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CAR - Q2 2018 Avis Budget Group Inc Earnings Call

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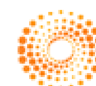

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PRESENTATION

Operator

Good morning, and welcome to the Avis Budget Group Second Quarter Earnings Conference Call. Today's call is being recorded.

At this time, for opening remarks and introductions, I would like to turn the meeting over to Mr. Neal Goldner, Vice President of Investor Relations. Please go ahead, sir.

Neal H. Goldner *- Avis Budget Group, Inc. - VP of IR*

Thank you, Jill. Good morning, everyone, and thank you for joining us. On the call with me are Larry De Shon, our Chief Executive Officer; and Martyn Smith, our Interim Chief Financial Officer.

Before we begin, I would like to remind everyone that the company will be discussing forward-looking information that involves risks, uncertainties and assumptions that could cause actual results to differ materially from the forward-looking information. Risks, assumptions and other factors that could cause future results to differ materially from those expressed in the forward-looking statements are identified in the company's earnings release and other periodic filings with the SEC. They can also be found on the Investor Relations section of our website. Except as required by law, the company undertakes no obligation to update or revise these forward-looking statements.

Our comments today will focus on our adjusted results. We believe that our financial performance is better demonstrated using these non-GAAP financial measures. All non-GAAP financial measures are reconciled from the GAAP numbers in our press release and in the earnings call presentation, which is available on our website.

With that, I'd like to turn the call over to Avis Budget Group's Chief Executive Officer, Larry De Shon.

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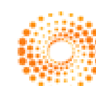

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Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Thanks, Neal, and good morning. We had a strong second quarter highlighted by double-digit profit growth, further margin expansion and exciting new business developments.

Starting with some of our achievements. We delivered strong overall volume growth and a 1% increase in America's underlying pricing in constant currency, with leisure pricing up 2%, despite the Easter shift. We drove a substantial reduction in per-unit fleet cost, our single largest expense, and improved utilization. We launched an exciting new product across multiple U.S. airports, which is helping improve the trends in ancillary revenue. We invested in and expanded our new Demand Fleet Pricing system in a next-generation connected car mobility platform that will enable us to employ advanced analytics and data science to optimize all aspects of our fleet. We've reached the 100,000 connected car level just last week, a significant milestone towards connecting our entire global fleet. And we announced new relationships with Amazon, Lyft and Luxury Retreats.

So let me start there. In July, we announced an exciting new program with Amazon to reward their customers who rent an Avis car, enabling them to save money on their rental and receive an Amazon gift card. We've already seen strong demand from Amazon customers since the announcement and look forward to working closely with them in the future.

We also began a new partnership with Luxury Retreats, making Avis their exclusive vehicle rental partner. For those who don't know Luxury Retreats, it was acquired by Airbnb in early 2017 and is a full-service villa rental company with more than 5,000 properties in over 300 destinations worldwide. The company is dedicated to creating authentic travel experiences for their customers and is a great partner for our premium Avis brand. The agreement went live in late June, and we are already seeing nice demand from Luxury Retreats customers.

I'm also excited about our deal with Lyft to add thousands of vehicles to the Lyft Express Drive program in cities across North America. The partnership will make it easier for people to drive with Lyft without the cost and burden of car ownership. With a global fleet of 600,000 vehicles, we are well positioned to take advantage of the continued growth in the ride-hailing space by providing new and existing Lyft drivers with on-demand access to clean, safe and well-maintained vehicles for those who are or want to become drivers for Lyft. As one of the world's largest fleet owners, we look forward to working with them as we expand our ability to address their growing demand for mobility services.

Moving now to a quick review of our second quarter, starting with profitable revenue growth. We made further progress towards having a global integrated Demand Fleet Pricing yield management system that can optimize our pricing and fleet decisions based on available demand. By the end of the quarter, the fully optimized system that we call DFP was supporting half of our U.S. car rental revenue. In those locations where implemented, we continue to see an incremental 1% to 2% higher pricing on average compared to non-DFP market.

In June, we also completed the first phase of DFP, the pricing robotic across all of our corporately owned international locations. This is the next step towards having our global business live by the end of 2020.

We grew America's prepaid reservations double digits in the quarter. Prepaid bookings represented nearly 40% of the reservations made on our own platform, a quarterly record, including greater than 45% at Budget. We also drove more business through our proprietary lower-cost direct channels in the second quarter than ever before, with website conversion rate in the Americas growing another 55 basis points. And I believe we still have opportunity to drive more business through these channels, enabling us to better interact with our customers, while also lowering our cost.

As a result of the success we've had driving higher website conversion and the increased number of people booking on our mobile apps, more and more of our customers are bypassing the counter, making it necessary for us to learn how to better sell ancillaries online. We began late last year by making the process of selecting ancillary products in out dot-com sites a lot easier, with better product placement and simplified language. We then launched an initiative to offer customers bundled products that is delivering positive results, with ancillary sales on avis.com growing 3% in the quarter.

We also started promoting on budget.com that the more ancillary products the customer takes, the more they can save, enabling us to grow our ancillary revenue an impressive 14% on the Budget site.

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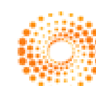

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We retrained our counter sales agents to use a more personalized approach, making sure they are offering the right products to the right customers. And we launched a new curbside delivery product in more than 40 locations that is proving very successful due to the time it saves and the convenience it provides.

