ADESA INC
Form 10-Q
November 08, 2006

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE**

**SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2006**

**Commission File Number 001-32198**

# ADESA, Inc.

(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **35-1842546** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**13085 Hamilton Crossing Boulevard**

**Carmel, Indiana 46032**

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: **(800) 923-3725**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

The number of shares of common stock outstanding as of October 31, 2006:

| Class | Number of Shares Outstanding |
|---|---|
| Common | 89,939,579 |

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**PART I**
**FINANCIAL INFORMATION**

**Item 1.** Financial Statements

**ADESA, Inc.**

**Consolidated Statements of Income**

***(In millions, except per share data)***

***(unaudited)***

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Operating revenues | | | | |
| Auction services group | **$ 236.2** | $ 208.1 | **$ 726.3** | $ 636.1 |
| Dealer services group | **36.7** | 32.9 | **108.1** | 94.1 |
| Total operating revenues | **272.9** | 241.0 | **834.4** | 730.2 |
| Operating expenses | | | | |
| Cost of services (exclusive of depreciation and amortization) | **137.8** | 116.8 | **419.7** | 346.4 |
| Selling, general and administrative | **64.7** | 57.5 | **195.4** | 168.4 |
| Depreciation and amortization | **12.1** | 10.8 | **33.9** | 30.0 |
| Total operating expenses | **214.6** | 185.1 | **649.0** | 544.8 |
| Operating profit | **58.3** | 55.9 | **185.4** | 185.4 |
| Interest expense | **7.1** | 7.4 | **21.2** | 24.0 |
| Other income, net | **(1.8)** | (2.5) | **(5.3)** | (6.3) |
| Loss on extinguishment of debt | | 2.9 | | 2.9 |
| Income from continuing operations before income taxes | **53.0** | 48.1 | **169.5** | 164.8 |
| Income taxes | **18.6** | 16.5 | **62.6** | 62.0 |
| Income from continuing operations | **34.4** | 31.6 | **106.9** | 102.8 |
| Loss from discontinued operations, net of income taxes | **(0.3)** | (0.1) | **(0.4)** | (0.4) |
| Net income | **$ 34.1** | $ 31.5 | **$ 106.5** | $ 102.4 |
| Earnings per share basic | | | | |
| Income from continuing operations | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| Loss from discontinued operations, net of income taxes | | | - | |
| Net income | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| Earnings per share diluted | | | | |
| Income from continuing operations | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| Loss from discontinued operations, net of income taxes | | | **(0.01)** | (0.01) |
| Net income | **$ 0.38** | $ 0.35 | **$ 1.18** | $ 1.13 |
| Dividends declared per common share (Note 11) | **$ 0.075** | $ 0.075 | **$ 0.225** | $ 0.225 |

See notes to consolidated financial statements

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**ADESA, Inc.**
**Consolidated Balance Sheets**
**(*In millions, except share and per share data*)**

| | September 30, 2006 (unaudited) | December 31, 2005 |
|---|---|---|
| **Assets** | | |
| ***Current assets*** | | |
| Cash and cash equivalents | **$ 211.2** | $ 240.2 |
| Restricted cash | **7.3** | 5.7 |
| Trade receivables, net of allowances of $5.8 (2006) and $3.9 (2005) | **272.1** | 188.6 |
| Finance receivables, net of allowances of $2.6 (2006) and $2.4 (2005) | **233.9** | 196.7 |
| Retained interests in finance receivables sold | **67.2** | 56.8 |
| Deferred income taxes | **19.6** | 21.6 |
| Other current assets | **15.2** | 14.5 |
| Total current assets | **826.5** | 724.1 |
| ***Other assets*** | | |
| Goodwill | **559.0** | 532.6 |
| Other intangible assets, net of accumulated amortization of $38.4 (2006) and $29.8 (2005) | **49.9** | 42.0 |
| Other assets | **64.0** | 50.9 |
| Total other assets | **672.9** | 625.5 |
| Property and equipment, net of accumulated depreciation of $180.7 (2006) and $155.2 (2005) | **606.7** | 595.9 |
| Total assets | **$ 2,106.1** | $ 1,945.5 |

See notes to consolidated financial statements

**ADESA, Inc.**
**Consolidated Balance Sheets**
**(*In millions, except share and per share data*)**

| | **September 30, 2006 (*unaudited*)** | **December 31, 2005** |
|---|---|---|
| **Liabilities and Stockholders Equity** | | |
| ***Current liabilities*** | | |
| Accounts payable | **$ 382.2** | $ 270.3 |
| Accrued employee benefits and compensation expenses | **42.0** | 35.0 |
| Other accrued expenses | **42.0** | 36.7 |
| Income taxes payable | **9.9** | 3.3 |
| Current maturities of long-term debt | **30.0** | 70.0 |
| Current liabilities of discontinued operations | **7.1** | 6.8 |
| Total current liabilities | **513.2** | 422.1 |
| ***Non-current liabilities*** | | |
| Long-term debt | **330.0** | 362.5 |
| Deferred tax liabilities | **59.7** | 63.6 |
| Other liabilities | **6.0** | 7.4 |
| Total non-current liabilities | **395.7** | 433.5 |
| Commitments and contingencies (Note 13) | | |
| ***Stockholders equity*** | | |
| Preferred stock, $0.01 par value: | | |
| Authorized shares: 50,000,000 | | |
| Issued shares: none | | |
| Common stock, $0.01 par value: | | |
| Authorized shares: 500,000,000 | | |
| Issued shares: 94,868,104 (2006 and 2005) | **1.0** | 1.0 |
| Additional paid-in capital | **672.6** | 668.3 |
| Retained earnings | **567.0** | 480.7 |
| Treasury stock, at cost: | | |
| Shares: 4,954,436 (2006) | | |
| 5,275,585 (2005) | **(104.0 )** | (110.7 ) |
| Accumulated other comprehensive income | **60.6** | 50.6 |
| Total stockholders equity | **1,197.2** | 1,089.9 |
| Total liabilities and stockholders equity | **$ 2,106.1** | $ 1,945.5 |

See notes to consolidated financial statements

**ADESA, Inc.**

**Consolidated Statement of Stockholders Equity**

***(In millions)***

***(unaudited)***

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|---|---|
| **Balance at December 31, 2005** | 94.9 | $ 1.0 | $ 668.3 | $ 480.7 | ($110.7 ) | $ 50.6 | $ 1,089.9 |
| Comprehensive income: | | | | | | | |
| Net income | | | | 106.5 | | | 106.5 |
| Other comprehensive income, net of tax: | | | | | | | |
| Foreign currency translation | | | | | | 10.2 | |
| Unrealized loss on interest rate swaps | | | | | | (0.2 ) | |
| Other comprehensive income | | | | | | | 10.0 |
| Comprehensive income | | | | | | | 116.5 |
| Cash dividends paid to stockholders | | | | (20.2 ) | | | (20.2 ) |
| Issuance of common stock under stock plans | | | (0.3 ) | | 6.8 | | 6.5 |
| Stock based compensation expense | | | 3.7 | | | | 3.7 |
| Tax benefits from employee stock plans | | | 0.9 | | | | 0.9 |
| Repurchase of common stock | | | | | (0.1 ) | | (0.1 ) |
| **Balance at September 30, 2006** | **94.9** | **$ 1.0** | **$ 672.6** | **$ 567.0** | **($104.0 )** | **$ 60.6** | **$ 1,197.2** |

