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Avis Budget Group, Inc. (CAR)

Q4 2013 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Avis Budget Group Fourth Quarter Earnings Conference Call. Today's call is being recorded. At this time for opening remarks and introduction, I would like to turn the meeting over to Mr. Neal Goldner, Vice President of Investor Relations. Please go ahead, sir.

Neal H. Goldner
Vice President-Investor Relations, Avis Budget Group, Inc.

Thank you, Kimberly. Good morning, everyone, and thank you for joining us. On the call with me are Ron Nelson, our Chairman and Chief Executive Officer and David Wyshner, our Senior Executive Vice President and Chief Financial Officer. Before we discuss our fourth quarter and full-year results, 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.

Important risks, assumptions and other factors that could cause future results to differ materially from those expressed in the forward-looking statements are specified in the company's earnings release and other periodic filings with the SEC, which are available on the investor relations section of our website at avisbudgetgroup.com. We've also provided slides to accompany this morning's conference call, which can be accessed on our website as well.

Our comments will focus on our results excluding certain items and other non-GAAP financial measures that are reconciled to our GAAP numbers in our press release and in the earnings call presentation on our website.

Now, I would like to turn the call over to Avis Budget Group's Chairman and Chief Executive Officer, Ron Nelson.

Ronald L. Nelson

Chairman & Chief Executive Officer, Avis Budget Group, Inc.

Thank you, Neal and good morning. Before we get started I'm going to apologize up front for the raspiness of my voice and if I suddenly burst into coughing, I seem to be suffering from the lingering effects of a mild flu and hopefully I'll get through it without interrupting your listening to our script here, but nonetheless. So we ended 2013 on a strong note and accomplished much from both a financial and strategic perspective. We delivered our second highest annual adjusted EBITDA ever, second only because of the unusually low fleet costs we had in 2012.

Last year's results reflect the continued benefit from executing against the strategic plan that we laid out a few years ago, benefits that drove volume growth in our car rental operations globally and grew revenue per day in our North America and Truck Rental segments. It also guided our acquisitions of Zipcar, Payless and several of our Budget licensees around the world and our strategic plan continues to drive our actions today. Actions that focus on efforts on faster growing and more profitable segments and channels, actions that expand our global footprint by investing in higher-growth markets such as India and Brazil, actions that improve the service we offer to our customers to drive loyalty and actions that are causing us to achieve efficiencies throughout the organization.

And those efforts were no more evident than in our fourth quarter results. To put a finer point on it with normalization of fleet costs, our fourth quarter results highlight the positive effect our strategies are having as they helped us grow revenue in North America and International segments, expand our margins and deliver double-digit profit growth. In North America we grew rental revenue both on and off-airport in the quarter, increased leisure pricing year-over-year and made significant progress integrating Payless and realizing synergies from our ownership of Zipcar.

In our International segment, we grew volume, improved utilization in the fourth quarter, increased our total revenue per rental day in Europe and captured additional synergies from the integration of our European operations. We completed the restructuring of our Truck Rental business. And we repurchased 720,000 shares in the quarter, bringing our total share repurchases in 2013 to 1.6 million shares.

Pricing in North America was unchanged in the fourth quarter, excluding Payless and foreign exchange, but that only tells part of the story. We continued to implement price increases, even when the competitive reaction was mixed, and our U.S. leisure pricing increased approximately 1% year-over-year. We faced a somewhat unusual comp, as our results in November and December of 2012 were impacted by industry-wide fleet tightness following Hurricane Sandy, whereas we believe that one of our principal competitors was over-fleeted in the fourth quarter of 2013, leading to a dampening effect on prices. These issues have begun to sort themselves out in the first quarter, and we've continued our efforts to improve realized rates. Over the first six weeks of the year, our realized pricing has been up 2%, excluding Payless, with gains in both commercial and leisure rates.

Commercial pricing declined 1% in the fourth quarter due primarily to declines in our contracted commercial book of business. As you know, we took an aggressive stance regarding contract negotiations this year to try to improve our realized commercial pricing and we did make some early progress. Over the course of the year, we renewed almost 1,400 commercial contracts, and were able to hold or increase rates roughly 60% of the time.

And while we had an average decline on renewals in the second half of the year, we are succeeding in stemming the rate of decline as we work our way through the renewal book. Needless to say, we're still not satisfied, and our goals continues to be to move our average renewal rate to positive territory.

Volume increased 6% in North America in the fourth quarter, or 3% excluding Payless, on top of the 5.5% volume growth in the last year's fourth quarter. Leisure volume grew 3%, and commercial volume increased 1%. We saw robust commercial demand of our Avis brand in the quarter. Our Budget brand also had a strong fourth quarter with on-airport leisure volume increasing 10% driven by growth in International inbound, small business and our exclusive agreement with AARP.

We continue to have a good mix of premium and specialty vehicles available which we believe helps us attract demand across the pricing spectrum and we again grew our local market operations which is now close to $1 billion dollar annual revenue business for us, reflecting growth across the fourth quarter and full year. More importantly, it's a profitable billion-dollar revenue stream made so by a continuing focus on capturing commercial customers total rental spend by attracting more leisure customers to our stores, and by consolidating brands and locations.