When a customer arrives at our return lot, we will drive them directly to the terminal for a fee, no taking luggage out of the car, no getting on the shuttle bus or airport tram and worrying about missing a flight. In May, we added this feature to the Avis app, enabling customers to add this product prior to arriving at the location and also began notifying them about this service a few hours before they are due to return the vehicle. With curbside revenue growing double digits month-over-month since its launch, this product clearly has wide appeal.

Turning now to mobility, starting with Zipcar. In May, Zipcar announced a partnership with Volkswagen that will add 325 electric Golf to its London offering. The first 100 of these are already in our fleet, with the balance scheduled to be deliver before year-end.

In the North America, Zipcar in the City of New York announced 2 major initiatives that put more cars in more neighborhoods, while reducing the need for personal vehicle ownership, awarding Zipcar more than 200 coveted on-street and municipal parking spots. Zipcar also signed a new partnership with the City of Columbus to bring Zipcars to a local resident, businesses and visitors, building on our success at the Ohio State University and Columbus International Airport.

Zipcar's commuter product continues to grow double digits. Available in 11 major markets in North America, this affordable new mobility solution primarily appeals to members living in Metropolitan markets who commute outside of the city for work. By offering a range of vehicle types for exclusive use from Monday to Friday, including parking, not only does the commuter offering expand Zipcar's mobility options to its members, it also offers an attractive alternative to car ownership.

The growth of Zipcar Flex, which we launched only last year, has also been gratifying. Recently expanded to its 10th borough, we are well on our way to achieving our goal of full coverage of inner London. As a reminder, Zipcar Flex allows members to pick up a car and then drop it off later in any approved parking space. Since its launch, members have completed more than 230,000 trips using Flex. And our current run rate has been utilizing Flex more than 9,000 trips per week.

We also reached a milestone on our Connected Car initiative. As you know, we have embarked on a journey to have our entire global fleet connected by the end of 2020, and we're well on our way. As of last week, we had 100,000 Connected Cars on our fleet, more than doubling the number we had been just a year ago. We've spoken in the past about some of the benefits we're already getting from these cars, including increased revenue, lower maintenance cost and faster vehicle recovery. I believe we've just scratched the surface. Our vision of a fully connected fleet includes greater utilization, lower fleet cost and new adjacent business models. We'll have more to say about this in the future.

Moving to Waymo. It was a little more than a year ago that we announced our multi-year partnership to provide fleet management services to all of their self-driving vehicles in Phoenix. Since then, our relationship has grown and now includes providing services in other locations. And our latest agreement allows our customers to utilize Waymo autonomous cars as the last mile solution to get to and from select Avis locations in the Phoenix area. This is a natural extension to our partnership, and we look forward to working closely with them in the future. Equally important, we continue to learn what it takes to support a fleet of self-driving cars, which will provide us with practical knowledge for when autonomous cars eventually become part of our rental fleet.

To summarize, we had a very strong second quarter highlighted by 15% adjusted EBITDA growth and a 70 basis point margin improvement. We also made good progress turning around ancillary revenue trends, with new products and new selling techniques gaining traction. We made important investments in our core systems to not only improve our current operations, but also position us well for the future. For example, we've invested in an integrated Demand Fleet Pricing system that now allows us to optimize rental profitability down to the channel and segment level, thus already benefiting our pricing.

We've implemented a new digital platform that has consolidated all of our brands and provides for enhanced personalization and customer experience as well as giving us greater flexibility to merchandise and target our customers and products. This new digital platform is the foundation of our highly successful Avis self-service mobile app.

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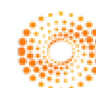

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We're in the final stage of modernizing our core rental and reservation systems that will improve our agility to enhance our time-to-market as we expand into the broader mobility services industry, while reducing our ongoing IT costs.

We are also well underway in modernizing our finance processes and systems, utilizing the latest cloud-based solution that, as the project is implemented, will greatly improve our productivity and enhance our analytical capabilities.

And we are in the process of building our next-generation Connected Car mobility platform that will solidify our position as the leader in integrating with new mobility providers. This platform, which currently supports our Kansas City Mobility Lab provides API integration with current and new partners, including Lyft. We'll be leveraging this platform as we scale our global feet beyond the 100,000 cars we already have connected using advanced analytics and data science to optimize all aspects of our fleet.

And with all this investment, we also generated $70 million of free cash flow in the quarter and expect again to generate a significant amount of free cash flow for the year.

Looking forward, we continue to pursue margin-enhancing opportunities by growing our direct business, expanding DFP to more locations and selling more cars through alternative channels, which Martyn will discuss.

And I'm very excited about our new and expanded relationships with Amazon, Lyft and Luxury Retreats.

With that, I'll turn the call over to Martyn.

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Thanks, Larry, and good morning, everyone. I'm now going to discuss our second quarter results, together with our cash flow liquidity and outlook. My comments will focus on our adjusted results, which as Neal mentioned, are reconciled from our GAAP numbers, both on our press release and earnings call presentation.

Beginning with an overview. We had a strong second quarter with overall volumes growing, underlying pricing in the Americas increasing and fleet cost and utilization each improving. As a strategy, we increased our overall fleet capacity by 2.8%, less than our rental day growth of 3.6%.

We delivered a record $2.3 billion of revenue and a 15% year-over-year improvement in adjusted EBITDA in the quarter with the margin expanding by 70 basis points.

