2016-15 in the first quarter of 2018 and the adoption did not have a material impact on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment, which simplifies the test for goodwill impairment by eliminating Step 2 (implied fair value measurement). Instead goodwill impairment would be measured as the amount by which a reporting unit's carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. The new guidance is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted. We do not expect the adoption of ASU 2017-04 will have a material impact on the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The update changes the methodology for measuring credit losses on financial instruments and the timing of when such losses are recorded. The new guidance is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted beginning in annual periods beginning after December 15, 2018, including interim periods within those fiscal years. We do not expect the adoption of ASU 2016-13 will have a material impact on the consolidated financial statements based on the short-term nature of AFC's loans.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which replaces existing lease guidance. The ASU is intended to provide enhanced transparency and comparability by requiring lessees to record right-of-use assets and corresponding lease liabilities on the balance sheet, with an exception for leases that meet the definition of a short-term lease. The new guidance will continue to classify leases as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income. The new guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted and the ASU is required to be applied with a modified retrospective approach to each prior reporting period presented with various optional practical expedients. The Company is currently evaluating the impact the adoption of ASU 2016-02 will have on the consolidated financial statements and anticipates that the new guidance will significantly impact its consolidated financial statements, as the Company has a significant number of leases. Our current minimum commitments under non-cancelable operating leases are disclosed in the "Contractual Obligations" section of "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2017 and in Note 13 to the Consolidated Financial Statements of the same report. In addition, the recognition of these leases on our consolidated balance sheet would increase our net debt calculation which is included in the determination of our Consolidated Senior Secured Leverage

Ratio. In this event, our Credit Agreement specifies that the covenant shall continue to be calculated as if the accounting standard had not been adopted and that we could enter into negotiations to amend such provisions in the Credit Agreement so as to equitably reflect such changes with the desired result that the criteria for evaluating our financial condition would be the same after the change as if such change had not been made.

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March 31, 2018 (Unaudited)

Note 2—Acquisition
On February 1, 2018, the Company completed the acquisition of STRATIM Systems Inc. ("STRATIM"). STRATIM is a mobility and fleet management software company based in San Francisco, California that uses data analytics to help fleet owners manage, maintain and service their fleets. The addition of STRATIM supplements KAR's broad portfolio of wholesale used vehicle physical, online and digital auction marketplaces and ancillary service providers.

The purchase price of STRATIM, net of cash acquired, was approximately $23.3 million. The purchase price for the acquired business was allocated to acquired assets and liabilities based upon fair values, including $2.3 million to intangible assets, representing the fair value of software of $1.4 million and acquired customer relationships of $0.9 million, which are being amortized over their expected useful lives. The purchased assets included accounts receivable, computer equipment and software. The purchase accounting associated with this acquisition is preliminary, subject to determination of tax attributes and final valuation results. The acquisition resulted in goodwill of $21.4 million. The goodwill is recorded in the ADESA Auctions reportable segment. The financial impact of the acquisition, including pro forma financial results, was immaterial to the Company's consolidated results for the three months ended March 31, 2018. Financial results for STRATIM have been included in our consolidated financial statements from the date of acquisition.
Note 3—Stock and Stock-Based Compensation Plans
The KAR Auction Services, Inc. 2009 Omnibus Stock and Incentive Plan ("Omnibus Plan") is intended to provide equity and/or cash-based awards to our executive officers and key employees. Our stock-based compensation expense includes expense associated with KAR Auction Services, Inc. performance-based restricted stock units ("PRSUs"), service-based restricted stock units ("RSUs") and service options. We have classified the KAR Auction Services, Inc. PRSUs, RSUs and service options as equity awards.
The following table summarizes our stock-based compensation expense by type of award (in millions):

	Three Months Ended March 31,	
	2018	2017
PRSUs	$3.4	$3.1
RSUs	2.9	2.2
Service options	0.1	0.5
Total stock-based compensation expense	$6.4	$5.8

PRSUs and RSUs
In the first quarter of 2018, we granted a target amount of approximately 0.2 million PRSUs to certain executive officers and management of the Company. The PRSUs vest if and to the extent that the Company's three-year cumulative operating adjusted net income per share attains certain specified goals. In addition, approximately 0.3 million RSUs were granted to certain executive officers and management of the Company. The RSUs are contingent upon continued employment and generally vest in three equal annual installments. The weighted average grant date fair value of the PRSUs and the RSUs was $54.11 per share, which was determined using the closing price of the Company's common stock on the grant date.
Share Repurchase Program
In October 2016, the board of directors authorized a repurchase of up to $500 million of the Company's outstanding common stock, par value $0.01 per share, through October 26, 2019. Repurchases may be made in the open market or through privately negotiated transactions, in accordance with applicable securities laws and regulations, including

pursuant to repurchase plans designed to comply with Rule 10b5-1 of the Securities Exchange Act of 1934, as amended. The timing and amount of any repurchases is subject to market and other conditions. No shares of common stock were repurchased during the first quarter of 2018. In 2017 we repurchased and retired 3,279,089 shares of common stock in the open market at a weighted average price of $45.74 per share under the October 2016 authorization.