See notes to consolidated financial statements

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**ADESA, Inc.**
**Consolidated Statements of Cash Flows**
***(In millions)***
***(unaudited)***

| | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| **Operating activities** | | |
| Net income | **$ 106.5** | $ 102.4 |
| **Adjustments to reconcile net income to net cash provided by operating activities:** | | |
| Depreciation and amortization | **33.9** | 30.0 |
| Bad debt expense | **3.5** | 1.8 |
| Deferred income taxes | **3.8** | 14.7 |
| Stock-based compensation expense | **4.5** | 2.2 |
| Loss on extinguishment of debt | | 2.9 |
| Other non-cash, net | **2.4** | 2.7 |
| | **154.6** | 156.7 |
| **Changes in operating assets and liabilities, net of acquisitions:** | | |
| Finance receivables held for sale | **(8.5)** | (24.6) |
| Retained interests in finance receivables sold | **(10.4)** | (6.9) |
| Trade receivables and other assets | **(82.3)** | (90.5) |
| Accounts payable and accrued expenses | **71.0** | 70.3 |
| **Net cash provided by operating activities** | **124.4** | 105.0 |
| **Investing activities** | | |
| Net increase in finance receivables held for investment | **(27.3)** | (4.5) |
| Acquisition of businesses, net of cash acquired | **(54.7)** | (18.7) |
| Purchases of property, equipment and computer software | **(24.2)** | (47.8) |
| Purchase of other intangibles | **(0.6)** | (1.0) |
| Proceeds from the sale of property, equipment and computer software | | 0.1 |
| Proceeds from the sale of discontinued operations | | 3.3 |
| Equity investments | **(12.6)** | |
| Transfer to restricted cash | **(1.6)** | (0.7) |
| **Net cash used by investing activities** | **(121.0)** | (69.3) |
| **Financing activities** | | |
| Net increase in book overdrafts | **53.4** | 51.1 |
| Net (decrease) increase in borrowings from lines of credit | **(50.0)** | 158.0 |
| Payments on long-term debt | **(22.5)** | (364.0) |
| Proceeds from long-term debt | | 150.0 |
| Payments for debt issuance costs | | (1.7) |
| Issuance of common stock under stock plans | **6.3** | 9.5 |
| Excess tax benefits from share-based compensation | **0.2** | |
| Dividends paid to stockholders | **(20.2)** | (20.2) |
| Repurchase of common stock | **(0.1)** | (43.5) |
| **Net cash used by financing activities** | **(32.9)** | (60.8) |
| Effect of exchange rate changes on cash | **0.5** | 1.0 |
| **Net decrease in cash and cash equivalents** | **(29.0)** | (24.1) |
| Cash and cash equivalents at beginning of period | **240.2** | 304.5 |
| Cash and cash equivalents at end of period | **$ 211.2** | $ 280.4 |

See notes to consolidated financial statements

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**ADESA, Inc.**
**Notes to Consolidated Financial Statements**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Summary of Significant Accounting Policies**

***Basis of Presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. In the opinion of management, the consolidated financial statements reflect all adjustments considered necessary (consisting of normal recurring accruals) for a fair statement of the Company s financial results for the periods presented. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures at the date of the financial statements and during the reporting period. Actual results could differ from these estimates. A listing of the Company s critical accounting estimates is described in the Critical Accounting Estimates section of Management s Discussion and Analysis of Financial Condition and Results of Operations in this Form 10-Q and in Part II, Item 7, Note 3 and elsewhere in the Notes to the Consolidated Financial Statements included in the Company s 2005 Annual Report on Form 10-K, which includes audited financial statements.

These consolidated financial statements and condensed notes to consolidated financial statements are unaudited and should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2005 included in the Company s Annual Report on Form 10-K (Commission file number 001-32198) filed with the Securities and Exchange Commission ( SEC ). The 2005 year-end consolidated balance sheet data included in this Form 10-Q was derived from the audited financial statements referenced above, but does not include all disclosures required by accounting principles generally accepted in the United States of America. As used herein, the terms the Company and ADESA shall mean ADESA, Inc. and its consolidated subsidiaries. The term ALLETE shall mean ADESA s former parent, ALLETE, Inc. and its consolidated subsidiaries.

ADESA is the second largest used vehicle auction network in North America, based upon the number of used vehicles sold through auctions annually, and also provides services such as inbound and outbound logistics, reconditioning, vehicle inspection and certification, titling, administrative and salvage recovery services. Through its wholly owned subsidiary Automotive Finance Corporation ( AFC ), the Company also provides short-term inventory-secured financing, known as floorplan financing, to used vehicle dealers. ADESA is able to serve the diverse and multi-faceted needs of its customers through the wide range of services offered at its facilities.

Included in the results for the nine months ended September 30, 2006, was a $2.7 million pretax charge incurred in the first quarter of 2006, or $0.02 per diluted share, related to the correction of certain unreconciled balance sheet differences concealed by a former employee at the Company s Kitchener, Ontario, auction facility. The corrections were recorded in Selling, general and administrative expenses and decreased net income for the nine months ended September 30, 2006 by a total of $1.7 million.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

***Reclassifications and Revisions***

Certain prior year amounts in the consolidated financial statements have been reclassified or revised to conform to the current year presentation.

***Discontinued Operations***

In February 2003, management approved a plan to discontinue the operations of the Company s vehicle importation business. In August 2005, ADESA sold ComSearch, Inc. The financial results of the vehicle importation business and ComSearch have been reclassified as discontinued operations for all periods presented.

***Revisions Related to Cash Flows from Finance Receivables***

AFC sells the majority of its U.S. dollar denominated finance receivables on a revolving basis and without recourse to a wholly owned, bankruptcy remote, consolidated, special purpose subsidiary ( AFC Funding Corporation ). AFC Funding Corporation securitizes a portion of its floorplan receivables using a revolving securitization structure. The securitization agreement allows for the revolving sale of undivided interests in certain eligible finance receivables by AFC Funding Corporation to a bank conduit facility.

Prior to December 31, 2005, ADESA reported an increase or decrease in operating cash flows in the Consolidated Statements of Cash Flows related to the origination and collection of certain finance receivables that were held for investment. This cash flow treatment followed AFC s principal operating activity, originating and servicing floorplan receivables; however, according to Statement of Financial Accounting Standards ( SFAS ) No. 102, *Statement of Cash Flows Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*, cash receipts and cash payments related to finance receivables held for investment should be classified within investing activities in the Consolidated Statements of Cash Flows. Cash flows related to the origination and collections of finance receivables held for investment are recorded in investing activities in the Consolidated Statements of Cash Flows.

The Company has revised its presentation of the cash flows from finance receivables held for investment in its Consolidated Statements of Cash Flows prospectively for the comparable quarterly periods in 2005 in its 2006 quarterly reports on Form 10-Q. Prior to December 31, 2005, the cash flows arising in connection with changes in finance receivables held for investment were reported as operating cash flows. These cash flows are now reported as investing cash flows. The amounts revised were deemed immaterial to the Company s prior financial statements. These revisions had no impact on the total Net (decrease) increase in cash and cash equivalents on the Consolidated Statements of Cash Flows. Operating and investing cash flows for the unaudited interim period in 2005 have been revised as follows:

| | Nine Months Ended September 30, 2005 | |
|---|---|---|
| | **Reported** | **Revised** |
| Operating cash flow | $ 100.5 | $ 105.0 |
| Investing cash flow | $ (64.1 ) | $ (69.3 ) |

The revisions also include reclassifications to operating cash flows of insignificant amounts related to presentation of the financial results of the Company s former vehicle importation business as discontinued operations.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

***Other Assets***

Other assets consist of investments held to maturity, debt issuance costs, notes receivable, deposits, cost and equity method investments and other long-term assets. In February 2006, AFC acquired a 15 percent interest in Finance Express LLC for $12.5 million in cash. Finance Express is a financial software and services company specializing in software to facilitate the origination and servicing of motor vehicle retail installment loan contracts between independent used vehicle dealers and lending institutions. In addition, the Company also receives certain fees from Finance Express for assistance in marketing its software product and services to independent used vehicle dealers. The Company evaluated its investment in Finance Express pursuant to Financial Accounting Standards Board Interpretation No. 46R, *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*. The Company is currently not the primary beneficiary of the VIE and its risk of loss is limited, in all material respects, to its investment in Finance Express. Finance Express is a LLC that maintains specific capital accounts for each member. Therefore, the Company uses the equity method of accounting for this investment in accordance with the guidance in Emerging Issues Task Force ( EITF ) 03-16, *Accounting for Investments in Limited Liability Companies*, Statement of Position ( SOP ) 78-9, *Accounting for Investments in Real Estate Ventures*, and SAB Topic D-46, *Accounting for Limited Partnership Investments*. The Company s share of Finance Express earnings or losses is recorded in Other income, net in the Consolidated Statements of Income and was not material for the three or nine month periods ended September 30, 2006.