Zipcar ended the year on a positive note, making further progress to capture the $50 million to $70 million in synergies we expect to achieve from the acquisition. A few highlights since closing the transaction in March of 2013. It's become even clearer that car sharing is an important growing market today because there's an unmet need for wheels when you want them in many locations and tomorrow because of the demographic cultural shift away from owning a car. We've maintained Zipcar's intense focus on the quality of the customer experience and our net promoter scores continue to be extraordinary.

We've launched Zipcar in six new markets and now offer Zipcar rentals at 28 airport locations in North America and Europe. We've made Zipcar available to members at more than 50 Avis and Budget urban locations with further expansions planned in 2014. We've replaced 45% of Zipcar's fleet with a younger, more diverse mix of cars, lowering our costs and improving the member experience. And we've begun to offer Zipcar to Avis and Budget's commercial customers, with early interest indicating significant demand, and we're now piloting one-way rentals and expect to be able to offer this mobility solution more broadly later this year.

We are pleased with Zipcar's financial results in 2013 but we continue to be even more enthusiastic about Zipcar's potential. Zipcar is still barely scratching the surface of the global market opportunity for car sharing, and as part of Avis Budget Group, Zipcar can leverage both our existing infrastructure as well as that of our licensees around the world to expand rapidly and profitably. As a result we expect our Zipcar operations to make a larger contribution to our EBITDA and especially to our EPS in 2014 and 2015.

Moving to our International segment, our European operations had another strong quarter with volume increasing 6% year-over-year. We saw strength in Italy, Austria, Holland and the U.K., while Spain remained soft. Budget's volume increased more than 70% in the fourth quarter with particular growth in Italy and Germany. Avis volume grew 1% in the quarter.

As we mentioned last quarter, we began to charge customers in certain countries separately for airport and train station surcharges that had previously been included in our base rates. So the best way to get an accurate picture of the revenue environment is to look at total revenue per day, which in constant currency has increased approximately 1% in the quarter.

We invested in 2013 and will continue to do so in 2014 to improve our digital and mobility platforms, completely changing the Budget website in the U.K. early in the fourth quarter, which is already driving higher conversion rates. The first iteration in new the digital platform that was rolled out in the U.K. has now been deployed in our four largest corporate countries in Europe.

Early returns show both an increase in conversion in the teens and an increase in total spend because of the improved merchandising of upgrades and ancillaries that are embedded in the platform. The full rollout of the new Avis platform is scheduled for May followed by the final iteration of the Budget platform in October. Our

European sales organization also continued to deliver in the fourth quarter including an expansion of our partnership with Scandinavian Airlines to include Budget starting in the second quarter of 2014.

In our Latin America and Asia Pacific region, volume increased 6% year-over-year and pricing increased approximately 1% excluding Apex as we raised rates despite competitive pressures in Australia. We also took aggressive cost actions during the quarter and improved utilization. Meanwhile our Apex brand had an inspiring first year as part of our company, opening four new locations in Australia, growing revenue 35% to more than $40 million. You'll hear more about this brand's potential at our Investor Day next week as we believe we have an opportunity to expand this brand to other countries.

As we look back across 2013, there are a few areas we're particularly enthusiastic about. First, we maintained our aggressive push for pricing, driving the first full-year increase in our pricing in North America since 2009. We acquired Zipcar, the leading brand in the burgeoning car share market and Payless, a significant player in the deep value car rental market. We made numerous improvements in our European operations increasing Budget volume by 50%, driving ancillary penetration, improving utilization of productivity by over 2 points and 5 points respectively and delivering on our synergy targets.

We invested in our Brazilian and India licensees, providing them capital to acquire fleet and grow share in these two high-growth car rental markets. We repositioned our Truck business, reducing our average fleet by 8%, growing our pricing by 7% and improving margins. And we drove efficiencies throughout our global operations.

So, turning to our 2014 outlook, 2014 is all about growth. We expect to grow our revenues, our margins, our capital investment in our business, our customer loyalty to our brands and our share repurchases in 2014. Our emphasis on process improvement, cost control, acquisition, fleet and yield optimization and pushing to improve our realized pricing will remain intact and intense.

In North America, we expect to grow revenue in the 4% to 6% range in 2014 reflecting higher rental volume and increased pricing driven by increasing demand in key segments. We'll maintain our focus on the fastest growing and most profitable segments particularly International inbound, small business and specialty and premium car classes as well as capturing a higher share of our commercial and leisure rentals total car rental spend.

We also plan to maintain our focus on achieving price increases where possible. We're encouraged by the leisure increases we've been able to achieve thus far in the quarter and we will continue our focus on improving large commercial pricing. On the cost side, we anticipate inflationary increases in fleet costs in 2014 with margin expansion coming from our Performance Excellence, fleet optimization and yield management efforts as well as additional synergies from Zipcar and Payless integrations.