Adjusted earnings per share increased 90% in the quarter, benefiting from the strong EBITDA performance, a lower tax rate and reduced average share count.

Now turning to our Americas business. Revenue growth in the quarter was driven by 2% higher volumes, with growth both on and off airport. Revenue per day, the new pricing metric we adopted at the start of the year, was lower by 1% in the quarter, partly due to a longer length of rental achieved and the roughly 50 basis point impact from difficult market in Brazil, but revenue per day did progressively improve during the quarter.

Our pricing under our historical T&M per-day metric increased to 1% in constant currency, despite the easy shift. The difference between RPD and T&M was largely due to ancillary revenue per day being lower by 3% as well as the change in customer loyalty accounting we adopted this year, which affected revenue per day by about 50 basis points in the quarter.

Ancillary revenue trends also improved in the second quarter compared to the first as a result of the initiatives we were working on, and that improvement has continued into the summer. We drove 5% higher leisure volume in the quarter, and this is overlapping the second quarter last year where we grew leisure volume 6%. We increased associated T&M per day by 2%, with the pricing trend improving as the period progressed.

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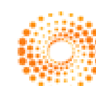

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Promotional volume was 1% lower in the quarter, with growth in a more profitable small business and international inbound subsegments being offset by lower large commercial account volume. We increased commercial length of rental 4% in the quarter, the results of our strategy to drive more longer rental length business, though -- although, it's affected commercial T&M per day, which was lower by 2%.

Moving now to Americas cost, starting with fleet. We reduced second quarter per-unit fleet cost by 7%. In contrast, the 10% increase in quarter 2 last year with the used car markets remaining strong through the quarter and into July. We also further increased the proportion of cars sold through alternative channels, achieving a second quarter record of 52% of risk car disposals. By the end of the quarter, 65% of the cars we plan to sell this year in the U.S. had been sold, with 75% sold by the end of July, limiting our exposure to changes in the used car market for the balance of the year.

While it's too early to give fleet cost guidance for next year, our negotiations for the U.S. model year '19 buy are now substantially complete. And we expect model year '19 purchase prices to be slightly lower again than the prior model year on a like-for-like basis.

Our strategy to increase our fleet slower than the rate of a volume growth, once again, delivered positive results with utilization improving 70 basis points in the second quarter and 90 basis points to the first half. Due largely to the effect of raising interest rates on our variable rate conduit facility, vehicle interest expense increased $9 million in the quarter.

Volume performance, lower per-unit fleet cost and improved utilization all helped our Americas business deliver an 11% increase in adjusted EBITDA in the quarter, with margin expanding by 60 basis points, despite the higher interest cost.

Turning now to our International business, which represented more than 30% of our revenues in the quarter. Revenue improved 4% in constant currency year-over-year. We grew rental days by 6%, largely driven by strong growth in France, Spain and Italy. Revenue per day was 2% lower in constant currency, primarily due to a longer length of rental, particularly reflecting our stronger growth in light commercial vehicles off-airport, and weaker market conditions in APAC.

Pricing under our historical T&M per-day metric was 1% lower. However, encouragingly, on-airport pricing was ahead in EMEA, breaking quite a long-term trend. We increased leisure volume by 2% in the quarter with strong growth seen in both France and Australia, and T&M per day was unchanged.

Commercial demand was very strong in the quarter with rental days up 14% against prior year with good growth achieved in U.K., Germany and Australia. T&M per day was 3% lower due to the strong local market growth we achieved in the period related to the commercial vehicles I mentioned earlier.

Our strong volume performance and improved utilization were essentially offset by higher airport concession fees and greater maintenance and damage expenses, resulting in an adjusted EBITDA in our International business growing 20% in the quarter, but largely due to a $19 million benefit from currency exchange.

Moving now to our cash flow and funding position. Adjusted free cash flow was $70 million positive for the second quarter, and we continue to expect it to be between $325 million and $375 million for the full year. Year-to-date, we have invested $115 million on non-fleet CapEx, including Connected Cars, new Avis functionality for the app, DFP and accounting modernization as well as completing the major multi-year upgrade of our global rental and reservation platform. For the full year, we are on track to invest around $225 million on non-fleet CapEx, some 14% higher than the previous year.

Our financial position remains strong with approximately $2.4 billion of available liquidity. This comprised ending the quarter with $489 million of cash, having $476 million of unused capacity of our revolving credit facility, plus $1.5 million of availability under our vehicle programs.

In April, we issued $400 million of U.S. asset-backed notes due 2023 at an interest cost of 3.8%. In June, we increased the capacity of our European securitization program by around $175 million to approximately $2.1 billion and extended its maturity to 2021 and at a slightly lower facility cost.

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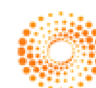

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Our net corporate leverage of 3.9x improved year-end and was within our targeted range of 3 to 4x. And for covenant purposes, we ended the quarter well below our maximum leverage ratio. And as a reminder, none of our corporate debts matures until 2022.

On the acquisition front, we purchased our largest German licensee, which I already mentioned on our last call, as well as a small U.S. licensee during the quarter. In June, we purchased an incremental 20% interest on our Greece licensee, bringing our total ownership now to 40%, having brought an initial stake earlier in the year. In total, we invested $65 million on acquisitions and investments in the first half. And in July, we acquired Morini, an independent car light commercial vehicle operator in Italy for approximately $40 billion.