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Note 4—Net Income Per Share
The following table sets forth the computation of net income per share (in millions except per share amounts):

	Three Months Ended March 31,	
	2018	2017
Net income	$90.0	$69.2
Weighted average common shares outstanding	134.6	136.8
Effect of dilutive stock options and restricted stock awards	1.2	1.5
Weighted average common shares outstanding and potential common shares	135.8	138.3
Net income per share		
Basic	$0.67	$0.51
Diluted	$0.66	$0.50

Basic net income per share was calculated by dividing net income by the weighted average number of outstanding common shares for the period. Diluted net income per share was calculated consistent with basic net income per share including the effect of dilutive unissued common shares related to our stock-based employee compensation program. The effect of stock options and restricted stock on net income per share-diluted is determined through the application of the treasury stock method, whereby net proceeds received by the Company based on assumed exercises are hypothetically used to repurchase our common stock at the average market price during the period. Stock options that would have an anti-dilutive effect on net income per diluted share and PRSUs subject to performance conditions which have not yet been satisfied are excluded from the calculations. No options were excluded from the calculation of diluted net income per share for each of the three months ended March 31, 2018 and 2017. In addition, approximately 0.7 million PRSUs were excluded from the calculation of diluted net income per share for the three months ended March 31, 2018 and 2017. Total options outstanding at March 31, 2018 and 2017 were 1.6 million and 2.4 million, respectively.

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Note 5—Finance Receivables and Obligations Collateralized by Finance Receivables

AFC sells the majority of its U.S. dollar denominated finance receivables on a revolving basis and without recourse to a wholly-owned, bankruptcy remote, consolidated, special purpose subsidiary ("AFC Funding Corporation"), established for the purpose of purchasing AFC's finance receivables. A securitization agreement allows for the revolving sale by AFC Funding Corporation to a group of bank purchasers of undivided interests in certain finance receivables subject to committed liquidity. The agreement expires on January 31, 2020. AFC Funding Corporation had committed liquidity of $1.50 billion for U.S. finance receivables at March 31, 2018.

We also have an agreement for the securitization of Automotive Finance Canada Inc.'s ("AFCI") receivables which expires on January 31, 2020. AFCI's committed facility is provided through a third party conduit (separate from the U.S. facility) and was C$125 million at March 31, 2018. The receivables sold pursuant to both the U.S. and Canadian securitization agreements are accounted for as secured borrowings.

The following tables present quantitative information about delinquencies, credit losses less recoveries ("net credit losses") and components of securitized financial assets and other related assets managed. For purposes of this illustration, delinquent receivables are defined as receivables 31 days or more past due.

	March 31, 2018 Total Amount of:		Net Credit Losses Three Months Ended March 31, 2018
(in millions)	Receivables	Receivables Delinquent	
Floorplan receivables	$1,921.7	$ 11.0	$ 7.4
Other loans	11.5	—	—
Total receivables managed	$1,933.2	$ 11.0	$ 7.4

	December 31, 2017 Total Amount of:		Net Credit Losses Three Months Ended March 31, 2017
(in millions)	Receivables	Receivables Delinquent	
Floorplan receivables	$1,901.1	$ 12.1	$ 10.9
Other loans	11.5	—	—
Total receivables managed	$1,912.6	$ 12.1	$ 10.9

AFC's allowance for losses was $13.3 million and $13.0 million at March 31, 2018 and December 31, 2017, respectively.

As of March 31, 2018 and December 31, 2017, $1,907.2 million and $1,893.2 million, respectively, of finance receivables and a cash reserve of 1 percent of the obligations collateralized by finance receivables served as security for the obligations collateralized by finance receivables. Obligations collateralized by finance receivables consisted of the following:

	March 31, 2018	December 31, 2017
Obligations collateralized by finance receivables, gross	$1,365.9	$1,371.4
Unamortized securitization issuance costs	(11.7)	(13.3)
Obligations collateralized by finance receivables	$1,354.2	$1,358.1

Proceeds from the revolving sale of receivables to the bank facilities are used to fund new loans to customers. AFC, AFC Funding Corporation and AFCI must maintain certain financial covenants including, among others, limits on the amount of debt AFC and AFCI can incur, minimum levels of tangible net worth, and other covenants tied to the performance of the finance receivables portfolio. The securitization agreements also incorporate the financial covenants of our Credit Facility. At March 31, 2018, we were in compliance with the covenants in the securitization agreements.

