



Financial Trends Review

Insurance Auto Auctions, Inc.

Scope of Analysis

Our analysis of Insurance Auto Auctions ("IAA" or the "Company") included (i) a review of the Company's annual report and 10-K for fiscal 2001, the 10-Q for the first nine months of 2002, and select historical financial summaries going back to 1999; and (ii) an interview with IAA's chief financial officer.

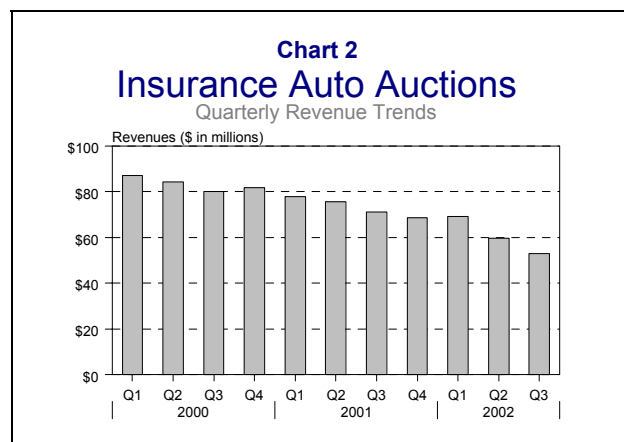
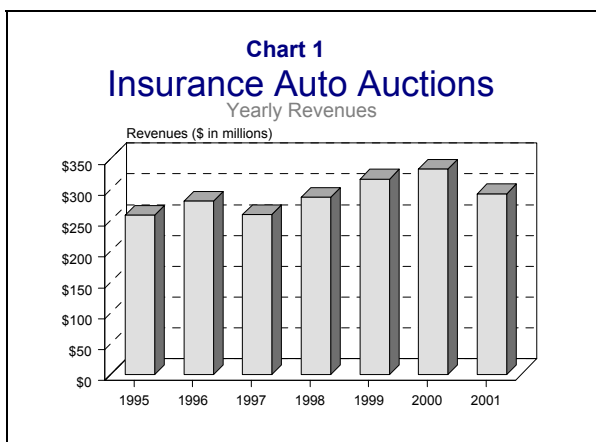
Corporate Profile

IAA provides automobile salvage and claim services to insurance companies and other vehicle suppliers such as rental car companies. In an accident, theft or other claims adjustment process, insurance companies typically take possession of a vehicle because (i) based on economic and customer service considerations, the vehicle has been classified as a "total loss" and the insured replacement value has been paid rather than the cost of repair or (ii) a stolen vehicle is recovered after the insurance company has settled with the insured. IAA generally sells these vehicles at live or closed bid auctions on a competitive-bid basis at one of the Company's facilities. The Company uses a network of 66 salvage centers to provide these services throughout the U.S. market.

Observations

We have summarized the key financial statistics from the financial documents we scrutinized in the Trends Table found on page two of this report. The following discussion pertains to those figures.

- As Chart 1 shows, the Company's **revenues** reached a peak in fiscal 2000 after three straight years of growth and began a decline in the following year. That downward trend continued in the first nine months of fiscal 2002, with revenues falling 19% during that period. Chart 2 shows that the revenue erosion has been pretty persistent throughout 2001 and 2002, with 2002 third quarter revenues dropping almost 26% as compared to the equivalent period in the prior year.



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For the years ended December 31,