We bought back 1.6 million or 2% of our shares outstanding in the second quarter at a cost of $67 million. Average weighted diluted shares were $81.5 million in the second quarter, 4% lower than a year ago. We repurchased a further $25 million of shares in July. And as you saw in our press release last night, our Board of Directors has increased our share authorization by an additional $250 million.

Regarding our full year 2018 expectations, we are updating our guidance as follows. We now expect our overall revenue to grow between 2.5% and 5%, largely reflecting changes in foreign exchange rates. Americas volume growth is still expected to be between 1% and 3%, and International volume growth to be between 5% and 7%.

We expect revenue per day for the Americas to be in the range of down 1% to up 1% versus prior year after a roughly 100 basis point impact related to ancillary revenue, which, as I mentioned, has already begun to improve and the change in loyalty accounting. This slightly lower pricing guidance, in part, reflects our success driving even more long length rentals, which tend to be lower priced, but very profitable business, as well as the continuing difficult market in Brazil, which we now expect to impact revenue per day by about 50 basis points this year. International revenue per day in constant currency is now expected to be lower by between 1% and 3%.

We now expect our per-unit fleet cost in the Americas to be in -- to improve 1% to 3%. International per-unit fleet cost are expected to remain in the range of flat to up 2% in constant currency.

We continue to expect around $20 billion higher vehicle interest expense due to rising U.S. benchmark interest rates.

To confirm, our U.S. fleet debt at 30th of June, being the seasonal high using a greater proportion of conduit funding, was approximately 70% fixed, 30% variable. Outside of the U.S., we are funded predominately floating rate debt that's approximately 20% fixed, 80% variable, again, at the seasonal high usage at the end of June.

We now expect net currency translation to contribute a $20 million to $30 million benefit to adjusted EBITDA, slightly lower than our prior guidance, due to the strength of the U.S. dollar.

We continue to expect our adjusted EBITDA to be between $740 million and $820 million.

Our corporate debt at 30th of June of $3.6 billion was approximately 90% fixed, 10% variable. Therefore, we do not expect, presently, any material expense impact from rising benchmark interest rates on our corporate debt.

We now estimate non-vehicle D&A, excluding acquisition-related amortization, to be between -- to be approximately $200 million. And as a consequence, adjusted pretax income is now expected to improve to between $340 million and $420 million.

We still expect our effective tax rates to be in the range of 25% to 7 -- 27% before any final adjustments to the provisional amounts we've previously recorded related to the 2017 Tax Act.

Finally, we now expect adjusted diluted earnings per share to be between $3 and $3.85 per share.

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In summary, we saw a strong year-over-year improvement in the second quarter, driven by robust overall volume growth, improved underlying pricing in the Americas, significantly lower per-unit fleet cost and high utilization. We are well funded with no corporate debt maturities until 2022. Our strategic initiatives to drive profitable revenue growth and reduced cost helped us improve our margin by nearly 70 basis points year-over-year.

Midway through the year, we are certainly headed in the direction, showing both top and bottom line growth and improved margin, all the while continuing to transform our business into a modern technology-based organization.

With that, we'd be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Hamzah Mazari with Macquarie Capital.

Hamzah Mazari - *Macquarie Research - Senior Analyst*

The first question, I was hoping if you could just add a little more color and just frame sort of the strategy of going after longer length of rental in commercial, I guess. Maybe just walk us through where do you see sort of the trade-off between price and volume. Are you showing traction in that this quarter? It seems like volume and pricing came in lower versus your largest competitor that's public. I know it's not apples-to-apples. You talked about Brazil and loyalty accounting, et cetera, but maybe just flesh out the strategy for us.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. I think one of the things that we learned when we started implementing DFP, DFP was built around trying to drive the profitability. And so it will make trade-offs based on the volume demand, based on the fleet that we have. It will make trade-offs around different decisions as it relates to trying to drive the ultimate profitability solution. So we know that when we drive longer length of rental, those are more profitable transactions for us. So we drive up our revenue per transaction, and we don't have to touch the car and handle the car as many times for the number of days that you get in the longer length. But as you drive longer length, it has a negative impact or an effect, if you will, on rate per day. It's the right profit solution. Instead of taking a lot of 1-day and 2-day businesses, if you can get 4 days, 5 days, 6 days, 7-day businesses or monthly business, that's a better profit solution over time, even though the rate per day is going to be less than if you did a 1-day or 2-day. So DFP is allowing us to push for longer length earlier in the process in an effort to try to get more of your fleet on longer length rentals. So we've been pushing hard on that, pushing hard on monthlies. And we're seeing our length of rental grow fairly significantly, particularly with the commercial book of business. And although the effect is going to have a lower length -- a lower rate per day, the overall revenue per transaction improves fairly significantly. And overall, it improves profitability.

Hamzah Mazari - *Macquarie Research - Senior Analyst*

Okay. Great. And then just a follow-up question on Brazil. Could you remind us how big that business is for you today and sort of the impact that you saw in Q2 versus Q1 in terms of just deterioration?

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Hamzah, we don't disclose market details, but the deterioration kind of worsened in quarter 2, and we're expecting it to be broadly similar for the balance of the year.

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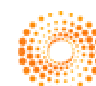

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Our next question is from John Healy with Northcoast Research.