***Stock-Based Compensation***

Prior to 2006, ADESA applied the intrinsic value method provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, to account for stock-based awards. Accordingly, the Company did not recognize compensation expense for employee stock options that were granted in prior years. However, compensation expense was recognized on other forms of stock-based awards, including restricted stock units and performance based stock awards. On January 1, 2006, the Company adopted the provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective application method, and therefore was not required to restate its financial results for prior periods. Under this method, as of January 1, 2006, ADESA began to apply the provisions of this statement to new and modified awards, as well as to the nonvested portion of awards granted and outstanding before the Company s adoption.

The Company s stock-based compensation awards, including both stock options and restricted stock units, have a retirement eligible provision, whereby awards granted to employees who have reached the retirement eligible age and meet certain service requirements with either ADESA and/or its former parent, ALLETE, automatically vest when an eligible employee retires from the Company. The Company has previously accounted for this type of arrangement by recognizing compensation cost (for both pro forma and recognition purposes) over the nominal vesting period (i.e., over the full stated vesting period of the award) and, if the employee retired before the end of the vesting period, by recognizing any remaining unrecognized compensation cost at the date of retirement. Following adoption of SFAS 123(R), new awards are subject to the non-substantive vesting period approach, which specifies that an award is vested when the employee s retention of the award is no longer contingent on providing subsequent service. Recognizing that many companies followed the nominal vesting period, the SEC issued guidance for converting to the non-substantive vesting period approach. The Company has revised its approach to apply the non-substantive vesting period approach to all new grants after adoption, but continues to follow the

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

nominal vesting period approach for the remaining portion of unvested outstanding awards. An additional requirement of SFAS 123(R) is that estimated forfeitures be considered in determining compensation expense. As previously permitted, the Company recorded forfeitures when they occurred. Estimating forfeitures did not have a material impact on the determination of compensation expense.

On March 9, 2005, the board of directors (the board ) of the Company accelerated the vesting of certain unvested and out-of-the-money stock options previously awarded to employees and officers that have an exercise price of $24 per share. The awards accelerated were made under the ADESA, Inc. 2004 Equity and Incentive Plan in conjunction with ADESA s initial public offering ( IPO ) in June 2004. As a result, options to purchase approximately 2.9 million shares of the Company s common stock became exercisable immediately and the Company disclosed incremental pro forma stock-based employee compensation expense of approximately $7.7 million, net of tax, in the first quarter 2005. The options awarded in conjunction with the IPO to the Company s named executive officers and the majority of the other officers would have vested in equal increments at June 15, 2005, 2006 and 2007. The options awarded to certain other executive officers and employees had different vesting terms. One-third of the options awarded to the other executive officers and employees vested on December 31, 2004. The remaining two-thirds of the options awarded to these executive officers and other employees in conjunction with the IPO would have vested in equal increments at December 31, 2005 and 2006. All of these options expire in June 2010. All other terms and conditions applicable to the outstanding stock option grants remain in effect.

The Company and its board considered several factors in determining to accelerate the vesting of these options. Primarily, the acceleration enhances the comparability of the Company s 2005 financial statements with those of 2006 and subsequent periods. The options awarded to the executive officers were special, one-time grants in conjunction with the Company s IPO. As such, these grants are not indicative of past grants when ADESA was a subsidiary of ALLETE prior to June 2004 and are not representative of the Company s expected future grants. The Company and board also believe that the acceleration was in the best interest of the stockholders as it reduces the Company s reported stock option expense in future periods mitigating the impact of applying SFAS 123(R).

As a result of adopting SFAS 123(R) on January 1, 2006, income from continuing operations before income taxes and net income for the nine months ended September 30, 2006, were $2.6 million and $1.6 million lower, respectively, than if the Company had continued to account for share-based awards under APB Opinion No. 25. Basic and diluted earnings per share from continuing operations were both $0.03 lower for the nine months ended September 30, 2006 as a result of the adoption of SFAS 123(R).

Prior to the adoption of SFAS 123(R), tax benefits of deductions resulting from the exercise of stock options were presented as operating cash flows in the Consolidated Statements of Cash Flows. SFAS 123(R) requires cash flows resulting from tax deductions from the exercise of stock options in excess of recognized compensation cost (excess tax benefits) to be classified as financing cash flows. This change in classification did not have a significant impact on the Consolidated Statement of Cash Flows in the current period as the excess tax benefits recognized for the nine months ended September 30, 2006 were approximately $0.2 million.

Prior to the adoption of SFAS 123(R), the Company applied the disclosure-only provisions of SFAS 123, *Accounting for Stock-Based Compensation*, as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, which permitted companies to apply the existing accounting rules under APB Opinion No. 25 and related interpretations. Generally, if the exercise price of options

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

granted under the plan was equal to the market price of the underlying common stock on the grant date, no share-based compensation cost was recognized in net income. As required by SFAS 148, prior to the adoption of SFAS 123(R), pro forma net income and pro forma net income per common share were provided for stock-based awards, as if the fair value recognition provisions of SFAS 123 had been applied.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to all stock-based employee awards in fiscal year 2005. The fair value of stock options was estimated as of the grant date using the Black-Scholes option-pricing model and the attribution method. The Black-Scholes option-pricing model does not consider the non-traded nature of employee stock options, the lack of transferability or a vesting period. If the model took these items into consideration, the resulting estimate for fair value of the stock options could be different. In addition, because of the change to the non-substantive vesting period approach, the application of estimated forfeitures, the acceleration of vesting of underwater IPO stock options, the fact that the Company s options vest over three years and additional option grants are expected to be made subsequent to January 1, 2006, the results of expensing stock-based awards under SFAS 123(R) may have a materially different affect on net income in future periods than that presented below.

| **(in millions except per share amounts)** | **Three Months Ended September 30, 2005** | **Nine Months Ended September 30, 2005** |
|---|---|---|
| Reported net income | $ 31.5 | $ 102.4 |
| Add: stock-based employee compensation included in reported net income, net of tax (1) | 0.4 | 1.1 |
| Deduct: total stock-based employee compensation expense, net of tax | (0.8 ) | (12.2 ) |
| Pro forma net income | $ 31.1 | $ 91.3 |
| Earnings per share: | | |
| Basic as reported | $ 0.35 | $ 1.14 |
| Basic pro forma | $ 0.35 | $ 1.01 |
| Diluted as reported | $ 0.35 | $ 1.13 |
| Diluted pro forma | $ 0.35 | $ 1.01 |

(1) Reported amounts include expense associated with restricted stock units and performance share awards.

***New Accounting Standards***

In March 2006, the FASB issued SFAS 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140*. SFAS 156 requires recognition of a servicing asset or liability at fair value each time an obligation is undertaken to service a financial asset by entering into a servicing contract. The standard also provides guidance on subsequent measurement methods for each class of servicing assets and liabilities and specifies financial statement presentation and disclosure requirements. SFAS 156 is effective for fiscal years beginning after September 15, 2006. The Company will adopt SFAS 156 on January 1, 2007, and is currently evaluating the impact the adoption of SFAS 156 will have on the consolidated financial statements.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

In July 2006, the FASB released Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No 109* ( FIN 48 ). FIN 48 clarifies the accounting and reporting for uncertainty in income taxes recognized in an enterprise s financial statements. This interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken on income tax returns. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company will adopt FIN 48 on January 1, 2007, and is currently evaluating the impact the adoption of FIN 48 will have on the consolidated financial statements. The cumulative effects, if any, of applying this Interpretation will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. The statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This standard is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of SFAS 157 will have on the consolidated financial statements.

**Note 2 Stock-Based Compensation**

***Equity and Incentive Plan***

Certain key employees of the Company and its subsidiaries participate in the ADESA, Inc. 2004 Equity and Incentive Plan ( the Plan ). The maximum number of shares reserved for the grant of awards under the 2004 Equity and Incentive Plan is 8.5 million. There were approximately 2.7 million remaining shares available for grant under the Plan on September 30, 2006. The Plan provides for the grant of incentive stock options and non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units and other stock-based awards. To date, the grants have taken the form of stock options, restricted stock and restricted stock units.

The Company currently uses its treasury stock to satisfy stock option exercises and stock distributions. At September 30, 2006, the Company holds 4,954,436 shares of treasury stock, and therefore does not expect to be required to purchase additional shares in fiscal 2006 to satisfy stock option exercises and stock distributions.