<i>(In thousands)</i>				
<i>Fiscal year</i>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<i>Nine months</i> <u>2002</u>
For the period				
Revenues				
Vehicle sales	\$204,785	\$200,858	\$138,427	58,269
Fee income	112,606	132,318	154,563	123,487
Total revenues	317,391	333,176	292,990	181,756
Year-to-year growth rate	11%	5%	(12%)	(19%)
Operating income (EBIT)	23,904	22,666	6,258	12,945
Pre-tax income	23,205	17,778	5,495	12,403
Margins				
Gross margin	26.3%	26.8%	30.8%	N/A
Operating (EBIT) margin	7.5%	6.8%	2.1%	7.1%
Pre-tax margin	7.3%	5.3%	1.9%	6.8%
EBITDA margin	10.4%	9.7%	5.8%	11.0%
Expense ratios (% of revs.)				
Direct operating expense	17.6%	18.9%	27.3%	N/A
Cash Flow				
EBITDA	33,039	32,307	16,907	19,986
Capital expenditures	(10,623)	(12,246)	(20,765)	(9,600)
Free cash flow	22,416	20,061	(3,858)	10,386
From operating activities ¹	22,397	20,232	6,199	19,685
From investing activities	(9,503)	(18,309)	(18,248)	(8,292)
From financing activities	2,610	1,829	5,578	(19,225)
Net change in cash & eqv.	15,504	3,752	(6,471)	(7,832)
At period end²				
Assets				
Cash & equivalents ³	34,031	35,797	26,628	16,635
Accounts receivable	40,188	48,091	54,674	44,780
Inventory	11,998	10,588	13,505	8,719
Total current assets	87,872	97,588	98,942	72,315
Prop., plant & equip. (net)	27,458	30,492	39,655	45,419
Intangible assets	125,128	130,264	131,268	132,271
Total assets	248,132	265,707	278,204	258,187
Liabilities/Equity				
Accounts payable	33,216	38,176	41,451	32,149
Current installment of LT Debt	135	37	20,040	42
Total current liabilities	40,883	44,384	73,656	46,741
Long-term debt	20,180	20,141	103	70
Net worth	175,286	187,741	188,994	193,148
Key financial ratios				
Current ratio	2.2	2.2	1.3	1.5
Quick ratio	1.9	2.0	1.2	1.4

¹ Net cash provided by operating activities reflects net cash from the operations of the company available for the company's liquidity needs after taking into consideration working capital changes not reflected in EBITDA.

² These are balance sheet highlights of what we consider to be key figures to consider. Certain line items have been excluded.

³ Includes short-term investments.

In order to understand the reasons for this top line erosion, it is helpful to understand the three methods that the Company uses to process salvage vehicles and the transition that is going on within the Company.

Fixed Fee Consignment -- Under this sales method, the Company charges fees to the insurance company supplier for specific services. This comprised 45% and 50% respectively of vehicles processed in 2001 and 2000.

Percentage of Sale Consignment -- Under this method of sale (36% and 24% of vehicles processed in 2001 and 2000), the Company charges fees to act as an agent for the insurance company in the salvage process.

Purchase Agreement -- Under this method of sale (19% and 26% of vehicles processed in 2001 and 2000), the Company is required to purchase, and the insurance company and other suppliers are required to sell to the Company, all total loss and recovered theft vehicles generated by that supplier in a designated geographic area.

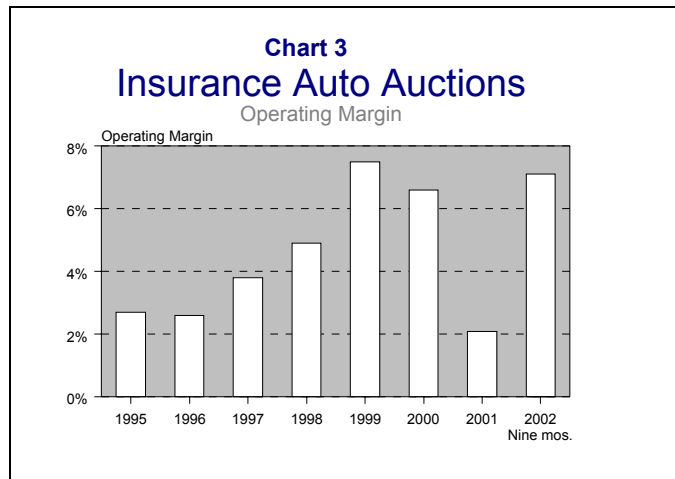
The revenue details on the Trends Table shows that the downward trend in total revenue has been caused by a decline in revenue from vehicle sales, which have fallen more rapidly than the growth in fee income. According to Management, that is part of a pro-active shift away from the use of Purchase Agreements to a business strategy focused on earning fees from consignment sales. Since the Company never takes ownership of the vehicle under a consignment arrangement, the revenues per vehicle under the consignment method of sale is approximately 5% to 15% of the revenue recognized per vehicle under the purchase agreement method, where the sale price of the vehicle is also recorded.