John Michael Healy - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Larry, I wanted to see if you could give us a little bit more color on the outlook for July and August. Hertz provided some pretty powerful numbers on how their July looked and, qualitatively, some confidence in August. And I know you guys have kind of talked to an improving trend throughout 2Q and there's some optimism. But was just wondering if you could maybe provide us maybe some more parameters regarding how successful July was for you guys and how you feel about summer 2018 ultimately shaking out.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Sure. In the Americas, I would say, leisure rates were pretty strong in July and we're expecting that to continue at least for the first 2 or 3 weeks of August. Once again, we really push for a longer length of rental in July, which we got. Once again, the effect of that, it will bring rate per day down, but we got very strong revenue per transaction growth in the month. And so I'm very pleased on how DFP is performing and how the other initiatives we have are impacting our length of rental. It's just -- it's proving to be extremely strong just month after month after month. But then you still have to balance that with the loyalty impact in the month of July, the loyalty program and, of course, the Brazil effect that Martyn has talked about. But I would say, leisure rates were strong. Length of rental very strong. Revenue per transaction is strong. And we expect to see that continue this month until you get kind of the fourth week of August and things start to slow down, then you head into the September kind of -- the typical kind of valley of the -- after the summer.

John Michael Healy - *Northcoast Research Partners, LLC - MD & Equity Research Analyst*

Great. And just to provide a little bit of a reminder about 2017. I know there was a little bit of benefit the industry got from some of the eclipses, I think, out West and then the storms in Texas and Florida. Is there a way to think about what kind of hurdle that might be for you guys as we think about September and just kind of -- I know it's a normally a shoulder period for you guys, but is it a material headwind that we should be thinking about as we calibrate our models? Or is it more modest?

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Well, I think the eclipse is a headwind because, obviously, it drove a lot of volume and good rates through the whole eclipse channel across the country, so you won't have a repeat of that. Not that we're not looking good in those markets for a normal summer period. We are. But you did have this kind of nice bump last year. The hurricane effects, we'll just have to see as it plays out. Obviously, it helped us on some residual values as we slow cars in October, November. But it also took out some business, obviously, in September and October, particularly in Florida where we didn't have bookings for, like, a solid week as it led up to the hurricane. So you expect those volumes to return back to normal versus last year. So I think there are -- there's some opportunities and there's some headwinds on residual values that we have to kind of deal with as we go through. So we just have to move -- move through the quarter and see how all the impact shake out.

Operator

Our next question comes from Chris Woronka with Deutsche Bank.

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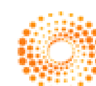

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Chris Jon Woronka - *Deutsche Bank AG, Research Division - Research Analyst*

Larry, I was hoping you could talk a little bit more about the Lyft partnership just in terms of how and when you expect to kind of ramp up on volume. And then what kind of impact you think it could have on things like fleet cost and margins.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. We're really excited about this. As you know, we didn't jump into this right away. We've been really taking our time working with the car hail companies, and Lyft has just been a tremendous partner to sit down and really work through this with. And we finally got to a solution that we think really works well for them and their drivers and works well for us. We won't start actually rolling fleet over to them until towards the end of this year and -- but we have said it'll be in the thousands of cars making available for them. Obviously, with the size of our fleet, that's fairly easy to do this. This -- the demand is going to be scattered across a number of different locations across the United States, which we'll be able to support pretty well. We're going to -- we have a lot to learn in this as we go through. We've had some experience with it on the Zipcar side, but we need to gain more experience on the rental car side. We're going to be probably a bit conservative on our fleet cost approach to this until we learn kind of the level of mileage and so forth that we put on these cars. We will have our eyes on each car every month -- at least every month. These are weekly rentals, and they can renew the weekly rental over again and over again. But every month, we have to see the car. So we'll use our data analytics team to really look at how the cars are accumulating miles and use the data that they have been able to put together, all the internal data and all the external data that we now have access to, to run models to see when is the absolutely right time to sell the cars. And since we'll have our eyes of these cars fairly often, and many of these cars will be connected, so we'll also be accumulating mileage information as they go. We'll have good insight to how they're creating miles. And then we can take a decision on whether we need to get that car sold earlier than what we had originally planned and put the driver into another car or we can let that car run to 100,000 miles, for example, and sell it at the end of its life then. So we've got a lot of flexibility, a lot of data analytics and a lot of data coming in that will help us kind of manage the fleet in a way that we felt pretty comfortable with as we go forward. So as I said, we'll be conservative upfront on the fleet cost and our depreciation levels. And then as we learn, we can make adjustments as we go from there.

Chris Jon Woronka - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Very helpful. And then realized you guys don't provide quarterly guidance, but maybe if we could look back on second quarter. Do that unfold generally in line with your expectations? Just trying to get a sense, you still have a wide range out there for the full year. How do you characterize second quarter versus your kind of internal budget?

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Chris, it's Martyn. We've come in very close expectations with a little bit of movement within the month, but it came in very close to what we expected. So we're on track.

Operator

Our next question is from Michael Millman with Millman Research Associates.

Michael Millman - *Millman Research Associates - Research Analyst*

Could you talk about concessions? Some of the airports supposedly have spread their concessions to the ride hailing. Some of the people in the industry says it's not working. Some say maybe it is. So be interested to hear your take on it. And secondly, on your strategic initiatives, I think when you talked about them publicly, you were spending -- expensing about $50 million a year. Does that expensing continue? Is that likely to be permanent expensing, change in one way or another?