In our International segment most forecasts now expect the European economy to stabilize in 2014 with the eurozone predicted to show a modest uptick in GDP. The U.K. forecast is to show even greater growth at slightly more than 3%, all of which is encouraging. There remain pockets of softness, Spain being the most notable, but keep in mind the economy has had little effect on our highly profitable summer period. Regardless, we plan to drive revenue growth through our Budget brand, increase our ancillary penetration and benefits from our digital investments. We expect our 2014 results will benefit not only from revenue growth, but also from all of the restructuring and integration actions we have taken in the last two years.

We will continue to have a portion of the digital investment running through the P&L in 2014 as well as an increase in brand marketing, but we are nevertheless looking for meaningful gains in EMEA income. As we have said in the past, we have not shied away from making these investments whether they be capital or P&L, those that will give us the most favorable operating leverage when the economy turns.

Results in our Latin America, Asia Pacific region are expected to be driven by growth in overall rental volumes, greater high margin inbound and outbound volume particularly from Asia and Europe and progress in our joint ventures in China, India, and Brazil. Pricing in Australia took a toll on our 2013 results and we are determined to turn that trend around. Early results for the summer season thus far are trending in the right direction. Foreign exchange will work in our favor in Europe. It is likely a headwind for our Latin America and the Asia Pacific operations.

Before I turn the call over to David, I want to reiterate our approach to capital allocation. Most of you know our board authorized a $200 million share repurchase plan this past August and we immediately began to execute on it repurchasing 1.6 million shares at a cost of approximately $50 million in the last five months of the year. As we move into 2014 we expect to generate approximately $400 million of free cash flow this year and our planned uses of free cash flow remain the same. One, tuck-in acquisitions such as the acquisitions of our Budget licensees around the world and of Payless; and two, share repurchases.

The mix will depend primarily on the opportunities available to us, but we anticipate completing the remainder of the $200 million authorization over the course of 2014 at a minimum and I remind you that our view is that one shouldn't start a share repurchase program without an intent to continue.

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

David B. Wyshner

Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.

Thanks, Ron. In the spirit of the show must go on, that was a pretty heroic effort. Good morning, everyone. Today I'd like to discuss our full year and fourth quarter results, our fleet costs and our integration of Zipcar as well as our balance sheet and our 2014 outlook. As Neal mentioned, my comments will focus on our results, excluding certain items. These results are reconciled to our GAAP numbers in our press release and in the earnings call presentation on our website.

The fourth quarter marked our 14th consecutive quarter of year-over-year revenue growth and our highest earnings for a fourth quarter ever. Revenue grew 9% to $1.8 billion primarily due to higher rental volumes and the acquisitions of Zipcar and Payless. Adjusted EBITDA increased 46% to $114 million and margins expanded by 160 basis points, principally as a result of higher volume, strong cost controls and incremental synergies in our European operations. For the full year, revenue grew 8% to $7.9 billion and adjusted EBITDA declined 8% to $769 million as North American fleet costs normalized throughout the year.

For those analysts who calculate EBITDA before deferred financing fees and stock-based compensation, our 2013 adjusted EBITDA would be $45 million higher, or $814 million. Our full-year tax rate was 38% and our diluted earnings per share were $2.20. Revenue in our North America segment grew 11% in the quarter and was up 2%, excluding the acquisitions of Zipcar and Payless. Volume increased 3% in Q4 while pricing was unchanged, excluding Payless and currency effects. Adjusted EBITDA in North America increased 57% year-over-year and margins strengthened by 190 basis points, primarily due to lower operating and selling costs as a percentage of revenue and benefits from the acquisition of Zipcar.

Revenue in our International segment grew 7% in the fourth quarter, primarily due to higher rental volumes and ancillary revenues which contributed to our 1% constant currency increase in total revenue per rental day in Europe. International adjusted EBITDA increased 37% year-over-year to $48 million in Q4 and margins improved 180 basis points due to higher revenues and our success in lowering cost and improving productivity across the region as well as higher fleet utilization. Our fourth quarter results include approximately $10 million in incremental synergies compared to the prior year.

Truck rental revenue declined 2% in the fourth quarter as a result of our strategic initiative to reduce our average fleet size, increase utilization, optimize our footprint and dealer network and focus on more profitable transactions. Our Truck Rental fleet was 14% smaller than a year earlier but our pricing was up 7% and our EBITDA more than doubled to $5 million. Corporate and other expenses increased $7 million in the fourth quarter because in 2013 we reallocated certain existing corporate level costs that benefit multiple regions and segments as we previously discussed. Going forward, we expect these expenses to remain relatively flat year-over-year.

Switching gears, our Zipcar operations contributed $74 million of revenue and $11 million of adjusted EBITDA in the fourth quarter and for the full year Zipcar contributed $246 million of revenue and $25 million of adjusted EBITDA. This has been an exciting year for Zipcar and its members. We made significant progress in realizing the synergies we laid out when we announced the acquisition last January.

We lowered Zipcar's depreciation, insurance, interest, maintenance and overhead costs. We've begun sharing fleet in several cities allowing Zipcar to capture more of its members' peak weekend demand. We're currently sharing hundreds of cars that are available to Avis Budget renters during the week and Zipcar members on the weekend and expect to be sharing even more vehicles for the summer peak.