The compensation cost that was charged against income for all plans was $4.5 million and $1.9 million for the nine months ended September 30, 2006 and 2005. The total income tax benefit recognized in the Consolidated Statements of Income for stock compensation agreements was approximately $1.7 million and $0.8 million for the nine months ended September 30, 2006 and 2005. Had the Company followed SFAS 123 rather than APB Opinion No. 25, an additional $11.1 million of compensation expense, net of tax, would have been recorded for the nine months ended September 30, 2005 (as disclosed in the pro forma information in Note 1). The Company did not capitalize any stock-based compensation cost in the nine months ended September 30, 2006.

***Stock Options***

Stock options may be granted under the Plan at an exercise price of not less than the fair market value of a share of ADESA common stock on the date of grant and generally vest in equal annual installments over three years with expiration not to exceed six years from the date of grant. The weighted average fair value of options granted was $8.54 and $7.36 per share for the first nine months of 2006 and 2005,

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

respectively. The fair value of stock options granted was estimated on the date of grant using the Black-Scholes option pricing model and the following assumptions:

| Assumptions | 2006 | 2005 |
|---|---|---|
| Risk-free interest rate | **4.6 5.0 %** | 3.6 % |
| Expected life years | **4** | 4 |
| Expected volatility | **38.0 %** | 41.0 % |
| Dividend yield | **1.15 1.18 %** | 1.34 % |

*Risk-free interest rate* *This* is the yield on U.S. Treasury Securities posted at the date of grant having a term equal to the expected life of the option. An increase in the risk-free interest rate will increase compensation expense.

*Expected life years* *This* is the period of time over which the options granted are expected to remain outstanding. Options granted by ADESA have a maximum term of six years, while the options converted from ALLETE to ADESA have a maximum term of ten years. An increase in the expected life will increase compensation expense.

*Expected volatility* *Actual* changes in the market value of the Company s stock are used to calculate the volatility assumption. Based on the Company s limited time as a publicly traded company, a combination of historical volatility and the volatility of its comparable peer group was used to calculate expected volatility. An increase in the expected volatility will increase compensation expense.

*Dividend yield* *This* is the annual rate of dividends per share over the exercise price of the option. An increase in the dividend yield will decrease compensation expense.

The following table summarizes stock option activity for the nine months ended September 30, 2006:

| ***Options*** | **Number** | **Weighted Average Exercise Price** | **Weighted Average Remaining Contractual Term** | **Aggregate Intrinsic Value (in millions)** |
|---|---|---|---|---|
| Outstanding at January 1, 2006 | 4,482,953 | $ 22.09 | | |
| Granted | 338,507 | $ 25.99 | | |
| Exercised | (288,637 ) | $ 21.20 | | |
| Forfeited or cancelled | (231,068 ) | $ 23.89 | | |
| Outstanding at September 30, 2006 | 4,301,755 | $ 22.36 | 4.2 | $ 6.5 |
| Exercisable at September 30, 2006 | 3,590,746 | $ 22.03 | 4.1 | $ 6.3 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on ADESA s closing stock price of $23.11 on September 30, 2006, that would have been received by the option holders had all option holders exercised their options as of that date. This amount changes continuously based on the fair value of the Company s stock. The total intrinsic value of options exercised during the nine months ended September 30, 2006 and 2005 was $1.0 million and $6.3 million. The fair value of all vested and exercisable shares at September 30, 2006 and 2005 was $83.0 million and $86.8 million.

As of September 30, 2006, there was approximately $3.2 million of total unrecognized compensation expense related to stock options granted which is expected to be recognized over a weighted average term

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

of 2.0 years. This unrecognized compensation expense only includes the cost for those options expected to vest, as the Company estimated expected forfeitures in accordance with SFAS 123(R). When estimating forfeitures, the Company considers voluntary and involuntary termination behavior as well as actual forfeitures. An increase in estimated forfeitures would decrease compensation expense.

***Restricted Stock Units***

The fair value of restricted stock units ( RSUs ) is the value of ADESA s stock at the date of grant, which have ranged between $15.60 and $26.17 per share. The grants are contingent upon continued employment and vest over periods ranging from one to three years. Dividends, payable in stock, accrue on a portion of the grants and are subject to the same specified terms as the original grants. As of September 30, 2006, a total of 3,444 stock units have accumulated on nonvested RSUs due to dividend reinvestment.

The following table summarizes RSU activity, excluding dividend reinvestment units, for the nine months ended September 30, 2006:

| ***Restricted Stock Units*** | **Number** | **Weighted Average Grant Date Fair Value** |
|---|---|---|
| RSUs at January 1, 2006 | 227,769 | $ 23.34 |
| Granted | 78,511 | $ 26.00 |
| Vested | (10,704 ) | $ 21.08 |
| Forfeited or cancelled | (19,082 ) | $ 23.83 |
| RSUs at September 30, 2006 | 276,494 | $ 24.15 |

As of September 30, 2006, there was $2.5 million of total unrecognized compensation expense related to nonvested RSUs granted which is expected to be recognized over a weighted average term of 1.6 years. The fair value of shares vested during the nine months ended September 30, 2006 was $0.2 million.

***Performance Based Restricted Stock Units***

The Company s 2006 long-term incentive plan includes performance based restricted stock units whose future award is contingent upon annual 2006 income from continuing operations performance. If applicable, the date of grant will occur in February 2007 and the fair value of the RSUs will be the value of ADESA s stock at the date of grant. The potential grants will also be contingent upon continued employment and would vest 33 percent in February 2008, 33 percent in February 2009 and 34 percent in February 2010. The Company has accrued $0.8 million, pretax, at September 30, 2006 for the performance based RSUs. The amount is included in Accrued employee benefits and compensation expenses on the Consolidated Balance Sheet. Based on current performance and forfeiture rate assumptions, the Company expects to accrue an additional $0.3 million, pretax, in fiscal 2006.

**Note 3 Acquisitions**

In February 2006, the Company completed the purchase of certain assets of the N.E. Penn Salvage Company, an independently owned salvage auction in northeast Pennsylvania. The purchased assets included the accounts receivables, operating equipment and customer relationships related to the auction. In addition, the Company entered into operating lease obligations related to the facility through 2016. Initial annual lease payments for the facilities total approximately $0.1 million per year. The Company did

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

not assume any other material liabilities or indebtedness in connection with the acquisition. Financial results for this acquisition have been included in the Company s consolidated financial statements since the date of acquisition.

In March 2006, the Company completed the acquisition of certain assets of Auction Broadcasting Company s South Tampa used vehicle auction serving western and central Florida. The Company has renamed the auction ADESA Sarasota. The assets purchased included land and buildings, the related operating equipment, accounts receivable and customer relationships related to the auction. The auction is comprised of approximately 63 acres and includes six auction lanes and full-service reconditioning shops providing detail, mechanical and body shop services. The Company did not assume any material liabilities or indebtedness in connection with the acquisition. Financial results for this acquisition have been included in the Company s consolidated financial statements since the date of acquisition.

In September 2006, the Company acquired three independent salvage auctions in the state of Texas, providing the Company a presence in the second largest salvage market in the U.S. The auctions have been renamed ADESA Impact San Antonio, ADESA Impact Houston and ADESA Impact Dallas/Ft. Worth. The assets purchased included operating equipment, accounts receivable and customer relationships related to the auctions. In addition, the Company entered into operating lease obligations related to the facilities through 2011. Initial annual lease payments for the facilities total approximately $1.2 million per year. The Company did not assume any other material liabilities or indebtedness in connection with the acquisition. Financial results for these acquisitions have been included in the Company s consolidated financial statements since the date of acquisition.

ADESA acquired the five previously mentioned auctions for a total cost of $54.3 million, in cash. Preliminary purchase price allocations have been recorded for each acquisition. The purchase price of the acquisitions was allocated to the acquired assets based upon fair market values, including $12.8 million to other intangible assets, representing the fair value of acquired customer relationships and non-compete agreements, which will be amortized over their expected useful lives of 3 to 15 years. The preliminary purchase price allocations resulted in aggregate goodwill of $23.2 million. The goodwill was assigned to the auction services group reporting segment and is expected to be fully deductible for tax purposes. The Company expects to finalize the purchase price allocations related to each of the acquisitions upon receipt and analysis of third party valuations. Pro forma financial results reflecting the acquisitions were not materially different from those reported.