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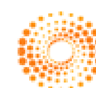

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Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Michael, on the concessions, I think every airport is trying to deal with the impact of ride hailing and the volume of cars that's putting onto the airport's curbs. And we're -- we don't get in the middle of those disputes, really. And so some airports have taken the stance to add certain taxes or concession fees to ride-hailing companies. And I think they're all kind of different in form and amounts and so forth. That's up to the airports. And the ride-hailing industry is not something that we're really actively getting involved in.

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Yes. Michael, just on the $50 million, we're -- I think it's materially the same, as you heard, which I think we've talked about several years ago, so predominantly through OpEx and some CapEx as well. But we're pretty much in a similar position to what you were calling.

Operator

Our next question is from David Tamberrino with Goldman Sachs.

David J. Tamberrino - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Larry, sounds like very well thought through slowpoke strategy to onboarding some longer-life vehicles and putting into Lyft network. I'm curious if you could communicate what you're targeting from a margin perspective and a returns perspective for that business relative to your base leisure and commercial rental.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. We're not really going to discuss kind of expectations around margin of that at this point. We've run our own models and run some pro formas of what we think it will be. Not ready to really discuss that publicly yet. But you're right at the beginning of your comments that we are going to take a steady approach to this and -- the way the rollout works with Lyft, it does actually support just a steady approach in learning as we go in multiple markets going at the same time. And it's kind of a perfect timing because it's a time we'll be de-fleeting a number of cars after the Christmas season. We'll be doing a little bit before Christmas, but most of it will come really in the first quarter, second quarter of next year. Still that works out well from a timing perspective. And as I said, we've got -- our fleet optimization folks are just -- we have so much more skill set, data, external data that allows us to have a lot more granularity, a lot more understanding and visibility into residual values than we've ever had before. And every year, it gets stronger and stronger and stronger. And we know that not every -- not all the cars should be sold at the exact same time. Not every car should be sold at 100,000 miles or 110,000 miles. And it really makes sense -- makes a difference depending on the make and model, where you're selling it, the trim levels that are on it, the mileage that's on it and so forth to make sure that you really optimize the opportunity of when you're going to sell them. And so we'll be using our fleet team to really help us understand that as we roll these cars in and out. And as I say, we're renting them on a weekly basis. And most of them will be connected, so we'll be getting data. And we'll have our hands on the car physically every single month. So that limits any sort of -- it limits any downside to a car kind of accreting mileage too fast. We can get our hands on and rectify it. So we feel confident, after many discussions with Lyft, on how we're going to manage through this. And they've been really terrific sharing the data with us to really help us understand how this works. We're -- we feel good about where we are with this agreement, but we're going to have to grow and learn with it as we go.

David J. Tamberrino - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Yes, yes. I think that's fair. I think it's -- you know and the industry knows that one of the larger competitors was in a similar business, and the maintenance cost ended up being larger than anticipated. And they ultimately discontinued it. So it could, potentially, with your data coming out off the vehicles and that kind of shared management of the maintenance expenses in the vehicles should help you. But that's more just of a

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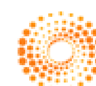

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comment. My second question or follow-up is just on the pricing dynamic from a leisure perspective. I think the slide deck said it was plus 2% year-over-year in the second quarter. Believe that's a sequential deceleration from plus 4% in 1Q. Is that all just because of within the Americas segment or what happened in Brazil? Or is there anything else going on in addition to that incremental length of haul -- or length of rental, the duration?

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. I think the impact, really, is Easter moving into the first quarter, which benefited the first quarter, but also obviously hurt pricing in April. So that had a fairly large impact for pricing in the month of April and overall impact for the quarter. And so when you have April -- when you have Easter that early in April 1, the number of yieldable opportunities between April 1 and the end of June is quite a bit less than it was in the first quarter. Other than Memorial Day weekend, there aren't as many kind of peak opportunities as you're going through the second quarter. In the first quarter, you're building fleet kind of month after -- because you've done the de-fleet after Christmas and then you start building fleet up for Easter and you kind of build it month by month. And it just so happens volume is kind of improving month after month after month to kind of help soak of those cars you're bringing in. When Easter is that early, you're bringing cars and in the second quarter for the buildup for summer, and there's not the buildup of the volume at the same time to kind of absorb the cars. I think the whole industry would probably love a second quarter like this one to bring the cars in all June 15, but that's not obviously how the industry works. So you're bringing cars in throughout the quarter, and the yieldable opportunity just aren't as many in that kind of quarter as it would have been the year before when you had a good strong Easter and a -- towards the end of April and the Memorial Day weekend and so forth. And as we also said, Brazil has also been an impact as leisure, so it's been really, really tough in Brazil this year.

Operator

Our next question comes from Brian Johnson with Barclays.

Brian Arthur Johnson - *Barclays Bank PLC, Research Division - MD & Senior Equity Analyst*

Yes. Want to ask you about the evolution of your U.S. fleet from sedan, which, of course, are out of favor in the showrooms with weak residuals toward CUVs. Is that -- and it certainly shows up in the auto fleet data in terms of rental car, fleet purchases which were up this year. Is that something you're participating in? Can you give us any metrics on percent of fleet in sedans versus CUVs and how that's evolve? And is there enough of a pricing boost you get on that to offset the higher fleet cost, if there, in fact, are any?