Note 6—Long-Term Debt

Long-term debt consisted of the following (in millions):

	Interest Rate*		Maturity	March 31, 2018	December 31, 2017
Term Loan B-4	Adjusted LIBOR	+ 2.25%	March 11, 2021	$711.3	$711.3
Term Loan B-5	Adjusted LIBOR	+ 2.50%	March 9, 2023	1,041.6	1,041.6
Revolving credit facility	Adjusted LIBOR	+ 2.0%	March 9, 2021	—	—
Senior notes		5.125%	June 1, 2025	950.0	950.0
Canadian line of credit	CAD Prime	+ 0.50%	Repayable upon demand	—	—
Total debt				2,702.9	2,702.9
Unamortized debt issuance costs/discounts				(21.8)	(22.8)
Current portion of long-term debt				(16.8)	(12.4)
Long-term debt				$2,664.3	$2,667.7

*The interest rates presented in the table above represent the rates in place at March 31, 2018.

Credit Facility

On May 31, 2017, we entered into an Incremental Commitment Agreement and Second Amendment (the "Second Amendment") to the Credit Agreement. The Second Amendment provided for, among other things, (i) the refinancing and repricing of the existing tranche B-2 term loans ("Term Loan B-2") remaining after the repayment with new tranche B-4 term loans in an aggregate principal amount of $717 million ("Term Loan B-4"), (ii) the refinancing and repricing of existing tranche B-3 term loans ("Term Loan B-3") remaining after the repayment with new tranche B-5 term loans in an aggregate principal amount of $1.05 billion ("Term Loan B-5") and (iii) a $350 million senior secured revolving credit facility (the "revolving credit facility"). A portion of the proceeds received from the issuance of the senior notes was used to repay a portion of Term Loan B-2 and Term Loan B-3, as well as the outstanding balance on the 2016 revolving credit facility.

The Credit Facility is available for letters of credit, working capital, permitted acquisitions and general corporate purposes. The Company also pays a commitment fee of 30 to 35 basis points, payable quarterly, on the average daily unused amount of the revolving credit facility. The rates on Term Loan B-4 and Term Loan B-5 were 4.56% and 4.81% at March 31, 2018, respectively.

The obligations of the Company under the Credit Facility are guaranteed by certain of our domestic subsidiaries (the "Subsidiary Guarantors") and are secured by substantially all of the assets of the Company and the Subsidiary Guarantors, including but not limited to: (a) pledges of and first priority perfected security interests in 100% of the equity interests of certain of the Company's and the Subsidiary Guarantors' domestic subsidiaries and 65% of the equity interests of certain of the Company's and the Subsidiary Guarantors' first tier foreign subsidiaries and (b) perfected first priority security interests in substantially all other tangible and intangible assets of the Company and each Subsidiary Guarantor, subject to certain exceptions. The Credit Agreement contains affirmative and negative covenants that we believe are usual and customary for a senior secured credit agreement. The negative covenants include, among other things, limitations on asset sales, mergers and acquisitions, indebtedness, liens, dividends, investments and transactions with our affiliates. The Credit Agreement also requires us to maintain a maximum leverage ratio, provided there are revolving loans outstanding. We were in compliance with the covenants in the Credit Agreement at March 31, 2018.

There were no borrowings on the revolving credit facility at March 31, 2018 and December 31, 2017. In addition, we had related outstanding letters of credit in the aggregate amount of $32.4 million and $42.8 million at March 31, 2018 and December 31, 2017, respectively, which reduce the amount available for borrowings under the respective revolving credit facility.

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Fair Value of Debt

As of March 31, 2018, the estimated fair value of our long-term debt amounted to $2,705.8 million. The estimates of fair value were based on broker-dealer quotes for our debt as of March 31, 2018. The estimates presented on long-term financial instruments are not necessarily indicative of the amounts that would be realized in a current market exchange.

Note 7—Derivatives

We are exposed to interest rate risk on our variable rate borrowings. Accordingly, interest rate fluctuations affect the amount of interest expense we are obligated to pay. We use interest rate derivatives with the objective of managing exposure to interest rate movements, thereby reducing the effect of interest rate changes and the effect they could have on future cash flows. Currently, interest rate cap agreements are used to accomplish this objective.

- In August 2017, we entered into two interest rate caps with an aggregate notional amount of $800 million to manage our exposure to interest rate movements on our variable rate Credit Facility when three-month LIBOR exceeds 2.0%. The interest rate cap agreements each had an effective date of September 30, 2017 and each matures on September 30, 2019. We paid an aggregate amount of approximately $1.0 million for the caps in August 2017.
- In March 2017, we entered into two interest rate caps with an aggregate notional amount of $400 million to manage our exposure to interest rate movements on our variable rate Credit Facility when three-month LIBOR exceeds 2.0%. The interest rate cap agreements each had an effective date of March 31, 2017 and each matures on March 31, 2019. We paid an aggregate amount of approximately $0.7 million for the caps in April 2017.