**Note 4 Long-Term Debt**

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

| | Interest Rate | | Maturity | September 30, 2006 | December 31, 2005 |
|---|---|---|---|---|---|
| Term Loan A | LIBOR + 1.00 | % | 06/30/2010 | **$ 112.5** | $ 135.0 |
| $350 million revolving credit facility | LIBOR + 1.00 | % | 06/30/2010 | **88.0** | 138.0 |
| Atlanta capital lease obligation | 5.0 | % | 12/01/2013 | **34.5** | 34.5 |
| Senior subordinated notes | 7⅝ | % | 06/15/2012 | **125.0** | 125.0 |
| Canadian line of credit | Prime + 0.25 | % | 12/31/2006 | | |
| Total debt | | | | **360.0** | 432.5 |
| Less current portion of long-term debt | | | | **30.0** | 70.0 |
| Long-term debt | | | | **$ 330.0** | $ 362.5 |

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**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

On July 25, 2005, the Company entered into a $500 million credit facility, pursuant to the terms and conditions of an amended and restated credit agreement (the Credit Agreement ) with Bank of America, N.A., as administrative agent, and a syndicate of lenders. The Credit Agreement provides for a five year $150 million term loan and a $350 million revolving credit facility. Letters of credit reducing the available line of credit were $14.6 million at September 30, 2006. Contractual debt obligations over the next twelve months are limited to principal payments totaling $30 million on the Company s Term Loan A. The credit facility is guaranteed by substantially all of the Company s material domestic subsidiaries (excluding, among others, AFC Funding Corporation), and is secured by a pledge of all of the equity interests in the guarantors and a pledge of 65 percent of certain capital interests of the Company s Canadian subsidiaries.

The Credit Agreement contains certain restrictive loan covenants, including, among others, financial covenants requiring a maximum total leverage ratio, a minimum interest coverage ratio, and a minimum fixed charge coverage ratio and covenants limiting ADESA s ability to incur indebtedness, grant liens, make acquisitions, be acquired, dispose of assets, pay dividends, repurchase stock, make capital expenditures and make investments. EBITDA (earnings before interest expense, income taxes, depreciation and amortization) adjusted to exclude after-tax (a) gains or losses from asset sales; (b) temporary gains or losses on currency; (c) certain non-recurring gains and losses; (d) stock option expense; and (e) certain other noncash amounts included in the determination of net income, is utilized in the calculation of the financial ratios contained in the covenants. In addition, the senior subordinated notes contain certain financial and operational restrictions on paying dividends and other distributions, making certain acquisitions or investments and incurring indebtedness, and selling assets. At September 30, 2006, the Company was in compliance with the covenants contained in both the credit facility and the senior subordinated notes.

**Note 5 Derivatives**

The Company uses interest rate swap agreements to manage its exposure to interest rate movements and to reduce borrowing costs. In June 2004, the Company entered into an interest rate swap agreement with a notional amount of $105 million to manage its exposure to interest rate movements on its variable rate debt. The interest rate swap agreement contains amortizing provisions and matures in December 2006. In November 2005, the Company entered into an interest rate swap agreement with a notional amount of $40 million to manage its exposure to interest rate movements on its variable rate credit facility. The swap matures in May 2008.

The Company designates its interest rate swap agreements as cash flow hedges. The fair value of the interest rate swap agreements is estimated using pricing models widely used in financial markets and represents the estimated amount the Company would receive or pay to terminate the agreements at the reporting date. At September 30, 2006, the fair value of the interest rate swap agreements was a $0.5 million gain recorded in Other assets on the Consolidated Balance Sheet. At December 31, 2005, the fair value of the interest rate swap agreements consisted of a $0.9 million gain recorded in Other assets and a $0.1 million loss recorded in Other liabilities on the Consolidated Balance Sheet. Changes in the fair value of the interest rate swap agreements designated as cash flow hedges are recorded in Other comprehensive income . Unrealized gains or losses on interest rate swap agreements are included as a component of Accumulated other comprehensive income . At September 30, 2006, there was a net unrealized gain totaling $0.3 million, net of taxes of $0.2 million. At December 31, 2005, there was a net unrealized gain totaling $0.5 million, net of taxes of $0.3 million.

**Note 6 Finance Receivables**

AFC sells the majority of its U.S. dollar denominated finance receivables on a revolving basis and without recourse to a wholly owned, bankruptcy remote, consolidated, special purpose subsidiary ( AFC Funding Corporation ), established for the purpose of purchasing AFC s finance receivables. Effective

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

March 31, 2006, AFC and AFC Funding Corporation amended their securitization agreement to extend the expiration date of the agreement from June 30, 2008 to April 30, 2009. This agreement is subject to annual renewal of short-term liquidity by the liquidity providers and allows for the revolving sale by AFC Funding Corporation to a bank conduit facility of up to a maximum of $600 million in undivided interests in certain eligible finance receivables subject to committed liquidity. AFC Funding Corporation had committed liquidity of $550 million and $425 million at September 30, 2006 and December 31, 2005, respectively. Receivables that AFC Funding sells to the bank conduit facility qualify for sales accounting for financial reporting purposes pursuant to SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities,* and as a result are not reported on the Company s Consolidated Balance Sheet.

At September 30, 2006, AFC managed total finance receivables of $786.7 million, of which $699.8 million had been sold without recourse to AFC Funding Corporation. At December 31, 2005, AFC managed total finance receivables of $655.7 million, of which $581.9 million had been sold without recourse to AFC Funding Corporation. Undivided interests in finance receivables were sold by AFC Funding Corporation to the bank conduit facility with recourse totaling $483.0 million and $399.8 million at September 30, 2006 and December 31, 2005, respectively. Finance receivables include $74.2 million and $51.1 million classified as held for sale and $162.3 million and $148.0 million classified as held for investment at September 30, 2006 and December 31, 2005, respectively. AFC s allowance for losses of $2.6 million and $2.4 million at September 30, 2006 and December 31, 2005, respectively, include an estimate of losses for finance receivables. Additionally, accrued liabilities of $4.8 million and $2.9 million for the estimated losses for loans sold by the special purpose subsidiary were recorded at September 30, 2006 and December 31, 2005, respectively. These loans were sold to a bank conduit facility with recourse to the special purpose subsidiary and will come back on the balance sheet of the special purpose subsidiary at fair market value if they become ineligible under the terms of the collateral arrangement with the bank conduit facility.

Proceeds from the revolving sale of receivables to the bank conduit facility were used to fund new loans to customers. AFC and AFC Funding Corporation must maintain certain financial covenants including, among others, limits on the amount of debt AFC can incur, minimum levels of tangible net worth, and other covenants tied to the performance of the finance receivables portfolio. The securitization agreement also incorporates the financial covenants of ADESA s credit facility. At September 30, 2006, the Company was in compliance with the covenants contained in the securitization agreement.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

**Note 7 Earnings Per Share**

The following table sets forth the computation of earnings per share *(in millions except per share amounts)*:

| | Three Months Ended September 30, 2006 | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|---|---|
| Income from continuing operations | **$ 34.4** | $ 31.6 | **$ 106.9** | $ 102.8 |
| Loss from discontinued operations, net of income taxes | **(0.3 )** | (0.1 ) | **(0.4 )** | (0.4 ) |
| Net income | **$ 34.1** | $ 31.5 | **$ 106.5** | $ 102.4 |
| Weighted average common shares outstanding | **89.90** | 89.53 | **89.84** | 89.97 |
| Effect of dilutive stock options and restricted stock awards | **0.32** | 0.44 | **0.37** | 0.46 |
| Weighted average common shares outstanding and assumed conversions | **90.22** | 89.97 | **90.21** | 90.43 |
| **Earnings per share basic** | | | | |
| Income from continuing operations | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| Loss from discontinued operations, net of income taxes | | | | |
| Net income | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| **Earnings per share diluted** | | | | |
| Income from continuing operations | **$ 0.38** | $ 0.35 | **$ 1.19** | $ 1.14 |
| Loss from discontinued operations, net of income taxes | | | **(0.01 )** | (0.01 ) |
| Net income | **$ 0.38** | $ 0.35 | **$ 1.18** | $ 1.13 |