Our Zipcar membership has grown at an 11% rate to 863,000 members at yearend. As a result, we've seen revenues increase to record levels and as Ron mentioned, we remain on track for $50 million to $70 million of annual synergies by the end of 2015. As we look toward next year and beyond, we're receiving the numerous growth opportunities for Zipcar within the United States at colleges and universities and on corporate campuses and perhaps most importantly outside the United States, but more to say on that topic at our Investor Day next week.

Moving to fleet, our North American per unit fleet cost were $299 per month in 2013. This represented a 25% increase from full year 2012 as residual values at around 82% of our net purchase price were much more consistent with historical norms than residuals were in 2011 and 2012. Looking at the fourth quarter in particular, we saw a relatively stable used car market consistent with the third quarter trend and our risk car sale volume was at the intentionally light level of around 11,000 vehicles.

For 2014, we anticipate only a modest inflationary increase in monthly per unit fleet cost to somewhere in the $300 to $310 range. We believe the used car market will continue to see good demand in 2014 amid a growing U.S. economy and available consumer financing, at rates that are still low by historical standards. We expect the supply off-lease vehicles to increase in 2014, which will most likely have a mild dampening effect on the prices of used vehicles. As a result, we have modeled about a two-point decline in residual values in 2014 compared to last year, a portion of which we expect to mitigate through actions we are taking.

First, we expect to generate incremental benefits from our fleet optimization system which is allowing us to make better decisions on vehicle hold periods and the timing of fleet purchases and disposal, as well as putting the right car in the right place at the right time. Second, we expect to expand our use of alternative distribution channels this year, including increased direct-to-dealer sales and growth in our direct-to-consumer partnership with AutoNation. Third, in November and December we took advantage of some attractive deals from both U.S. and foreign manufacturers which helped us fill out our 2014 fleet plan with low cost per month cars that also provide us with good flexibility.

And fourth, we now have the ability to cascade some of our cars to Payless. This flexibility is quite valuable from a fleet optimization standpoint, and we anticipate that nearly all of Payless' fleet will be comprised of former Avis and Budget cars by the end of 2014. Finally, the composition of our fleet will remain relatively unchanged this year, which almost two-thirds of our North America fleet comprised of rich vehicles and no manufacturer representing more than 30% of our vehicle purchases.

Turning to the balance sheet, our liquidity position remains strong, with $5.3 billion of available liquidity worldwide. We ended the year with $693 million of cash, no borrowings under our corporate revolver and roughly $1 billion of availability under that facility. We had unused capacity of $3.6 billion under various vehicle back-funding programs and our ratio of net corporate debt to LTM adjusted EBITDA was 3.5 times.

We actively managed our balance sheet in 2013, taking advantage of attractive financing available to us. We capped off the year by completing a $250 million offering of floating rate notes and used the proceeds to redeem all of the floating rate notes due in May to repay $45 million of outstanding term loans and to repurchase $39 million of our 8.25% notes and $9 million of convertible notes. As a result of these efforts, we entered 2014 with no corporate debt maturities until 2017, except for the remaining convertible notes, which we expect will convert into common stock in October of this year.

Over the course of 2013, we repurchased $62 million of our convertible debt. Combined with our $50 million of share repurchases we reduced our diluted shares outstanding by $5.4 million or more than 4%. Our average price per share for these repurchases was just over $30. This 4% reduction in our diluted share count in 2013 is on top of a 10% reduction in 2012. Our full-year 2013 free cash flow was $460 million or almost exactly $4.00 a share. Our free cash flow over the last two years has totaled $978 million.

As we expect, our free cash flow was generally in line with our pre-tax income, excluding items, in part because we continued not to be a federal cash taxpayer in the United States. Our capital expenditures were in line with our depreciation expense, and both working capital and vehicle programs were a source of cash for us in 2013. To be fair, we also benefited from the timing of cash inflows in our International operations in the fourth quarter and we attribute most of the $50 million by which free cash flow exceeded our full-year pre-tax income to this timing benefit.

Now before we move into Q&A, I'd like to spend a few minutes discussing our 2014 outlook. Over the last several months, we've gone through a global planning process with extensive involvement of virtually all parts of our organization. Based on that work, we expect our 2014 revenues to be approximately $8.3 billion to $8.5 billion, a 5% to 7% increase compared to 2013. In North America we expect our rental days to increase 3% to 5%. We will continue to push for better achieved pricing and we expect our time and mileage revenue per rental date increase approximately 1% in 2014. As I mentioned earlier, we expect North America per-unit fleet costs to be in the range of $300 to $310 per month and total company fleet costs to be approximately $295 to $305 per unit per month in 2014.