The reason for this shift toward consignment sales is that Purchase Contracts carry a significantly higher level of business risk with them since IAA actually takes title to the vehicle and assumes the risk of market price variation for vehicles sold.

- ❑ Overall **profitability** has suffered during this transition period, with operating margin in 2001 declining to 2.1%, as compared to 7.5% two years earlier (see Chart 3). That decline was due to a combination of lower revenues providing less coverage of revenue factors and a spike in operating expenses as a percentage of revenues (see Expense Ratios on Trends Table) driven by the cost of opening six new sites in 2000 and the addition of seven new sites added during 2001.

Profit margins rebounded in the first nine months of 2002 because of improvements in gross margin⁴ and a sizeable decrease in charges for amortization of intangibles. In order to net out that type of non-cash charges,

EBITDA is probably the best overall measure of the Company's profitability. Note that EBITDA margin in the first nine months of 2002 jumped to a level that was the high point for the years we scrutinized.



- ❑ The Company's **cash flow** from operating activities was decidedly positive in all periods we reviewed, albeit somewhat depressed in 2001. While higher levels of capital expenditures in 2001 (combined with lower EBITDA levels) resulted in negative free cash flow, the margin recovery in 2002 brought it back above the \$10 million level. The good news is that IAA has little or no debt to service, meaning that cash flow can be used to operate and expand the company.
- ❑ The trends within IAA's **balance sheet** are relatively positive: while cash reserves have declined by \$19 million over the last seven quarters, long-term debt has fallen by \$20 million; there are not any anomalies apparent in accounts receivable, inventory and accounts payable; and assets and net worth have been on an overall upward trend since 1999.

⁴ The Company changed its accounting treatment of gross margin and operating expenses in 2002, which didn't allow us to make year-to-year comparisons.

Conclusions

2001 was a difficult year for IAA and was the culmination of a growth strategy centered on the acquisition of independent salvage companies that ultimately resulted in a network of 66 salvage centers in 26 states. From the outset, Management's policy for newly acquired companies was to allow them to continue to run their operations as they always had, which ultimately resulted in centers operating in 50 different ways and running on 20 different types of information systems. In the end, that lack of integration of the individual parts resulted in significant operational inefficiencies. The impact of those problems began to be seen in fiscal 2000, as profits and cash flow began to erode, and the full extent of the problems became apparent in 2001 as overall profitability and cash flow dropped sharply.

A company-wide turnaround was initiated in early 2001 beginning with a complete change in the senior management team, including CEO, COO, CFO and CIO. The new team made a sweeping re-evaluation of all aspects of IAA's business and implemented a number of initiatives designed to address the major problems facing the Company.

- The first major change was to accelerate the Company's exit from the purchase agreement method of sale (which had been under discussion for a long time), with Management succeeding in reducing the percentage of vehicles processed under this method to 8% by the end of September 2002, down from 30% in 1999. This change is expected to substantially lower IAA's business risk and to generate more predictable margins going forward.
- The second change was to redesign and standardized company-wide business practices in order to improve overall operational efficiency.
- The third major change was to initiate an information systems redesign, with the goal of creating a single, efficient centralized repository for data and to design and implement a new system to manage the salvage and auction process.

We have to admit to being uneasy that the entire executive suite has been replaced in the last 1½- 2 years, which is the cleanest sweep of executive offices that we have seen and is a leading indicator of how serious the Company's problems were. While the initial results from their efforts are positive, we will be much more comfortable after a few more quarters have passed and this new management team is able to prove its ability to solidify IAA's turnaround.

We are certainly impressed with the aggressiveness of IAA's turnaround efforts and the broad nature of the changes being made within the Company. We are also heartened by the improvement in the Company's operating results during the first nine months of fiscal 2002. While revenues were down 19% because of the declining use of the purchase agreement method of sale, EBITDA margin almost doubled over the level reported in fiscal 2001. That statistic, along with the Company's relatively sound capitalization, suggests that the worst of IAA's problems may be behind it.

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Michael F. Calhoun has 25 years of experience in financial analysis, business management and corporate evaluation. He is President of The Alliance Group, a consulting firm specializing in corporate due-diligence studies, acquisition searches, business valuations and investment analysis services. Mr. Calhoun is a former investment analyst for both the Dreyfus Corporation and Oppenheimer Management.