Basic earnings per share were calculated based upon the weighted-average number of outstanding common shares for the period. Diluted earnings per share were calculated consistent with basic earnings per share including the effect of dilutive unissued common shares related to the Company s stock-based employee compensation programs. Total options outstanding at September 30, 2006 and 2005 were 4.3 million and 4.6 million. Stock options with an exercise price per share greater than the average market price per share were excluded from the calculation of diluted earnings per share for all periods presented as including these options would have an anti-dilutive impact. Approximately 3.6 million and 3.1 million options were excluded from the calculation of diluted earnings per share for the quarters ended September 30 and 2006 and 2005, respectively. For the nine months ended September 30, 2006 and 2005, approximately 3.0 million and 3.1 million options were excluded from the calculation of diluted earnings per share. The Company s policy for calculating the potential windfall tax benefit or shortfall for the purpose of calculating assumed proceeds under the treasury stock method excludes the impact of pro forma deferred tax assets related to partially or fully vested awards on the date of adoption.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

**Note 8 Comprehensive Income**

The components of comprehensive income are as follows (*in millions*):

| | Three Months Ended September 30, 2006 | 2005 | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|---|---|
| Net income | **$ 34.1** | $ 31.5 | **$ 106.5** | $ 102.4 |
| Other comprehensive income, net of tax | | | | |
| Foreign currency translation gain (loss) | **(0.3 )** | 12.5 | **10.2** | 7.8 |
| Unrealized gain (loss) on interest rate swaps | **(0.4 )** | | **(0.2 )** | 0.7 |
| Comprehensive income | **$ 33.4** | $ 44.0 | **$ 116.5** | $ 110.9 |

The composition of Accumulated other comprehensive income at September 30, 2006 and December 31, 2005 was the net unrealized gains or losses on interest rate swaps of $0.3 million and $0.5 million and foreign currency translation adjustments of $60.3 million and $50.1 million, respectively.

**Note 9 Segment Information**

During the second quarter of 2006, the Company implemented several organizational realignment and management changes intended to better position the Company to serve its diverse customer bases, accommodate anticipated growth and realize operational efficiencies across all business lines. The former auction and related services or ARS segment is now referred to as Auction Services Group ( ASG ). ASG encompasses all wholesale and salvage auctions throughout North America (U.S. and Canada). The former dealer financing segment is now referred to as Dealer Services Group ( DSG ). DSG is the umbrella group that was formed to include the Automotive Finance Corporation ( AFC ) finance business as well as other businesses and ventures the Company may enter into, focusing on providing the Company s independent used vehicle dealer customers with value-added ancillary services and products.

Prior to the second quarter of 2006, the Company s operations were grouped into four operating segments: U.S. used vehicle auctions, Canada used vehicle auctions, Impact salvage auctions and AFC and aggregated into two reportable business segments: auction and related services and dealer financing. Prior to the second quarter of 2006, the used vehicle auction operating segment consisted of two operating segments (U.S. used vehicle auctions and Canada used vehicle auctions). As a result of the realignment, the Company combined the U.S. and Canadian used vehicle auctions into one operating segment. As of the second quarter of 2006, the Company aggregates its three operating segments (used vehicle auctions, Impact salvage auctions and AFC) into two reportable business segments: ASG and DSG. The realignment had no impact on aggregation of financial information at the reportable segment level.

The holding company is maintained separately from the two reportable segments and includes expenses associated with being a public company, such as salaries, benefits, and travel costs for the corporate management team, board of directors fees, investor relations costs, and incremental insurance, treasury, legal, accounting, and risk management costs. Holding company interest includes the interest incurred on the corporate debt structure. The majority of costs incurred at the holding company are not allocated to the two business segments.

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

Financial information regarding the Company s reportable segments is set forth below *(in millions)*:

| | Auction Services Group | Dealer Services Group | Holding Company | Consolidated |
|---|---|---|---|---|
| **Three Months Ended September 30, 2006** | | | | |
| Operating revenues | $ 236.2 | $ 36.7 | $ | $ 272.9 |
| Operating expenses | | | | |
| Cost of services (exclusive of depreciation and amortization) | 131.5 | 6.3 | | 137.8 |
| Selling, general and administrative | 53.8 | 5.1 | 5.8 | 64.7 |
| Depreciation and amortization | 11.0 | 0.9 | 0.2 | 12.1 |
| Total operating expenses | 196.3 | 12.3 | 6.0 | 214.6 |
| Operating profit (loss) | 39.9 | 24.4 | (6.0 ) | 58.3 |
| Interest expense | 1.1 | | 6.0 | 7.1 |
| Other (income) expense, net | (1.7 ) | 0.3 | (0.4 ) | (1.8 ) |
| Income (loss) from continuing operations before income taxes | 40.5 | 24.1 | (11.6 ) | 53.0 |
| Income taxes | 15.7 | 7.2 | (4.3 ) | 18.6 |
| Income (loss) from continuing operations | $ 24.8 | $ 16.9 | $ (7.3 ) | $ 34.4 |
| Assets | $ 1,743.8 | $ 387.4 | $ (25.1 ) | $ 2,106.1 |
| **Three Months Ended September 30, 2005** | | | | |
| Operating revenues | $ 208.1 | $ 32.9 | $ | $ 241.0 |
| Operating expenses | | | | |
| Cost of services (exclusive of depreciation and amortization) | 110.5 | 6.3 | | 116.8 |
| Selling, general and administrative | 47.4 | 5.3 | 4.8 | 57.5 |
| Depreciation and amortization | 9.6 | 1.0 | 0.2 | 10.8 |
| Total operating expenses | 167.5 | 12.6 | 5.0 | 185.1 |
| Operating profit (loss) | 40.6 | 20.3 | (5.0 ) | 55.9 |
| Interest expense | 1.0 | | 6.4 | 7.4 |
| Other income, net | (1.2 ) | (0.2 ) | (1.1 ) | (2.5 ) |
| Loss on extinguishment of debt | | | 2.9 | 2.9 |
| Income (loss) from continuing operations before income taxes | 40.8 | 20.5 | (13.2 ) | 48.1 |
| Income taxes | 14.0 | 7.7 | (5.2 ) | 16.5 |
| Income (loss) from continuing operations | $ 26.8 | $ 12.8 | $ (8.0 ) | $ 31.6 |
| Assets | $ 1,626.2 | $ 335.0 | $ 97.8 | $ 2,059.0 |

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

| | Auction Services Group | Dealer Services Group | Holding Company | Consolidated |
|---|---|---|---|---|
| **Nine Months Ended September 30, 2006** | | | | |
| Operating revenues | $ 726.3 | $ 108.1 | $ | $ 834.4 |
| Operating expenses | | | | |
| Cost of services (exclusive of depreciation and amortization) | 398.5 | 21.2 | | 419.7 |
| Selling, general and administrative | 162.1 | 16.4 | 16.9 | 195.4 |
| Depreciation and amortization | 30.7 | 2.7 | 0.5 | 33.9 |
| Total operating expenses | 591.3 | 40.3 | 17.4 | 649.0 |
| Operating profit (loss) | 135.0 | 67.8 | (17.4 ) | 185.4 |
| Interest expense | 3.2 | | 18.0 | 21.2 |
| Other (income) expense, net | (4.3 ) | 0.9 | (1.9 ) | (5.3 ) |
| Income (loss) from continuing operations before income taxes | 136.1 | 66.9 | (33.5 ) | 169.5 |
| Income taxes | 52.6 | 23.0 | (13.0 ) | 62.6 |
| Income (loss) from continuing operations | $ 83.5 | $ 43.9 | $ (20.5 ) | $ 106.9 |
| Assets | $ 1,743.8 | $ 387.4 | $ (25.1 ) | $ 2,106.1 |
| **Nine Months Ended September 30, 2005** | | | | |
| Operating revenues | $ 636.1 | $ 94.1 | $ | $ 730.2 |
| Operating expenses | | | | |
| Cost of services (exclusive of depreciation and amortization) | 327.9 | 18.5 | | 346.4 |
| Selling, general and administrative | 138.8 | 15.5 | 14.1 | 168.4 |
| Depreciation and amortization | 26.5 | 3.1 | 0.4 | 30.0 |
| Total operating expenses | 493.2 | 37.1 | 14.5 | 544.8 |
| Operating profit (loss) | 142.9 | 57.0 | (14.5 ) | 185.4 |
| Interest expense | 3.9 | | 20.1 | 24.0 |
| Other income, net | (3.2 ) | (0.3 ) | (2.8 ) | (6.3 ) |
| Loss on extinguishment of debt | | | 2.9 | 2.9 |
| Income (loss) from continuing operations before income taxes | 142.2 | 57.3 | (34.7 ) | 164.8 |
| Income taxes | 53.7 | 21.9 | (13.6 ) | 62.0 |
| Income (loss) from continuing operations | $ 88.5 | $ 35.4 | $ (21.1 ) | $ 102.8 |
| Assets | $ 1,626.2 | $ 335.0 | $ 97.8 | $ 2,059.0 |