We currently expect our North America fleet costs to be fairly consistent in the $300 to $310 range throughout 2014. As a result, we expect to have an increase of 8% to 10% in per-unit fleet costs in the first quarter as per unit costs were only $280 in Q1 last year, and we project flattish year-over-year comparisons for the rest of 2014. We expect adjusted EBITDA, excluding items, to be $825 million to $900 million and our 2014 pre-tax income, excluding items, to be $450 million to $530 million. We estimate that our effective tax rate in 2014 will be roughly 38% and that our diluted share count will be approximately 114 million shares. Based on these expectations, we forecast that our 2014 diluted earnings per share excluding certain items will increase between 11% and 30% to $2.45 to $2.85.

Capital expenditures were $154 million in 2013 as we invested in our infrastructure and began to see some attractive opportunities to invest in our business, particularly our digital presence in North America and Europe. We expect to continue that investment in 2014 and 2015 and estimate that our capital expenditures will be approximately $190 million this year.

And finally, we expect our cash taxes to be approximately $60 million to $75 million this year and for free cash flow to be in the $400 million range absent any significant timing differences. As is typical for us, we expect that our free cash flow generation will be significantly weighted towards the second half of the year.

To wrap up, we were proud of our accomplishments in 2013. In North America we achieved top line revenue growth that reflected increased volume and pricing. We continue to focus on growing the more profitable segments of our business, while we continue to be aggressive in controlling costs and optimizing our fleet.

Internationally, we made 2013 another year of strong growth for our Budget brand, further realigned our European operations for greater efficiency and effectiveness, invested in areas like digital, putting us in an excellent position to benefit from the eventual recovery in the European economy. In the Asia Pacific region we also expanded our Apex brand to more locations and grew Apex's annual revenue by 35%.

We completed the acquisitions of Zipcar and Payless, as well as a few small tuck-ins in Europe. We invested in our Brazil and India licensees to position us for long-term growth in these markets. We took advantage of historically low interest rates completing both corporate and asset-backed offerings that allowed us to lock in low rates for several years to come. We initiated a $200 million share repurchase program through which we returned over $50 million of cash flow to our shareholders in 2013.

And while we were proud of these accomplishments, we're now focused on 2014 and on delivering on our strategic initiatives teasing the opportunities associated with our acquisitions, strengthening our brands and the customer experience we offer and achieving our financial targets. We will also be keeping an eye on our goal of generating $1 billion of adjusted EBITDA by 2015 which should translate into at least $500 million of free cash flow, more than $4.25 per share.

We continue to feel this is a realistic goal that we are on track to achieve. Our 2014 Investor Day is scheduled for Monday and I hope to see many of you there. If you would like to attend and haven't registered yet, there's still time to do so on our website. The event will also be webcast for those that cannot attend the event live.

With that, Ron and I would happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from John Healy of Northcoast Research. You may ask your question.

John M. Healy
Analyst, Northcoast Research Partners LLC

Q

Good morning, guys. I wanted to ask a little bit more about the Budget opportunity in Europe. I know a year ago, a lot of it was focused on improving the marketing, and it sounds like now there are some things on the digital side and the customer side that you're trying to improve. And I was just trying to see what phase you think you're in, in terms of getting the Budget brand to exactly where you'd like it to compete? And maybe a little bit of update where you're at from a share standpoint and what you think the opportunity is? And also, have you see any sort of competitive response in kind of that leisure segment of the European market? Thanks.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

Well that's a mouthful, John. I would say we're probably in the third inning of a nine-inning game with Budget. I think the digital platform is going to increase conversion, increase revenue pretty significantly. We've got a greater than – and it's probably right around 30% growth in volume expected for 2014. We're getting a lot smarter about how we yield Budget. I was just looking at some numbers this morning how we yielded Budget over the Christmas season, which is actually a bigger season in Europe than it is here. And we were getting average price increases year-over-year in Budget in the low teens.

And I think that it's become a far bigger asset than even we imagined. We thought it was big, but it's big. We tripled its presence in terms of revenue mix. If it was 2%, it's now 6% of our revenue in EMEA, and I think there's a lot more to go. We haven't seen significant competitive threats from the other value players in the market. I think the independents are still very challenged. I think the InterRent and Advantage in Europe don't have the same sort of brand calling that Budget does in the marketplace. And, so, we're continuing to move as fast as we can and build the brand up. And as we get more and more critical mass, it gives us more and more opportunities for a bigger presence with the OTAs and in affinity agreements like we did with Scandinavian Airlines and all the other airlines. So, a lot more to come and I think we're getting smarter and better at it as every month goes by.

John M. Healy
Analyst, Northcoast Research Partners LLC

Q

Great. And then I just wanted to ask a follow-up question on the comment you made about U.S. pricing over the last six weeks. The 2% figure you quoted, was that inclusive of both leisure and corporate? And I was hoping to see if you can maybe try to quantify what sort of headwind you might have in March just given the timing of Easter. Just anything you could call out there.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

Yeah. Pricing has actually been fairly robust and we had a good month in January, we're having a less of a good month in February. There will no doubt be some volume and pricing impact in March. It's still too early, really, to get a good sense of where March is going to come out. I do think we're going to end up with positive pricing over the course of the quarter. Don't forget our pricing in leisure was up 8% last year's first quarter, so if we come in at up 2% or more positive pricing, that's a big jump in leisure pricing. I don't think there's any question that the shift of Easter into April this year is going to have some impact on pricing and volume in the March period and I think our hope is, and what we're counting on, is that we'll hold on to the gains that we've had through the first six weeks of the year.