We are exposed to credit loss in the event of non-performance by the counterparties; however, non-performance is not anticipated. ASC 815, Derivatives and Hedging, requires companies to recognize all derivative instruments as either assets or liabilities at fair value in the balance sheet. The fair values of the interest rate derivatives are based on quoted market prices for similar instruments from commercial banks. The following table presents the fair value of our interest rate derivatives included in the consolidated balance sheets for the periods presented (in millions):

	Asset Derivatives			
	March 31, 2018		December 31, 2017	
Derivatives Not Designated as Hedging Instruments	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
2017 Interest rate caps	Other assets	$ 7.3	Other assets	$ 2.6

We have not designated any of the interest rate caps as hedges for accounting purposes. Accordingly, changes in the fair value of the interest rate caps are recognized as "Interest expense" in the consolidated statement of income. The following table presents the effect of the interest rate derivatives on our consolidated statements of income for the periods presented (in millions):

Derivatives Not Designated as Hedging Instruments	Location of Gain / (Loss) Recognized in Income on Derivatives	Amount of Gain / (Loss) Recognized in Income on Derivatives Three Months Ended March 31, 2018	2017

2017 Interest rate caps	Interest expense	$4.7	$(0.1)

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Note 8—Commitments and Contingencies

We are involved in litigation and disputes arising in the ordinary course of business, such as actions related to injuries; property damage; handling, storage or disposal of vehicles; environmental laws and regulations; and other litigation incidental to the business such as employment matters and dealer disputes. Management considers the likelihood of loss or the incurrence of a liability, as well as the ability to reasonably estimate the amount of loss, in determining loss contingencies. We accrue an estimated loss contingency when it is probable that a liability has been incurred and the amount of loss (or range of possible losses) can be reasonably estimated. Management regularly evaluates current information available to determine whether accrual amounts should be adjusted. Accruals for contingencies including litigation and environmental matters are included in "Other accrued expenses" at undiscounted amounts and exclude claims for recoveries from insurance or other third parties. These accruals are adjusted periodically as assessment and remediation efforts progress, or as additional technical or legal information becomes available. If the amount of an actual loss is greater than the amount accrued, this could have an adverse impact on our operating results in that period. Such matters are generally not, in the opinion of management, likely to have a material adverse effect on our financial condition, results of operations or cash flows. Legal fees are expensed as incurred. There has been no significant change in the legal and regulatory proceedings which were disclosed in our Annual Report on Form 10-K for the year ended December 31, 2017.

Note 9—Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss consisted of the following (in millions):

	March 31, 2018	December 31, 2017
Foreign currency translation loss	$(32.2)	$ (25.3)
Unrealized gain on postretirement benefit obligation, net of tax	0.1	0.1
Accumulated other comprehensive loss	$(32.1)	$ (25.2)

Note 10—Segment Information

ASC 280, Segment Reporting, requires reporting of segment information that is consistent with the manner in which the chief operating decision maker operates and views the Company. Our operations are grouped into three operating segments: ADESA Auctions, IAA and AFC, which also serve as our reportable business segments. These reportable business segments offer different services and have fundamental differences in their operations.

The holding company is maintained separately from the three reportable segments and includes expenses associated with the corporate offices, such as salaries, benefits and travel costs for the corporate management team, certain human resources, information technology and accounting costs, and certain insurance, treasury, legal and risk management costs. Holding company interest expense includes the interest expense incurred on capital leases and the corporate debt structure. Intercompany charges relate primarily to interest on intercompany debt or receivables and certain administrative costs allocated by the holding company.

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Financial information regarding our reportable segments is set forth below for the three months ended March 31, 2018 (in millions):

	ADESA Auctions	IAA	AFC	Holding Company	Consolidated
Operating revenues	$ 528.1	$ 337.3	$ 85.1	$ —	$ 950.5
Operating expenses					
Cost of services (exclusive of depreciation and amortization)	306.0	206.7	22.3	—	535.0
Selling, general and administrative	108.8	30.5	8.0	40.1	187.4
Depreciation and amortization	31.2	24.1	7.8	7.2	70.3
Total operating expenses	446.0	261.3	38.1	47.3	792.7
Operating profit (loss)	82.1	76.0	47.0	(47.3)	157.8
Interest expense	0.6	—	13.4	27.5	41.5
Other (income) expense, net	(0.3)	—	—	0.2	(0.1)
Intercompany expense (income)	12.1	9.4	(0.5)	(21.0)	—
Income (loss) before income taxes	69.7	66.6	34.1	(54.0)	116.4
Income taxes	15.5	16.3	8.4	(13.8)	26.4
Net income (loss)	$ 54.2	$ 50.3	$ 25.7		