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. Brian, you didn't come through really clearly, but I'll try to address the question as I think you asked it. I couldn't hear all of it. But I think it starts with our view of what customer demand is. And we -- before we go into the buying year, we sit down and really take a look at what customers are looking for in rental car. We don't buy cars outside of what the customer demand is by make and model. So we really try to focus putting the right fleet in place that's going to meet the needs of the customers. And if the customers own purchasing habits have changed more to crossovers and to SUVs, so has rental demand has matched that. People like to rent what they like to drive. And so we always keep that in sync as we go forward. So as we've shifted out of -- we have shifted out of some sedans into SUVs and crossovers and some into larger SUVs. And yes, we can get a higher rate per day on some of the bigger SUVs and what we call our non-core fleet. And even though the cap cost of those cars are more expensive, the residual values have also been stronger. So net-net, when we take a look at those acquisitions, our fleet optimization team and our fleet acquisition team look at, take all that into consideration starting with the most important thing and that is make sure you've got cars that customers want by marketplace and then get -- use the data analytics to get the right makes and models with the right trim levels and the right colors and the right markets to maximize your residual value on the other end and then take the advantage of what those non-core cars can help you with rate per day. So we haven't seen any issues. We haven't seen any kind of misalignment as we've made transitions to some of the richer fleet that we did in the last half of last year. Yes, it puts a little pressure on fleet cost and, obviously, the comparable this year over last year, but it's the right thing to do because the -- that's what customers want. And the residual values will be there to support it on the other rental when we go to sell them.

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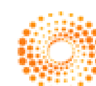

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Brian Arthur Johnson - *Barclays Bank PLC, Research Division - MD & Senior Equity Analyst*

And is -- do you have a rough percent of where sedans are as a percent of your fleet?

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

I think it's about 24%, somewhere around there.

Neal H. Goldner - *Avis Budget Group, Inc. - VP of IR*

Brian, it's Neal. So in the U.S., our fleet plant for the U.S. this year, call it, all of our cars, mid, small and large, are going to be a little less than 50% of our fleet this year. That's the -- kind of what we call the -- typically, the car cost.

Brian Arthur Johnson - *Barclays Bank PLC, Research Division - MD & Senior Equity Analyst*

Okay. And then second question. As airports roll out the centralized renting facilities. We're in the process of that at O'Hare, as you know. Do you see any difference in just price sensitivity competing against TNCs and others who are still picking up at the curb? And as you kind of look at that, is that a trend that is, at all, affecting your business? Or is it just that's -- you move from one type of lot to, et cetera, lot?

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

I'm sorry, Brian. Can you just repeat the question. If you could just...

Brian Arthur Johnson - *Barclays Bank PLC, Research Division - MD & Senior Equity Analyst*

The impact, if you look at the city that has moved -- if you look at the city that's moved from central -- to a centralized pickup lot from the older system of buses going to individual lots, do you see any material difference in the rates you can get, the volumes you're getting? There certainly is a bare pieces out there that when you go to a big central facility, like Miami or Houston, the budget -- small B budget brands are in equal footing with the larger brands. And hence, it's harder to maintain price differentiation. And secondly, the hassle of getting to those central lots may flip some travelers over into TNCs or other forms of transport.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes, I think, as you take a look at how things have evolved over the years for the number of walk-ups that you used to get our -- not -- you don't get near the number of walk-ups, where people are just walking up into the counters without reservations. With the advancements of apps -- mobile apps and we're seeing a huge growth in our mobile app, most people are arriving to the airport already booked. And through things like mobile apps, they're actually booking and not -- not only booking, but they're also selecting their car in advance and so forth before they even get into the airport. So having a consolidated rental facility versus nonconsolidated rental facility isn't really -- it doesn't really make much difference at this point. I think most people have already thought through it, booked their reservation and selected their rental car company. I think as it relates to airports where it is more -- where it's a lengthier transaction to get from the airport over to the rental facility, yes, of course, that can impact convenience, which is why things like dropping customers off, the new product that we're offering, has some real appeal that people are willing to pay a fee for us just to drive them directly to the curb and not have to go through, perhaps, a long tram ride or a congested bus ride or so forth. So when the rental car facility is right across the street from the airport, sure, that makes a difference. When it's a tram right away, yes, you can feel it. And that's why coming up with products that make it more convenient, providing more technology, more ability for people to transact online and use their apps and select their cars on the app and do everything that they need to do on the app makes it a lot easier for our customers

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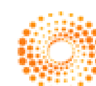

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to be able to get to their car and have a more enjoyable experience. So that's why we're focused on those types of new product offerings. It's just that it saves some time for consumers and make it more convenient.

Operator

(Operator Instructions) Our next question is from Wayne Cooperman with Cobalt Capital.

Wayne Manning Cooperman - *Cobalt Capital Management, Inc. - President*

Question is, first, the expenses in the quarter, operating expenses grew 6%, SG&A grew 10%, if you could talk about that. And I thought I heard you say depreciation and amortization will be $200 million for the year, which seem kind of low since you've been run rating like $65 million a quarter for quite some time. So if you could elaborate on those 2 things.