John M. Healy
Analyst, Northcoast Research Partners LLC

Q

Great. Thank you, guys.

Operator: Our next question comes from Chris Agnew with MKM Partners. You may ask your question.

Chris Agnew
Analyst, MKM Partners LLC

Q

Thanks very much. Good morning. Just following up on the last comment, is the weather impacting February pricing, do you think? And can you quantify that?

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

Good morning, Chris. The weather hasn't had a lot of impact on our revenues so far. In January, given the timing of the storms, we felt it was kind of a wash. If anything it may have hurt us a little bit in terms of revenue in the month of February, particularly since one of the big storms was on a Monday, but we don't see it having a large impact. From a pricing standpoint at the margin it has probably been a little bit helpful because we pick up some one-way volume, but we don't see that as being the principal driver of the positive pricing that we've had so far this quarter.

Chris Agnew
Analyst, MKM Partners LLC

Q

Great. And moving on to free cash flow, you said that first priority is tuck-in acquisitions. Can you sort of give us a sense of size and frequency of those opportunities? And are you prepared to chase tuck-in acquisitions a little bit more than you have in the past, given that you're trading on a higher multiple than you did a couple of years ago? Thanks.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

The answer to the last one is I sure hope not, Chris. Look, I think as I've said before, a big tuck in acquisition for us is going to be in the $30 million to $40 million range. At any given point in time, we've probably got a half a dozen of deals of varying size in our development roster. And not all of them will close. It's hard for me to see tuck-in acquisitions with what I can see today consuming more than $100 million plus or minus $25 million of this year's cash flow. And so the balance is left there for free cash flow, depending on what's going on for share repurchases, depending on what's going on in the business. Because we've said our thinking about debt reduction is that we're going to grow into the lower end of the 3% to 4% range and probably not aggressively look to buy back debt to reduce our outstandings and get our leverage ratio down.

Chris Agnew
Analyst, MKM Partners LLC

Q

And, David, just a quick follow-up for you. You had a timing difference last year that benefited 2012. Can you explain the reason for the stronger free cash flow at the end of this year? But you're still talking about $400 million of free cash flow next year.

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

Sure, Chris. We, again, had a number of – we had strong working capital trends throughout the year. And then we, again, had I think some positive surprises in cash receipts, cash inflows and payments that we received late in the quarter in Europe that we weren't counting on to repeat again. And they did. So that's part of the reason why we ended up a little bit stronger this year.

The roughly $50 million of timing benefits or cash inflows we had late in the year, we still have free cash flow in the $410 million range which is really close to the $413 million of pre-tax income, excluding items that we had. And as you know, we typically view pre-tax income, excluding items, as being a good proxy for cash flow over time. And I really look at 2013 as a whole as being consistent with that.

Chris Agnew
Analyst, MKM Partners LLC
Q

Gotcha. Thank you.

Operator: Our next question comes from Brian Johnson with Barclays. You may ask your question.

Brian A. Johnson
Analyst, Barclays Capital, Inc.
Q

Yes. Good morning. Most of my pricing questions have been taken. So I'm going to drill down on fleet costs. I guess first a couple things. You originally talked about reducing your risk mix. And now it seems to be two thirds about where it was. Kind of what changed in that? And was that just a function of good risk opportunities that you were able to buy second quarter?

Kind of second question is when we think about dealer direct, are you already giving yourself credit for the eventual disposal of cars through dealers, I mean, through direct lots in your depreciation assumption? Or could that actually result in improvements down the road?

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

Thanks, Brian. Good morning. With respect to – let me work backward there. In terms of dealer direct, I think we've incorporated a little bit of that into our expectations for the year. But I think we've been conservative in doing so. So I do think that could have a positive impact compared to where we were. In terms of the risk versus program mix, we're going to be in the 60%s again in terms of our risk percentage. And really, it came down to optimization in the primarily in the context of the various repurchase programs that were being offered to us. And we really ended up in a situation where some of the flexibility associated with program cars we wanted to take advantage of, so we're keeping the risk program mix in the 60%s this year.

Brian A. Johnson
Analyst, Barclays Capital, Inc.
Q

Okay. So the December deals you talked about, were those on program cars or on risk cars?

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

Those ended up being primarily on program cars. We always go into – or typically go in the November, December time period with some spots in our fleet plan not spoken for yet. We refer to them as phantom cars internally. And we look for opportunities to fill out the fleet plan with opportunities when they become available. It's not unusual for us to do that. It was a relatively small number of deals. It isn't the principle driver of our cost but at the margin it did help a bit as we finalized our 2014 fleet plan.

Brian A. Johnson
Analyst, Barclays Capital, Inc.
Q

And just a final question around fleet cost. We've seen high inventory levels in the U.S. car market particularly in small and mid cars, the mainstay of your fleet. You know, we've regressed to – it looks like that does spill over at some point into Manheim. How are you kind of in your used car staff kind of thinking about that situation and whether it's going to result in additional pressures above and beyond the used car supply on the market?