**Note 10 Discontinued Operations**

In February 2003, management approved a plan to discontinue the operations of the Company s vehicle importation business. In August 2005, ADESA sold ComSearch, Inc. which provides professional claims outsourcing services, automotive parts-locating and desk-auditing services to the property and

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

casualty insurance industry. The financial results of the vehicle importation business and ComSearch have been accounted for as discontinued operations for all periods presented. Both businesses were formerly included in the ASG segment.

Revenues from discontinued operations were $0.4 million and $2.9 million for the three and nine months ended September 30, 2005. Net loss from discontinued operations for the three and nine months ended September 30, 2006 of $0.3 million and $0.4 million ($0.01 per diluted share for the nine months ended September 30, 2006) includes interest on the vehicle importation business adverse judgment as well as accrued legal fees. Net loss from discontinued operations for the three and nine months ended September 30, 2005 of $0.1 million and $0.4 million ($0.01 per diluted share for the nine months ended September 30, 2005) is representative of operating losses at ComSearch and interest on the vehicle importation business adverse judgment.

At September 30, 2006 and December 31, 2005, there were no assets and $7.1 million and $6.8 million, respectively, in liabilities related to discontinued operations. Liabilities at September 30, 2006 and December 31, 2005 represent the accrual of the importation adverse judgment, currently under appeal, and accrued interest on the award pursuant to Michigan law. This and other legal matters are discussed in the description of legal proceedings in Part II, Item 1 ( Legal Proceedings ) of this report.

**Note 11 Dividends**

On September 15, 2006, the Company paid a third quarter dividend of $0.075 per common share. On October 26, 2006, the Company s board of directors declared a fourth quarter dividend of $0.075 per common share payable December 15, 2006, to stockholders of record on November 14, 2006.

**Note 12 Income Taxes**

The effective income tax rates for the quarters ended September 30, 2006 and 2005 were 35.1% and 34.3%. The effective income tax rates for the nine-month periods ended September 30, 2006 and 2005 were 36.9% and 37.6%. The decrease in the effective tax rate for the quarter ended September 30, 2006 compared with previous quarters in 2006 was a result of a settlement of pre spin-off tax matters with the Company s former parent, ALLETE, Inc. The effective income tax rate for the quarter ended September 30, 2005 was favorably impacted by the following: the recognition of certain 2004 provision to tax return differences, the elimination of valuation allowances for state net operating losses and tax credits, and changes in estimates regarding tax contingencies.

**Note 13 Commitments and Contingencies**

The Company is involved in litigation and disputes arising in the ordinary course of business, such as actions related to injuries; property damage; handling, storage or disposal of vehicles; environmental laws and regulations; and other litigation incidental to the business such as employment matters and dealer disputes. Management considers the likelihood of loss or the incurrence of a liability, as well as the ability to reasonably estimate the amount of loss, in determining loss contingencies. The Company accrues an estimated loss contingency when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. Management regularly evaluates current information available to determine whether accrual amounts should be adjusted. Accruals for contingencies including litigation and environmental matters are included in Other accrued expenses and Other liabilities at undiscounted amounts and generally exclude claims for recoveries from insurance or other third parties. These accruals

**ADESA, Inc.**
**Notes to Consolidated Financial Statements (Continued)**

are adjusted periodically as assessment and remediation efforts progress, or as additional technical or legal information become available. If the amount of an actual loss is greater than the amount accrued, this could have an adverse impact on the Company s operating results in that period. Legal fees are expensed as incurred.

The Company has accrued, as appropriate, for environmental remediation costs anticipated to be incurred at certain of its auction facilities. Liabilities for environmental matters included in Other accrued expenses and Other liabilities were $3.2 million at September 30, 2006 and December 31, 2005. No amounts have been accrued as receivables for potential reimbursement or recoveries to offset this liability.

The Company stores a significant number of vehicles owned by various customers and consigned to the Company to be auctioned. The Company is contingently liable for each consigned vehicle until the eventual sale or other disposition; however, the Company is generally not liable for damage related to severe weather conditions, natural disasters or other factors outside of the Company s control. Loss is possible; however, at this time management cannot estimate a range of loss that could occur. Individual stop loss and aggregate insurance coverage is maintained on the consigned vehicles. These vehicles are consigned to the Company and are not included in the Consolidated Balance Sheets.

In the normal course of business, the Company also enters into various other guarantees and indemnities in its relationships with suppliers, service providers, customers and others. These guarantees and indemnifications do not materially impact the Company s financial condition or results of operations, but indemnifications associated with the Company s actions generally have no dollar limitations and currently cannot be quantified.

As noted above, the Company is involved in litigation and disputes arising in the ordinary course of business, such as actions related to injuries; property damage; handling, storage or disposal of vehicles; environmental laws and regulations; and other litigation incidental to the business such as employment matters and dealer disputes. Such litigation is generally not, in the opinion of management, likely to have a material adverse effect on the Company s financial condition, results of operations or cash flows. Certain legal and regulatory proceedings which could be material are discussed in the description of legal proceedings in Part II, Item 1 ( Legal Proceedings ) of this report.

**Note 14 Subsequent Event**

On November 2, 2006, the Company received written notice of ALLETE, Inc. s election to withdraw from joint ownership of two corporate aircraft and terminate the Joint Aircraft Ownership and Management Agreement between ALLETE, Inc. and the Company dated as of June 4, 2004 (the Aircraft Agreement ). The Aircraft Agreement sets forth the terms and conditions relating to the duties and responsibilities of ALLETE and the Company with respect to two aircraft previously owned by ALLETE. In addition, pursuant to the Aircraft Agreement, ALLETE contributed a 70 percent ownership interest in each of the two aircraft to the Company. Upon termination of the Aircraft Agreement, each owner is entitled to 100 percent ownership interest in, and title to, one of the aircraft. As a result of the termination of the Aircraft Agreement, the Company expects to record a non-cash pretax charge in the range of approximately $3.0 million to $4.0 million in the fourth quarter of 2006 representing a reduction of ownership interests in the aircraft and other costs associated with the termination of the Aircraft Agreement.

**Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations**

**Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks, trends, and uncertainties. In particular, statements made in this report on Form 10-Q that are not historical facts (including, but not limited to, expectations, estimates, assumptions and projections regarding the industry, business, future operating results, potential acquisitions, and anticipated cash requirements) may be forward-looking statements. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, and similar expressions identify forward-looking statements. Such statements, includin statements regarding: the Company s future growth; trends and expectations regarding conversion rates; expectations regarding economic conditions and their impact on retail used vehicle sales and the Company; increases in auction volumes; management s ability to capitalize on increasing volumes, if any; anticipated capital expenditures; the Company s competitive position; and acquisition opportunities are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from the results projected, expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in Item 1A Risk Factors in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 and filed on March 16, 2006. Some of these factors include:

- trends in new and used vehicle sales and incentives, including wholesale used vehicle pricing;
- economic conditions including fuel prices and Canadian exchange rate and interest rate fluctuations;
- weather;
- competition;
- litigation developments;
- trends in the vehicle remarketing industry;
- business development activities, including acquisitions and integration of acquired businesses;
- investments in technology;
- strategic actions, including dispositions;
- general business conditions;
- changes in applicable tax laws and regulations (including significant accounting and tax matters);
- vehicle production; and
- other risks described from time to time in ADESA s filings with the Securities and Exchange Commission ( SEC ), including the Quarterly Reports on Form 10-Q filed by ADESA in 2006.