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Yes. It's Martyn, Wayne. Just on operating expenses and SG&A, they're both -- probably, it's currency translation is making it look higher. Possibly also -- and I think we talked about this as we presented last time. We've reset our comp schemes, which largely didn't pay out in 2017, so we have to reset those for 2018 at target. And there's a bit of further channel commission cost because of the growth of leisure that Larry and I were discussing earlier. It tends to bring in some more channel-related fees into SG&A as well. So in summary, it's translations and expense, channel cost and expense, plus resetting the computation schemes. On the depreciation, some of it is currency and some of it is timing as well. Just when the [stuff] is falling within the quarters, but the depreciation number, that's what we're expecting for this year -- for the year nonacquisition-related.

Wayne Manning Cooperman - *Cobalt Capital Management, Inc. - President*

Yes, that's a big step down.

Martyn Smith - *Avis Budget Group, Inc. - Interim CFO*

Yes, it's a bit. But it's got -- it's probably timing in the quarter just the way it kind of folds.

Operator

Our last question at this time is from James Albertine with Consumer Edge.

James Joseph Albertine - *Consumer Edge Research, LLC - Senior Analyst of Automotive & Managing Partner*

Wanted to ask again -- to follow on here with sort of this narrative around future mobility and connected vehicles. Can you help us better frame you're providing how many vehicles are connected in your fleet? We appreciate that, saying it's higher revenue, lower cost. And we appreciate that. But can you help us frame the economics here? And is this something that we need to track more closely? With respect to -- as a percentage of your overall fleet adjusted for seasonality, what this number should look like over time? And is this going to be net more costs than benefits here in the short term? Or is it already a positive sort of margin situation?

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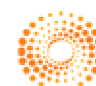

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Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Yes. The revenue generation that we're getting from Connected Cars right now is really focused around gas collection. So we're collecting more gas revenue on every Connected Car transaction than a non-Connected Car transaction because it's going to read gas down to 1/10 of 1 gallon. It also will refund gas to a consumer if they brought it back with more gas than they had in it when they took the car out because it's calculating that as well. So even net that, we generate more revenue per transaction on gas collections. And that more than offsets the cost of the technology, altogether. The -- what we're really focused on now, through the Kansas Mobility Lab, is looking at ways of how we use the connectivity to manage the fleet and so there's tighter control around the asset since we know pretty much where the car is at all times. So we've developed a number of reports that managers are now using that keeps track of exactly where the cars are at all times, whether they're on rent, how they actually show in the system versus what we actually see them doing, making sure that we get our cars back and on rent, service and on rent, faster than not by -- than non-Connected Cars. And also we're using the technology to get ahead of maintenance concerns on the car by being able to read the diagnostic codes on the car. One of the first ones we launched was the ability to actually know that there's going to be a tire inflation problem before a customer sees the red light go off on the dashboard that causes them concern during the rentals. That allows us to quickly be able to know exactly what tire we need to inflate before that light goes off. The customer never has to experience. They never had to call roadside assistance. We don't have that follow-up expense and so forth. So when you think about all the different processes that the car goes through, all the places the car ends up, at maintenance facility or sometimes an impound lot, wherever the car may go, we have tighter control because we know exactly where the car is. We recover our cars faster when they do end up in situations like an impound yard being towed somewhere. We get them back several days faster with less damage on them. That allows us to put the car back on rent and not really lose those days. There are literally hundreds of ways of which the car can be tightly controlled through the connectivity. And then down the line, as we collect data, we're already discussing with different partners data that they may be interested in purchasing from us, not customer-related data. We don't collect anything about the customer, but just the car itself, where the car actually went as far as traffic patterns, and so forth, the other companies may be interested in knowing. So there's a lot of potential for this as we continue to explore data as a service, fleet management as a service and our mobility as a service product offerings and having that connectivity and having it integrated into our systems allows us to not only collect the data, but actually do something with the data. So my example earlier with Lyft,with the next-generation platform around mobility that we're building, we'll be able to collect the data, collect the mileage, it will make determinations around what that car should be doing, the life it should have with us, when we should be exiting that car, where we should be exiting it to maximize residual values and actually have a system that can manage that process for 600,000 cars versus trying to have people manually try to management that, which would be impossible. So the connectivity just -- it brings -- it just is a whole new dawn for us. It's a whole new opportunity to have us look at all of our processes, how we manage fleet in a very different way that allows us to use data analytics in a way that can really drive asset utilization and security of our assets and protect mileage, balance miles across the fleet, things that we could never do in the past.

Operator

For closing remarks, I will turn the call back over to Mr. Larry De Shon. Please go ahead, sir.

Larry D. De Shon - *Avis Budget Group, Inc. - CEO, President, COO & Director*

Thank you very much. Before we close, I think it's important to reiterate the key takeaways from today's call. We had a strong second quarter with volume, underlying pricing and fleet cost improving. Our work to improve our profitability was evident this quarter with margins increasing 70 basis points. We reached a significant milestone towards our goal of having a fully connected global fleet. And we announced exciting new relationships with Amazon, Lyft and Luxury Retreats. We have a full calendar of investor relations activities planned again this quarter, including events in New York, Boston and California, and we hope to see many of you during our travels. With that, I want to thank you for your time and your interest in our company.

Operator

That does conclude today's conference call. You may disconnect at this time.

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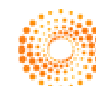

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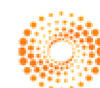

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