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

We're watching it carefully but we've been pleased with the used car market so far. Despite some of the weather issues that we've obviously had over the first seven weeks of the year, we've head gains so far this quarter on vehicles that we sold in North America. They're modest but we are in a gain position. You saw the Manheim Index in January, which was positive and that was consistent with the experience we had. We're going to be watching it very carefully now because, as we've spoken about, I think in the past, the spring season in terms of used car sales really begins after President's Day. And so how things shape up from now to the end of the quarter – now until Easter ends up being an important time. But I think we're happy that we're starting that period of time with the used car market in fairly good shape and in a position that's allowed us to realize gains on sale.

Brian A. Johnson
Analyst, Barclays Capital, Inc.
Q

Which is also I think reflective of having realistic depreciation estimates coming into the year or realistic mark on your book.

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

I think that's right.

Brian A. Johnson
Analyst, Barclays Capital, Inc.
Q

Okay. Thanks.

Operator: Our next question comes from Afua Ahwoi with Goldman Sachs. You may ask your question.

Afua A. Ahwoi
Analyst, Goldman Sachs & Co.
Q

Thank you. So two questions from me, first, on the – I noticed on the desire to sort of have more premium cars. I know those typically come with a little bit of lower utilization, so how do you think about balancing utilization of your fleet versus going a little heavier on the premium luxury end?

And then the other question was I noticed in your forecast for 2014 you have built in about 1 point in pricing and I think historically at least, the most recent history, you've maybe maintained a flat view on pricing. So maybe can talk about some of the drivers that you see that give you confidence that at least 1 point of pricing is a base case for 2014? Thanks.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.
A

Hi, Afua. It's Ron. Look, I think on the premium cars we're less focused on utilization and more focused on revenue per unit per month and ideally you're going to buy as many of those cars as there is demand that allows you to make margin. Right now the RPUs on those cars range anywhere from 60% to 70% than the RPU on an A, B or C car, and so you don't need – utilization is really less relevant.

The good news is that while we – over the course of this past year we've seen utilization tick up on these cars from the mid 50%s into the low 60%s and so it has actually been a fairly good initiative that's driven a fair amount of very profitable revenue, but I think ultimately there is a limit. There's only so much demand for these cars and you've got to find that sweet spot where you can fill all the demand and continue to keep your RPU at these profitable levels. On the lower end smaller cars, the A, B and C cars, the commodity cars as I call them, those really are utilization intensive and you have to – we monitor it very carefully and spend a lot of time adjusting the fleet to optimize the utilization on those.

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

And with respect to pricing and the work we did in planning and ending up with a forecast of a roughly 1% increase in pricing in North America, I think there are three things that underpinned our decision to land there. The first is that our push to increase our realized pricing and to do so in all channels and segments is one that we plan to continue, and we really do hope and expect that that will have a positive impact, particularly because there are two other items that will help that.

The first is that our fleet costs are going up and have moved up from where they were in late 2012, and we think that's an industry-wide phenomenon, but that should help create some cost push pressures that help in the pricing environment. And in addition to that, we've begun to utilize our new yield management system, which we think is very helpful for optimizing pricing. At this point it's helping significantly with the automation of our processes and making us a quicker responder to changes or developments in the marketplace.

And we think that's going to have a positive impact over the course of this year as we continue to use that more and to roll out additional elements of it. So when you put together our push for pricing, yield management and a delayed cost push element here, we are comfortable with the forecast we gave of a roughly 1% increase in pricing in 2014. We do view that as our current estimate. And the reason I mention that is that we're going to push for as much as we can. It's not a limit or a target that we want to stop there. We continue to feel the product that we offer is under-priced compared to the value of the service. And that's a big driver of why we think more pricing makes sense.

Operator: Our next question comes from Fred Lowrance of Avondale Partners. You may ask your question.

Fred T. Lowrance
Analyst, Avondale Partners LLC
Q

Hey. Good morning, guys. Just want to dig in on fleet costs just a little more. I guess first on North America, do you have a specific view on Manheim? And really just trying to get to sort of what that core market pressure is that you're going to be facing. And then secondly, as we kind of look at the total company fleet cost guidance, it would seem that the international business is going to feel a little bit more pressure on fleet costs. So can you talk about the dynamics that are at play overseas that are maybe contributing to this internationally? Thanks.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.
A

Let me answer your last question, Fred. Fleet costs in EMEA are actually right in line on an apples-to-apples basis with where they are in North America. What we've got is a reclass of unrepaired damage that's going into fleet costs this year. So between that, and some higher eco-taxes in a couple of the markets and mix, that accounts for the majority of the increment that would appear that is occurring in the international markets. But when you really get down to the deals and where the cars are and what they're selling for, the actual transaction for the car is roughly equal to where it is in North America.