Many of these risk factors are outside of ADESA s control, and as such, they involve risks which are not currently known to ADESA that could cause actual results to differ materially from those discussed or implied herein. The forward-looking statements in this document are made as of the date hereof and ADESA does not undertake to update its forward-looking statements.

The Company s future growth depends on a variety of factors, including its ability to increase vehicle sold volumes and loan transaction volumes, acquire additional auctions, manage expansion and integration of acquisitions, control costs in its operations, introduce modest fee increases, expand its product and service offerings including technological development and retain its executive officers and key employees.

In addition, the Company s indebtedness will require it to use a portion of its operating cash flow to pay interest and principal on debt instead of for other corporate purposes, including funding future expansion and ongoing capital expenditures. Accordingly, the Company cannot predict whether its growth strategy will be successful. In addition, the Company cannot predict what portion of overall sales will be conducted through online auctions or other redistribution methods in the future and what impact this may have on its auction business.

The interim financial statements included in this Quarterly Report on Form 10-Q and the following discussion and analysis should be read in conjunction with the historical financial statements, related notes thereto, and other financial information included in the Company s Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, which includes audited financial statements for each of the three years in the period ended December 31, 2005.

**Executive Overview**

The volume of used vehicles coming to auction continued to increase in the third quarter of 2006. The Company believes the increase in used vehicles coming to auction is a positive longer-term trend for the business. In addition, retail used vehicle sales appear to be rebounding. Retail used vehicle sales increased 5.1 percent from August to September representing the largest monthly August to September increase since 1997 while falling gasoline prices contributed to the first price increase for full-size sport utility vehicles since April 2004. In addition, retail used vehicles prices have returned to a more favorable range between 50 percent to 60 percent of the price of a new vehicle. However despite the recent improvement, retail used vehicle sales for the nine months ended September 30, 2006 were down about 10 percent from the comparable period in 2005, representing the steepest January through September year-over-year decline in the last six years. The continued relative weakness in retail demand for used vehicles was reflected in the Company s used vehicle conversion percentage which decreased from 58.8 percent in the third quarter of 2005 to 58.2 percent in the third quarter of 2006 representing the lowest third quarter used vehicle conversion rate for the Company since 2002. However, the year-over-year decline in the used vehicle conversion rate narrowed significantly in the third quarter of 2006 compared with the first and second quarters of 2006.

Despite a continuing challenging environment, ADESA s third quarter revenues increased approximately 13 percent compared with the third quarter of 2005, primarily due to a 10 percent increase in revenue per vehicle sold resulting from an increase in ancillary services driven by a 2 percent increase in the vehicles entered to the Company s used vehicle auctions. In addition, the Dealer Services Group segment performed well in the third quarter of 2006 reporting a 5 percent increase in loan transactions and a 7 percent increase in revenue per loan transaction. However, operating results were negatively impacted by increases in costs of services as much of the incremental revenue was related to lower margin ancillary services from an additional 15,000 institutional vehicles coming to auction as compared with the third quarter of 2005. In addition, there were increased costs associated with handling those additional vehicles entered for sale combined with the continuing weakness in used vehicle conversion rates.

For the quarter ended September 30, 2006, the Company reported third quarter revenue of $272.9 million and net income of $34.1 million or $0.38 per diluted share, compared with revenue of $241.0 million and net income of $31.5 million or $0.35 per diluted share for the third quarter of 2005. On January 1, 2006, the Company implemented Statement of Financial Accounting Standards ( SFAS ) 123(R), *Share-Based Payment*, which resulted in approximately $0.8 million of pretax incremental stock-based compensation or nearly $0.01 per diluted share for the quarter ended September 30, 2006. The results for the third quarter of 2005 included a $1.5 million after-tax charge ($0.02 per diluted share) related to debt refinancing.

For the nine months ended September 30, 2006, the Company reported revenue of $834.4 million and net income of $106.5 million or $1.18 per diluted share, compared with revenue of $730.2 million and net income of $102.4 million or $1.13 per diluted share for the nine months ended September 30, 2005. In addition, in the first nine months of 2006, ADESA incurred $4.5 million of pretax stock based compensation expense, of which $2.6 million was incremental as a result of the adoption of SFAS 123(R). Included in the results for the nine months ended September 30, 2006, is a $2.7 million pretax charge incurred in the first quarter of 2006, or $0.02 per diluted share, related to the correction of certain unreconciled balance sheet differences concealed by a former employee at the Company s Kitchener, Ontario, auction facility acquired in June 2000. The results for the first nine months of 2005 include the impact of the previously mentioned $1.5 million after-tax debt refinancing charge. The business continues to generate a significant amount of cash. Cash provided by operations was $124.4 million for the nine months ended September 30, 2006, compared with cash provided by operations of $105.0 million for the nine months ended September 30, 2005.

During the third quarter, the Company also completed the acquisition of three salvage sites in Texas, giving ADESA Impact a presence in the second largest salvage market in the United States. In addition, ADESA Impact opened a new location in Syracuse, New York, providing ADESA with its 42nd salvage location. The Company continues to be optimistic about its acquisition opportunities.

On November 2, 2006, the Company received written notice of ALLETE, Inc. s election to withdraw from joint ownership of two corporate aircraft and terminate the Joint Aircraft Ownership and Management Agreement between ALLETE, Inc. and the Company dated as of June 4, 2004 (the Aircraft Agreement ). The Aircraft Agreement sets forth the terms and conditions relating to the duties and responsibilities of ALLETE and the Company with respect to two aircraft previously owned by ALLETE. In addition, pursuant to the Aircraft Agreement, ALLETE contributed a 70 percent ownership interest in each of the two aircraft to the Company. Upon termination of the Aircraft Agreement, each owner is entitled to 100 percent ownership interest in, and title to, one of the aircraft. As a result of the termination of the Aircraft Agreement, the Company expects to record a non-cash pretax charge in the range of approximately $3.0 million to $4.0 million in the fourth quarter of 2006 representing a reduction of ownership interests in the aircraft and other costs associated with the termination of the Aircraft Agreement.

**Seasonality**

Generally, the volume of vehicles sold at the Company s auctions is highest in the first and second calendar quarters of each year and slightly lower in the third quarter. Fourth quarter volume of vehicles sold is generally lower than all other quarters. This seasonality is affected by several factors including weather, the timing of used vehicles available for sale from selling customers, holidays, and the seasonality of the retail market for used vehicles, which affect the demand side of the auction industry. Used vehicle auction volumes tend to decline during prolonged periods of winter weather conditions. In addition, mild weather conditions and decreases in traffic volume can each lead to a decline in the available supply of salvage vehicles because fewer traffic accidents occur, resulting in fewer damaged vehicles overall. As a result, revenues and operating expenses related to volume will fluctuate accordingly on a quarterly basis, and the Company s earnings are generally highest in the second calendar quarter. The fourth calendar quarter typically has the lowest earnings as a result of the lower auction volume and additional costs associated with the holidays and winter weather.

**Results of Operations**

The following table sets forth operations data for the periods indicated *(in millions)*:

| Operations Data: | Three Months Ended September 30, 2006 | 2005 | Change $ | % | Nine Months Ended September 30, 2006 | 2005 | Change $ | % |
|---|---|---|---|---|---|---|---|---|
| Auction services group revenue | | | | | | | | |
| U.S. | **$ 180.6** | $ 163.7 | | | **$ 559.6** | $ 498.9 | | |
| Canada | **55.6** | 44.4 | | | **166.7** | 137.2 | | |
| Dealer services group revenue | | | | | | | | |
| U.S. | **33.3** | 30.9 | | | **98.8** | 88.0 | | |
| Canada | **3.4** | 2.0 | | | **9.3** | 6.1 | | |
| Total revenue | **272.9** | 241.0 | 31.9 | 13 % | **834.4** | 730.2 | 104.2 | 14 % |
| Cost of services (exclusive of depreciation and amortization) | **137.8** | 116.8 | 21.0 | 18 % | **419.7** | 346.4 | 73.3 | 21 % |
| Selling, general and administrative | **64.7** | 57.5 | 7.2 | | | | | |