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.
A

And then with respect to how we think about fleet costs, we don't have a particular Manheim number that we would look at. But what we tend to focus on is our residual values as a percentage of cap costs. And as I mentioned, we're forecasting that to be down roughly two points this year and are building that into our forecast of fleet costs. It's always hard to know exactly what that's going to translate into in terms of the Manheim Index, particularly since the Manheim Index considers all used cars, not just our subset of typically 12-month to 18-month old used cars. But it's a 2 point decline we're factoring in and I guess if Manheim operated that sort of same way it would probably translate into about a 2 point decline in Manheim but we really focus on the percentage of residual value because I can't be sure that Manheim would translate just that way.

Operator: Our final question comes from Adam Jonas with Morgan Stanley. You may ask your question.

Yejay Ying
Analyst, Morgan Stanley & Co. LLC
Q

Morning, everyone. This is Yejay in for Adam. I wanted to drill down into commercial pricing for a second, which was a headwind throughout last year. Is that a dynamic you expect to continue this year? Or given that you've been actively working to improve those renewal rates, do you expect commercial to contribute positively this year?

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.
A

Well, look, I think we're going to continue to try to push commercial rates up wherever and whenever we can. I think it's going to remain a small headwind just by virtue of the fact that not all contracts renew over the course of a year. And there are some contracts that actually are three and four years old where they're simply not at market, and we'll renew a contract in market but we're not going to take the contract down to a level where we're not going to make any money.

What I think the opportunity for us is, that will have the most immediate impact, is changing the mix of our commercial business and being more aggressive on mid-market and more aggressive on small business, both of which have higher RPDs, and will effectively average down the large commercial contract base that's sort of winding through. Having said that we're pushing wherever we can. I think something like 60% of the contracts renewed have been either flat or up on rate but we've not lost heart or initiative. We're going to continue to push because it's certainly declined in terms of profitability contribution in our revenue mix.

Yejay Ying
Analyst, Morgan Stanley & Co. LLC

Q

Got it. That is helpful. And maybe a bit more modeling related on your alternative sales channel initiatives. Can you help us think about how much benefit you expect to get from selling a car direct to dealer versus wholesale, and then maybe the same with direct to retail through your partnership with AutoNation.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

Yeah. I think on the direct-to-dealer our experience is that the increment that you're getting is really a function of avoiding fees and saving interest because your time from last revenue to sale is much shorter than it is in the traditional option. So it's something in the $300 to $400 range on an apples-to-apples basis. A 30,000 mile Ford in the auction, a 30,000 mile Ford going to the dealer.

I think on our AutoNation deal, you can take the average spread between wholesale and retail and divide it by two. I mean, we're equal partners on this, and that's about where the numbers are coming out. But what I would tell you is that at least for 2014, both of those segments are not going to amount to an enormous share of our risk car volume. If they were 10% of our total sales, I would be surprised. I mean, it could be 15%. But certainly that's the range that they're going to be in.

Yejay Ying
Analyst, Morgan Stanley & Co. LLC

Q

10% on a combined basis you mean?

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

A

Yeah. Between direct to dealer and sales to AutoNation. I mean that's – you think of the 300,000 cars we sell, the 200,000 are risk. So you're talking about 15,000 to 20,000 cars of them.

Yejay Ying
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And one final quick one on interest expense guidance. You guys mentioned that in 2014 you are expecting about $220 million of interest expense, which is going to be below roughly the $230 million that you saw in 2013. Does that guidance bake in some action regarding the refinancing of the $900 million of debt above 8% that you mentioned, or is there something else driving that?

David B. Wyshner
Chief Financial Officer and Senior Executive Vice President, Avis Budget Group, Inc.

A

The decline is primarily driven by the refinancings that we completed last year. So it doesn't, the assumption that we built in is that the 8.25% notes have become callable in October are called then. If we were to refinance any of those sooner, there would be some one-time costs associated with doing that, but it would lower our interest expense for the year.

Yejay Ying
Analyst, Morgan Stanley & Co. LLC

Q

Okay. That's very clear. Thank you.

Operator: For closing remarks, this call will be turned back over to Mr. Ronald Nelson. Please go ahead, sir.

Ronald L. Nelson
Chairman & Chief Executive Officer, Avis Budget Group, Inc.

Thanks, Kimberly. So before we close, I think it's important to reiterate what we believe are the key points from today's call. One, we had a strong 2013, overcoming the normalization of fleet costs in North America and a less than robust European economy and went on to report our second highest adjusted EBITDA ever.

Two, our integration efforts are going well and we expect to achieve higher synergy benefits in 2014 compared to the year just past. And three, while it's still early days, we're enthusiastic about the pricing that we've been able to achieve in January and February. These are exciting times in the global mobility industry which is why, as David mentioned, we're hosting our next Investor Day in New York City on Monday. The day will include presentations by all of our regional presidents, Kaye Ceille our new President of Zipcar as well as David and me. In addition, we'll also have more than a dozen members of our senior leadership team at the event for attendees to interact with during lunch. So I hope to see many of you there.

With that, I thank you for your time and your interest in our company.

Operator: This concludes today's conference call. You may disconnect at this time.